



Texas Health Resources

Consolidated Financial Statements

December 31, 2017 and 2016

(With Independent Auditors' Report Thereon)



KPMG LLP
Suite 1400
2323 Ross Avenue
Dallas, TX 75201-2721

Independent Auditors' Report

The Board of Trustees,
Texas Health Resources:

We have audited the accompanying consolidated financial statements of Texas Health Resources, a Texas non-profit corporation, 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 consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Texas Health Resources as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

KPMG LLP

Dallas, Texas
April 23, 2018

**TEXAS HEALTH RESOURCES
CONSOLIDATED BALANCE SHEETS
December 31, 2017 and 2016
(Dollars in Thousands)**

	2017	2016
Assets		
Current Assets:		
Cash and cash equivalents	\$ 435,168	\$ 501,826
Short-term investments	8,275	6,250
Receivables -		
Patient, less allowance for doubtful accounts of \$150,476 in 2017 and \$173,769 in 2016	532,595	495,667
Other, net	110,818	62,925
Assets limited as to use	504,341	353,161
Other current assets	144,267	147,614
Total current assets	1,735,464	1,567,443
Assets limited as to use	4,564,995	3,945,898
Property and equipment, net	1,989,474	2,007,745
Investments in unconsolidated affiliates	369,917	224,500
Goodwill and intangible assets, net	148,412	153,816
Other assets, net	86,966	85,302
Total assets	\$ 8,895,228	\$ 7,984,704
Liabilities and Net Assets		
Current Liabilities:		
Current portion of long-term debt	\$ 351,226	\$ 268,628
Accounts payable	238,004	262,885
Estimated third-party payor settlements	33,275	29,971
Accrued salaries, wages, and employee benefits	239,389	231,387
Other accrued liabilities	240,308	160,655
Total current liabilities	1,102,202	953,526
Long-term debt, net of current portion	1,600,980	1,719,571
Other noncurrent liabilities	47,255	46,092
Total liabilities	2,750,437	2,719,189
Net Assets:		
Net assets of Texas Health Resources:		
Unrestricted	5,853,468	4,993,413
Temporarily restricted	98,676	91,762
Permanently restricted	72,520	69,643
Total net assets of Texas Health Resources	6,024,664	5,154,818
Non-controlling ownership interest in equity of consolidated affiliates - unrestricted	120,127	110,697
Total net assets	6,144,791	5,265,515
Total liabilities and net assets	\$ 8,895,228	\$ 7,984,704

See accompanying notes to the consolidated financial statements.

TEXAS HEALTH RESOURCES
CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
For the Years Ended December 31, 2017 and 2016
(Dollars in Thousands)

	<u>2017</u>	<u>2016</u>
Operating Revenue:		
Net patient service revenue before provision for bad debts	\$ 4,794,014	\$ 4,637,812
Less: Provision for bad debts	<u>362,776</u>	<u>337,265</u>
Net patient service revenue	4,431,238	4,300,547
Equity in earnings of unconsolidated affiliates	77,436	60,971
Other operating revenue	<u>179,882</u>	<u>160,491</u>
Total operating revenue	<u>4,688,556</u>	<u>4,522,009</u>
Operating Expenses:		
Salaries, wages, and employee benefits	2,378,759	2,249,804
Supplies	777,809	720,848
Depreciation and amortization	232,797	224,263
Interest expense	90,779	84,373
Other operating expenses	<u>888,937</u>	<u>903,651</u>
Total operating expenses	<u>4,369,081</u>	<u>4,182,939</u>
Operating Income	<u>319,475</u>	<u>339,070</u>
Nonoperating Gains (Losses):		
Net realized investment income and gains	278,882	101,130
Net unrealized gains on investments	358,357	167,494
Equity in earnings (losses) of unconsolidated affiliates, nonoperating	1,450	(1,007)
Gain on extinguishment of long-term debt	2,098	1,057
Other, net	<u>(10,953)</u>	<u>1,065</u>
Total nonoperating gains, net	<u>629,834</u>	<u>269,739</u>
Revenue and Gains In Excess of Expenses and Losses before Income Taxes	949,309	608,809
Less: Income Tax Expense	<u>4,880</u>	<u>3,606</u>
Revenue and Gains In Excess of Expenses and Losses	944,429	605,203
Less: Revenue and Gains in Excess of Expenses and Losses Attributable to Non-Controlling Interest	<u>83,643</u>	<u>83,284</u>
Revenue and Gains In Excess of Expenses and Losses from Continuing Operations Attributable to Texas Health Resources	860,786	521,919

(Continued)

See accompanying notes to the consolidated financial statements.

TEXAS HEALTH RESOURCES
CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
For the Years Ended December 31, 2017 and 2016
(Dollars in Thousands)

	2017	2016
Other Changes in Unrestricted Net Assets:		
Net unrealized losses on investments, other than trading securities	\$ (4,164)	\$ (4,914)
Net assets released from restrictions used for purchase of property and equipment	5,310	5,592
Change in fair value of interest rate swap agreements	117	768
Other changes, net	(1,994)	(338)
Increase in Unrestricted Net Assets	860,055	523,027
Changes in Temporarily Restricted Net Assets:		
Contributions received for purchase of property and equipment	906	435
Contributions received for operations	8,795	18,094
Net realized investment gain	4,673	1,492
Net unrealized gains on investments	8,839	2,844
Change in value of split-interest agreement	352	(27)
Net assets released from restrictions	(16,651)	(15,813)
Increase in Temporarily Restricted Net Assets	6,914	7,025
Changes in Permanently Restricted Net Assets:		
Contributions	321	329
Net realized investment gain	861	525
Unrealized investment gains (losses) on beneficial interest in perpetual trust, net	1,695	(78)
Increase in Permanently Restricted Net Assets	2,877	776
Increase in Net Assets of Texas Health Resources	869,846	530,828
Net Assets of Texas Health Resources, beginning of year	5,154,818	4,623,990
Net Assets of Texas Health Resources, end of year	\$ 6,024,664	\$ 5,154,818

See accompanying notes to the consolidated financial statements.

TEXAS HEALTH RESOURCES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2017 and 2016
(Dollars in Thousands)

	2017	2016
Cash Flows From Operating Activities:		
Increase in net assets of Texas Health Resources	\$ 869,846	\$ 530,828
Adjustments to reconcile increase in net assets to net cash provided by operating activities, excluding the net effects of acquisitions -		
Gain on extinguishment of long-term debt	(2,098)	(1,057)
Settlement of interest rate swap agreement	-	1,031
Net unrealized gains on investments	(364,727)	(165,346)
Net realized gains on investments	(208,761)	(40,600)
Change in value of split-interest agreement	(352)	27
Provision for bad debts	367,406	340,567
Restricted contributions received for purchase of property and equipment	(906)	(435)
Depreciation and amortization	232,797	224,263
Amortization of bond premiums/discounts and debt issuance costs	(2,547)	(993)
Net losses on impairment and disposal of property and equipment	11,986	2,219
Equity in earnings of unconsolidated affiliates	(77,436)	(60,971)
Distributions from unconsolidated affiliates	65,301	61,048
Equity in (earnings) losses of unconsolidated affiliates, nonoperating	(1,450)	1,007
Change in fair value of interest rate swap agreements	(117)	(670)
Revenue and gains in excess of expenses and losses attributable to non-controlling interest	83,643	83,284
(Increase) decrease in:		
Receivables, patient, net	(399,704)	(393,321)
Receivables, other, net	(52,523)	(600)
Other assets, net	1,910	(71,747)
Increase (decrease) in:		
Accounts payable	(24,881)	93,386
Estimated third-party payor settlements	3,304	(1,222)
Accrued salaries, wages, and employee benefits	8,002	29,087
Other accrued liabilities	80,209	3,737
Other noncurrent liabilities	1,327	(32,900)
	<u>590,229</u>	<u>600,622</u>
Net cash provided by operating activities	<u>590,229</u>	<u>600,622</u>

(Continued)

See accompanying notes to the consolidated financial statements.

TEXAS HEALTH RESOURCES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2017 and 2016
(Dollars in Thousands)

	2017	2016
Cash Flows From Investing Activities:		
Purchases of property and equipment, net	\$ (264,689)	\$ (423,135)
Proceeds from disposal of property and equipment	44,759	3,490
Cash used to acquire physician practices and other consolidated affiliates	(1,308)	(2,073)
Investment in unconsolidated affiliates, net	(131,832)	(14,866)
Purchases of short-term investments and assets limited as to use, net	(198,462)	(230,571)
Net cash used in investing activities	(551,532)	(667,155)
Cash Flows From Financing Activities:		
Proceeds from issuance of long-term debt	137,633	751,022
Debt issuance costs	-	(5,127)
Principal payments on capital lease obligations	(152)	(809)
Principal payments on long-term debt	(42,554)	(43,617)
Redemption of long-term debt	(126,875)	(520,499)
Settlement of interest rate swap agreement	-	(1,031)
Contributions from non-controlling interest holders	5,508	3,380
Distributions to non-controlling interest holders	(79,821)	(78,474)
Proceeds from restricted contributions received for purchase of property and equipment	906	435
Net cash (used in) provided by financing activities	(105,355)	105,280
Net (Decrease) Increase in Cash and cash equivalents	(66,658)	38,747
Cash and cash equivalents, beginning of year	501,826	463,079
Cash and cash equivalents, end of year	\$ 435,168	\$ 501,826
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	\$ 87,280	\$ 91,129
Cash paid for income taxes	\$ 4,940	\$ 4,289

See accompanying notes to the consolidated financial statements.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2017

1. Organization

Texas Health Resources (THR), a Texas non-profit corporation, operates through its controlled affiliates a health care system with services and facilities throughout north central Texas. THR is organized and operated for the benefit of its tax-exempt controlled affiliates and has been recognized by the Internal Revenue Service (IRS) as exempt from federal income taxes under Section 501(a) of the Internal Revenue Code of 1986, as amended (the Code), as an organization described in Section 501(c)(3). THR's wholly-controlled facilities include 14 acute care hospital locations, a 10-bed long-term care hospital and a rehabilitation hospital. The following table provides the locations of THR's tax-exempt member hospitals (the Tax-Exempt Hospitals) as of December 31, 2017. The Tax-Exempt Hospitals have been recognized as exempt from federal income taxes under the Code as organizations described in Section 501(c)(3).

<u>Tax-Exempt Hospital</u>	<u>Location (Texas)</u>
Texas Health Arlington Memorial Hospital	Arlington
Texas Health Harris Methodist Hospital Alliance	Fort Worth
Texas Health Harris Methodist Hospital Azle	Azle
Texas Health Hospital Clearfork ¹	Fort Worth
Texas Health Harris Methodist Hospital Cleburne	Cleburne
Texas Health Harris Methodist Hospital Fort Worth	Fort Worth
Texas Health Harris Methodist Hospital Hurst-Euless-Bedford	Bedford
Texas Health Harris Methodist Hospital Southwest Fort Worth	Fort Worth
Texas Health Harris Methodist Hospital Stephenville	Stephenville
Texas Health Presbyterian Hospital Allen	Allen
Texas Health Presbyterian Hospital Dallas	Dallas
Texas Health Presbyterian Hospital Denton	Denton
Texas Health Presbyterian Hospital Kaufman	Kaufman
Texas Health Presbyterian Hospital Plano	Plano
Texas Health Specialty Hospital Fort Worth (10-bed long-term care hospital)	Fort Worth
Texas Health Recovery and Wellness Center	Mansfield

¹ *Texas Health Hospital Clearfork is a separate hospital location serving as a licensed department of Texas Health Harris Methodist Hospital Southwest Fort Worth.*

In addition, THR is the sole member or sole shareholder of certain other wholly-controlled affiliates engaged in health care related activities in support of its mission including Texas Health Physicians Group (THPG), a Texas non-profit organization certified by the Texas Medical Board pursuant to Section 162.001(b) of the Texas Occupations Code and recognized as exempt from federal income taxes under the Code as an organization described in Section 501(c)(3) that consists of approximately 940 employed physicians and mid-level providers in more than 225 locations throughout north central Texas.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

1. Organization, continued

THR and some of its controlled affiliates participate in joint ventures with physicians and non-physicians to operate hospitals and other health related ventures. The following table provides the location of the joint venture hospitals along with THR's ownership interest in those hospitals as of December 31, 2017 and 2016:

<u>Hospital</u>	<u>Location (Texas)</u>	<u>2017 Ownership Interest</u>	<u>2016 Ownership Interest</u>
Consolidated:			
Texas Institute for Surgery, L.L.P. (d/b/a Texas Institute for Surgery at Texas Health Presbyterian Hospital Dallas)	Dallas	50.0%	50.0%
Physicians Medical Center, L.L.C. (d/b/a Texas Health Center for Diagnostics & Surgery Plano)	Plano	53.5%	53.1%
Southlake Specialty Hospital, L.L.C. (d/b/a Texas Health Harris Methodist Hospital Southlake)	Southlake	54.1%	53.9%
Rockwall Regional Hospital, L.L.C. (d/b/a Texas Health Presbyterian Hospital Rockwall)	Rockwall	61.8%	61.0%
Flower Mound Hospital Partners, L.L.C. (d/b/a Texas Health Presbyterian Hospital Flower Mound)	Flower Mound	53.5%	53.5%
AMH Cath Labs, L.L.C. (d/b/a Texas Health Heart & Vascular Hospital Arlington)	Arlington	54.0%	54.0%
Unconsolidated:			
USMD Hospital of Arlington, L.P.	Arlington	51.0%	51.0%
USMD Hospital of Fort Worth, L.P.	Fort Worth	51.0%	51.0%
Texas Health Huguley, Inc. (d/b/a Texas Health Huguley Hospital Fort Worth South)	Fort Worth	51.0%	51.0%
Texas Rehabilitation Hospital of Fort Worth, L.L.C.	Fort Worth	30.0%	30.0%
Texas Rehabilitation Hospital of Arlington, L.L.C.	Arlington	30.0%	30.0%
Texas Health Hospital (in Carrollton)	Carrollton	51.0%	51.0%

In addition to the hospitals listed above, there are numerous other non-hospital health related joint ventures included in THR's accompanying consolidated financial statements, including outpatient imaging and surgery centers and free-standing emergency rooms. The Company does not control the governing bodies of the unconsolidated affiliates.

THR and its tax-exempt controlled affiliates receive support from the Texas Health Resources Foundation (Foundation). The Foundation operates as a non-private foundation exempt from federal income taxes under Section 501(a) of the Code as an organization described in Section 501(c)(3), and THR is the sole corporate member.

The accompanying consolidated financial statements include the accounts of THR, the Foundation, its wholly controlled affiliates and its consolidated joint ventures (collectively, the System). All significant intercompany accounts and transactions have been eliminated in the accompanying consolidated financial statements.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash, money market funds, and governmental or other securities with original maturities of three months or less at time of purchase, excluding amounts limited as to use by board designation or other arrangements. THR's cash management system provides for daily investment of available balances and the funding of outstanding checks when presented for payment. Outstanding but unrepresented checks, totaling approximately \$36,036,000 and \$29,594,000 at December 31, 2017 and 2016, respectively, have been included in accounts payable in the accompanying consolidated balance sheets. Upon presentation for payment, these checks are funded through available cash or cash equivalent balances. The change in outstanding but unrepresented checks is included in cash used in operating activities on the accompanying consolidated statements of cash flows.

Investments and Investment Income

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the consolidated balance sheets. Realized investment income or loss (including realized gains and losses on investments, interest, and dividends) is included in revenue and gains in excess of expenses and losses unless the income or loss is restricted by donor or law. Investments in mineral interests, which have limited marketability, are stated at fair value, as estimated based on a multiple of annual revenues. Investments in real estate are stated at fair value, as estimated by private valuations. Investments in hedge funds are stated at fair value, as estimated by the general partner of the hedge fund and reviewed by management. Unrealized gains and losses on investments are excluded from revenue and gains in excess of expenses and losses unless the investments are trading securities. Management reviews individual securities to determine whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in realized investment gains or losses in the consolidated statements of operations and changes in net assets. To determine whether a decline is other than temporary, management considers whether it has the ability and intent to hold the investment until a market price recovery, which may be maturity, and whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary.

The System invests in various securities. Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility risks. Due to the level of risk associated with certain investment securities, it is reasonable to assume that changes in the values of investment securities will occur in the near term and that such changes could be material to the accompanying consolidated financial statements.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Split-Interest Agreements

The System has received as contributions various types of split-interest agreements, including charitable gift annuities, charitable remainder unitrusts and perpetual trusts held by a third party. Under charitable gift annuity arrangements for which the System is the trustee of the assets, the System records the assets at fair value and the liabilities to the beneficiaries at the present value of the estimated future payments to be distributed by the System to such beneficiaries. The amount of the contribution is the difference between the asset and the liability and is recorded as unrestricted revenue, unless otherwise restricted by the donor. Subsequent changes to the annuity liability are recorded as changes in value of split-interest agreements in the appropriate net asset class.

Under charitable remainder unitrust arrangements for which the System is the trustee of the assets, the System records as donor-restricted contributions the present value of the residual interest in the trust in the period in which the trust is established. The assets held in trust are recorded at fair value when received, and the liabilities to the beneficiaries are recorded at the present value of the estimated future payments to be distributed by the System to such beneficiaries. The amount of the contribution is the difference between the asset and the liability and is recorded as temporarily restricted or permanently restricted support. Subsequent changes in fair value for charitable remainder unitrusts are recorded as changes in value of split-interest agreements in the appropriate net asset class.

Under perpetual trusts held by a third-party arrangement, the System records contribution revenue and an asset when it is notified of the trust's existence. The fair value of the contribution is measured at the present value of the estimated future cash receipts from the trust's assets and that value may generally be measured by the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the assets contributed to the trust differs from the present value of the expected future cash flows. Distributions from the trust are reported as investment income that increases the appropriate net asset class. Adjustments to the amount reported as an asset, based on periodic review, are recognized as unrealized investment gains or losses on beneficial interest in perpetual trust in the permanently restricted net asset class.

Under the charitable gift annuity arrangements and charitable remainder unitrust arrangements for which the System is not the trustee of the assets, the System records a receivable and contribution revenue at the present value of the estimated future distributions expected to be received by the System over the expected term of the agreement. However, if an unrelated third-party has variance power to redirect the benefits to another organization or if the System's rights to the benefits are conditional, the System does not recognize its potential for future distributions from the asset held by the trustee.

The discount rates and actuarial assumptions used in calculating present values have been based on Internal Revenue Service guidelines and actuarial tables. For agreements in which the System is the trustee, the discount rates used are commensurate with the risks involved at the time the contributions are initially recognized and are not subsequently revised. For agreements in which the System is not the trustee, under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958-30, *Not-for-Profit Entities Split Interest Agreements*, and the guidance as provided in the *AICPA Audit and Accounting Guide, Not-for-Profit Organizations*, split-interest agreements held by others net expected cash flows are revalued to fair value at each year-end using a current risk-free rate of return, which ranged from 2.20% to 2.74% and 1.93% to 3.06% for the years ended December 31, 2017 and 2016, respectively.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Accounts Receivable and Allowance for Doubtful Accounts

Patient accounts receivable are reported net of estimated allowances for doubtful accounts and contractual adjustments in the consolidated balance sheets. The allowance and resulting provision for bad debts is based upon a combination of the aging of receivables and management's assessment of historical and expected net collections considering business and economic conditions, trends in health care coverage and other collection indicators for each of its major payor sources of revenue. Management assesses the adequacy of the allowance for doubtful accounts based upon historical write-off experience and payment trends by payor category. Patient accounts are also monitored and, if necessary, past due accounts are placed with collection agencies in accordance with guidelines established by management. 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 bad debts, if necessary (for example, for expected uncollectible deductibles and copayments, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the System records a significant provision for 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 billed rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The System's allowance for doubtful accounts for self-pay patients (including allowances for charity care) was 97.5% and 97.7% of self-pay accounts receivable at December 31, 2017 and 2016, respectively. In addition, the System's self-pay write-offs for bad debts was approximately \$368,000,000 and \$306,000,000 for the year ended December 31, 2017 and 2016, respectively. The System does not maintain a material allowance for doubtful accounts from third-party payors, nor did it have significant write-offs from third-party payors.

Assets Limited as to Use

The System maintains certain assets that are limited as to use under board designation, indenture agreements, donor restriction, and other provisions. Amounts required to fund current liabilities of the System have been classified as current assets in the consolidated balance sheets.

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated statements of operations and changes in net assets. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support and are excluded from revenue and gains in excess of expenses and losses unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Goodwill and Intangible Assets

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized. The System reviews goodwill annually, or more frequently if circumstances warrant a more timely review, to determine if there has been an impairment. FASB ASC Topic 350, *Intangibles—Goodwill and Other* (Topic 350), provides an entity the option to first assess qualitative factors to determine whether the existence of events or circumstances indicates that it is more likely than not that the fair value of a reporting unit is less than its carrying amount or that indefinite-lived assets are impaired. If, after assessing the totality of events and circumstances, an entity determines it is not more likely than not that the fair value of the reporting unit is less than its carrying amount or that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to perform the two-step goodwill impairment test described in Topic 350 or determine the fair value of the indefinite-lived intangible asset and perform a quantitative impairment test by comparing the fair value with the carrying amount. For the years ended December 31, 2017 and 2016, the System prepared a qualitative assessment of goodwill and indefinite-lived intangible assets impairment for all reporting units that have assigned goodwill and indefinite-lived intangible assets. Impairment of \$56,000 related to the closure of specific physician practices was identified for the year ended December 31, 2017. No impairment was identified for the year ended December 31, 2016.

A summary of goodwill activity for the years ended December 31, 2017 and 2016 is presented below (dollars in thousands):

	<u>2017</u>	<u>2016</u>
Balance at beginning of year	\$ 145,629	\$ 149,631
Goodwill acquired from purchases of consolidated affiliates and/or physician practices	-	-
Impairment of goodwill	(56)	-
Amortization of goodwill - consolidated joint venture	<u>(4,002)</u>	<u>(4,002)</u>
Balance at end of year	<u>\$ 141,571</u>	<u>\$ 145,629</u>

Asset Retirement Obligations

The fair value of a liability for a legal obligation associated with the retirement of long-lived assets is recognized in the period in which it is incurred if the fair value can be reasonably estimated. The fair value, which approximates the cost a third party would incur in performing the tasks necessary to retire such assets, is recognized at the present value of expected future cash flows and is added to the carrying value of the associated asset and depreciated over the asset's useful life. The liability is accreted over time and is reduced upon settlement of the obligation.

Impairment or Disposal of Long-Lived Assets

When events or changes in circumstances indicate that the carrying amount of long-lived assets, including property and equipment, or other long-lived assets, may not be recoverable, an evaluation of the recoverability of currently recorded costs is performed. When an evaluation is performed, the estimated value of undiscounted future net cash flows associated with the assets is compared to the assets' carrying value to determine if a write-down to fair value is required.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Impairment or Disposal of Long-Lived Assets, continued

If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Long-lived assets to be disposed of are reflected at the lower of either their carrying amounts or their fair value less costs to sell or close. In such circumstances, estimates of fair value are based on independent appraisals, established market prices for comparable assets, or internal calculations of estimated discounted future cash flows.

Derivative Instruments

AMH Cath Labs, L.L.C. (ACL), a consolidated joint venture, uses interest rate swap agreements to manage interest rate risk associated with their floating rate borrowings and account for derivative instruments utilized in connection with these activities in accordance with FASB ASC Topic 815, *Derivatives and Hedging*, which requires entities to recognize all derivative instruments as either assets or liabilities in the consolidated balance sheets at their respective fair values.

ACL designates and accounts for its interest rate swap agreements as cash flow hedges in accordance with FASB ASC Subtopic 815-30, *Derivatives and Hedging – Cash Flow Hedges*. For all hedging relationships, ACL formally documents the hedging relationship and its risk management objective and strategy for undertaking the hedge, the hedging instrument, the hedged item, the nature of the risk being hedged, how the hedging instrument's effectiveness in offsetting the hedged risk will be assessed prospectively and retrospectively, and a description of the method of measuring ineffectiveness. ACL also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in the hedging transactions are highly effective in offsetting cash flows of hedged items. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as other changes in unrestricted net assets and reclassified into earnings in the same period or periods during which earnings are affected by the variability in cash flows of the designated hedged item. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in revenues and gains in excess of expenses and losses.

ACL will discontinue hedge accounting prospectively when it is determined that the derivative is no longer effective in offsetting cash flows of the hedged item, the derivative expires or is sold, terminated, or exercised, or the derivative designation is removed.

In all situations in which hedge accounting is discontinued and the derivative is retained and not redesignated as part of a new hedging relationship, ACL continues to carry the derivative at its fair value in the consolidated balance sheets and recognize any subsequent changes in its fair value in revenues and gains in excess of expenses and losses. When it is probable that a forecasted transaction will not occur, ACL discontinues hedge accounting and recognizes immediately any gains and losses that were accumulated in other changes in unrestricted net assets.

By using derivative financial instruments to hedge exposures to changes in interest rates, the System exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the System, which creates credit risk for the System. When the fair value of a derivative contract is negative, the System owes the counterparty and, therefore, the System is not exposed to the counterparty's credit risk in these circumstances. The System minimizes counterparty credit risk in derivative instruments by entering into transactions with high-quality counterparties. The derivative instruments entered into by the System do not contain credit-risk-related contingent features.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Derivative Instruments, continued

Market risk is the adverse effect on the value of a derivative instrument that results from a change in interest rates. The market risk associated with interest-rate contracts is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

Physician Income Guarantees

Consistent with its policy on physician relocation and recruitment, THR hospitals provide income guarantee agreements to certain non-employed physicians who agree to relocate to its communities to fill a need in the hospital's service area and commit to remain in practice there. Under such agreements, THR hospitals are required to make payments to the physicians in excess of the amounts they earn in their practice up to the amount of the income guarantee. The income guarantee periods are typically 12 months, but are occasionally negotiated for longer periods of time if obstacles to the physician's startup are anticipated. Such payments plus interest are recoverable from the physicians if they do not fulfill their obligation to practice full-time in the community and maintain active privileges at the recruiting hospital for typically three years subsequent to the guarantee period. At December 31, 2017, the maximum potential amount of future payments under these guarantees was approximately \$5,986,000.

At December 31, 2017 and 2016, THR had a liability of approximately \$2,110,000 and \$3,098,000, respectively, for the fair value of guarantees entered into, with a corresponding asset recorded in other current assets in the consolidated balance sheets, which will be amortized over the commitment period.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to THR and its tax-exempt controlled affiliates are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is 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 accompanying consolidated statements of operations and changes in net assets as net assets released from restrictions and other operating revenue.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by THR and its tax-exempt controlled affiliates have been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by THR and its tax-exempt controlled affiliates in perpetuity.

Revenue and Gains in Excess of Expenses and Losses

The consolidated statements of operations and changes in net assets include revenue and gains in excess of expenses and losses. Changes in unrestricted net assets which are excluded from revenue and gains in excess of expenses and losses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets), and other items required by GAAP to be reported separately.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Net Patient Service Revenue

Net patient service revenue is recognized as services are provided and 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 the related services are rendered and adjusted in future periods as final settlements are determined.

Charity Care

The Tax-Exempt Hospitals and THPG provide care to patients who meet criteria established under THR's financial assistance policy without charge or at amounts less than their established rates. The consolidated joint venture hospitals and healthcare entities have similar financial assistance policies, or have adopted the THR financial assistance policy. Because the System does not pursue collection of amounts determined to qualify as charity care, those amounts are not reported as net patient service revenue or patient receivables.

Self-Insurance

Under THR's self-insurance programs, claims are reflected as liabilities based upon actuarial estimation, including both reported, and incurred but not reported claims, taking into consideration the severity of the incidents and the expected timing of claim payments.

Recent Accounting Pronouncements

In August 2016, the FASB issued Accounting Standards Update (ASU) 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, which applies to all entities that are required to present a statement of cash flows under Topic 230. ASU 2016-15 addresses the presentation and classification of cash flows related to (i) debt prepayment or debt extinguishment costs, (ii) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, (iii) contingent consideration payments made after a business combination, (iv) proceeds from the settlement of insurance claims, (v) proceeds from the settlement of corporate-owned life insurance policies (including bank-owned life insurance policies), (vi) distributions received from equity method investees, (vii) beneficial interests in securitization transactions, and (viii) separately identifiable cash flows and application of the predominance principle. The amendments in ASU 2016-05 should be applied using a retrospective transition method to each period presented, unless it is impracticable. Management is currently evaluating the potential impact of this guidance, which is effective for THR beginning January 1, 2019, and does not expect the adoption of this guidance to have a material effect on the statement of cash flows.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, which requires not-for-profit entities to report two classes of net assets, as well as enhances disclosures on board designated funds, liquidity, and functional expenses. THR adopted this guidance as of January 1, 2018.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements, continued

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which significantly modifies the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under current GAAP. Recognition of these assets and liabilities will have a material impact to our consolidated balance sheets upon adoption. In addition, while the new standard retains most of the principles of the existing lessor model, it aligns many of those principles with the FASB's new revenue guidance (ASU 2014-09). Under ASU 2016-02, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which includes a number of optional practical expedients. Management is currently evaluating the potential impact of this guidance, which is effective for THR beginning January 1, 2019, including performing an assessment of the quantity of and contractual provisions in various leasing arrangements to guide our implementation plan related to processes and the conclusion on the use of the optional practical expedients.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which makes targeted improvements to the measurement and disclosure of financial assets and financial liabilities, especially equity investments and other financial instruments, liabilities resulting from instrument-specific credit risk, and valuation allowances for deferred tax assets. Management has evaluated all of the provisions of this ASU, which is effective for THR beginning January 1, 2018, and adoption will not have a material impact on the consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, *Simplifying the Measurement of Inventory*, which requires an entity to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion and transportation. The amendments do not apply to inventory that is measured using last-in, first-out (LIFO) or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out (FIFO) or average cost. Management has evaluated all of the provisions of this ASU, which was effective for THR beginning January 1, 2017, and adoption did not have a material impact on the consolidated financial statements.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

2. Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements, continued

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets unless those contracts are within the scope of other standards. The core principle of the guidance in this ASU is that an entity should recognize 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. Management evaluated all of the provisions of the ASU, which are effective for THR beginning January 1, 2018, as amended by ASU 2015-14. Adoption of ASU 2014-09 will result in changes to our presentation for and disclosure of revenue related to uninsured or underinsured patients. Prior to the adoption of ASU 2014-09, a significant portion of our provision for bad debts related to self-pay patients, as well as co-pays and deductibles owed to us by patients with insurance. Under ASU 2014-09, the estimated uncollectible amounts due from these patients are generally considered a direct reduction to net patient service revenues and, correspondingly, result in a material reduction in the amounts presented separately as provision for bad debts. Management used a portfolio approach to apply the new model to classes of payers with similar characteristics and analyzed cash collection trends over an appropriate collection look-back period depending on the payer. Management also completed an initial assessment of the impact of the new standard on various reimbursement programs that represent variable consideration and concluded that accounting for these programs under the new standard is substantially consistent with THR's historical accounting practices. The FASB has issued additional guidance subsequent to ASU 2015-14 pertaining to this topic. The additional guidance has not changed the effective date as of the date of issuance of the consolidated financial statements and will be adopted in conjunction with ASU 2014-09. While the adoption of ASU 2014-09 will have a material effect on the presentation of net patient service revenue in our consolidated statements of operations and changes in net assets and will impact certain disclosures, it will not materially impact our financial position, results of operations or cash flows.

Reclassifications

Certain reclassifications have been made to the December 31, 2016 financial statements to conform to the December 31, 2017 presentation. The reclassifications had no effect on revenue and gains in excess of expenses and losses or net assets as previously reported. Previously, investments in funds measured at net asset value using the practical expedient were presented in the fair value hierarchy table in the fair value footnote. As a result of adopting FASB ASU 2015-07, Fair Value Measurement (Topic 820) – Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), all investments measured at net asset value using the practical expedient are excluded from the fair value hierarchy table to eliminate diversity in practice resulting from the way in which investments measured at net asset value per share are classified.

3. Net Patient Service Revenue

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

Medicare. Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Inpatient non-acute services, outpatient services, and certain capital and medical education costs related to Medicare beneficiaries are paid based on a combination of prospective and cost reimbursement methodologies or fee schedule. The hospitals are reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the hospitals and audits thereof by the Medicare fiscal intermediary.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

3. Net Patient Service Revenue, continued

Medicaid. Inpatient services rendered to Medicaid program beneficiaries are reimbursed under a prospectively determined system similar to Medicare. Most outpatient services are reimbursed by the Medicaid program under a cost reimbursement methodology or fee schedule. The hospitals are reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the hospitals and audits thereof by the Medicaid fiscal intermediary.

Managed Care and Commercial. The System has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the hospitals and THPG under these arrangements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates. Items such as high cost drugs and implants are sometimes paid as an add-on to prospectively determined rates. All of these payment methods can occur independently or in combination for different commercial agreements.

Private Pay. The Tax-Exempt Hospitals provide discounted pricing to uninsured patients. The pricing is calculated by applying a discount to charges for services received. The discount rate was 45% in 2017 and 2016. The consolidated and unconsolidated joint venture hospitals also provide similar discounted pricing to uninsured patients.

Medicare and Medicaid cost report settlements are estimated in the period services are provided to the program beneficiaries. These estimates are revised as needed until final settlement of the cost report. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Net patient service revenue increased approximately \$9,048,000 and \$12,406,000 in 2017 and 2016, respectively, due to reassessment of settlement issues and other changes in estimates related to final settlements.

The System recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the System recognizes revenue on the basis of its standard discounted rates for services provided. Based on historical experience, a significant portion of the System's uninsured patients will be unable or unwilling to pay for the services provided; thus, the System records a significant provision for bad debts and (or) charity care related to uninsured patients in the period the services are provided.

Patient service revenue for the years ended December 31, 2017 and 2016, net of contractual allowances and discounts (but before the provision for bad debts) from these major payor sources, is as follows (dollars in thousands):

	2017	2016
Medicare	\$ 800,992	\$ 781,196
Medicare Managed Care	543,048	459,747
Medicaid	104,050	127,722
Medicaid Managed Care	132,770	130,566
Managed Care	2,925,868	2,853,747
Commercial and Other	175,688	171,020
Private Pay	111,598	113,814
	\$ 4,794,014	\$ 4,637,812

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

4. Section 1115 Waiver

In late 2011, the Texas Health and Human Services Commission (HHSC) implemented a five-year demonstration program, the Texas Healthcare Transformation and Quality Improvement Program: Section 1115 Waiver Program (Waiver Program), which was approved by the Centers for Medicare & Medicaid Services (CMS). The Waiver Program was extended through December 31, 2017 and provides for two pools of Medicaid supplemental funding: an uncompensated care (UC) pool and a delivery system reform incentive payment (DSRIP) pool. On December 21, 2017, CMS approved an additional extension of the 1115 Waiver effective January 1, 2018 through September 30, 2022. THR (through certain wholly controlled tax-exempt and joint venture hospitals) participates in UC programs in Tarrant, Dallas, Collin and Johnson counties.

The UC pool of the Waiver Program helps eligible hospitals and certain other providers offset a portion of their unreimbursed costs associated with treating Medicaid patients and uninsured persons. During 2017 and 2016, THR, on behalf of its participating hospitals, recorded supplemental Medicaid patient service revenue of approximately \$83,827,000 and \$68,567,000, respectively, under the UC pool of the Waiver Program. At December 31, 2017 and 2016, THR has a receivable of approximately \$17,280,000 and \$11,574,000, respectively, related to the UC pool of the Waiver Program and included in other receivables, net on the consolidated balance sheets.

THR also receives other operating revenue from the DSRIP pool of the Waiver Program. The DSRIP pool provides funding, distributed as incentive revenue to be earned by facilities for initiating programs that benefit the community and help redesign the overall healthcare delivery system to improve access, quality, and efficiency. Hospitals receive funding for reaching predetermined, CMS-approved metrics for each project. In year one of the program, facilities that chose to participate received incentive revenue for submitting acceptable project plans that would span the five years of the Waiver Program. For year two of the program and after, providers earned revenue by meeting the project metrics and reporting achievement to HHSC. THR recognized approximately \$37,251,000 and \$30,944,000 in DSRIP revenue in 2017 and 2016, respectively, which was recorded as other operating revenue in the accompanying consolidated statements of operations and changes in net assets, of which \$22,229,000 and \$22,666,000 are included in other receivables, net in the accompanying consolidated balance sheets at December 31, 2017 and 2016, respectively.

CMS and HHSC have purview over project achievement and conduct regular audits to ensure DSRIP project metrics are met in accordance with the requirements set forth by the agencies. At December 31, 2017 and 2016, \$4,430,000 and \$4,003,000, respectively, was recorded in other accrued liabilities in the accompanying consolidated balance sheets as a reserve for possible adjustments resulting from HHSC compliance audits.

During the course of the Waiver Program, CMS has reviewed funding arrangements in certain geographic areas of the State of Texas to ensure the Waiver Program is in compliance with the provider-related donation prohibitions in federal law. On June 9, 2015, CMS authorized the longstanding public-private collaborative funding model arrangements in Texas to continue for waiver-payment dates through September 30, 2017; however, CMS subsequently disallowed matching funds for the quarter ended December 31, 2015 in the Dallas and Tarrant markets, as noted below.

Funding for both UC and DSRIP depends on the Tarrant County Hospital District (TCHD) and Dallas County Hospital District (DCHD) providing intergovernmental transfers to HHSC as the state share, which is then matched by federal funds. CMS alleges that the private hospitals participating in these affiliations failed to comply with the federal provider-related donation requirements. All Waiver Program payments made to private hospitals using these funding mechanisms could be at risk if CMS prevails in its disallowance claim, or the State of Texas does not implement any changes that may be required through negotiations between CMS and HHSC.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

4. Section 1115 Waiver, continued

On October 28, 2016, HHSC requested a reconsideration by the Secretary of Health & Human Services. CMS responded on December 21, 2016, stating the agency believes HHSC's arguments do not merit a withdrawal or revision to the disallowance. HHSC appealed the disallowance to the Departmental Appeals Board (DAB) in June 2017. Certain private hospitals, including THR, have intervened in the case before the DAB. On October 5, 2017, the DAB granted a stay in proceedings for the parties to discuss a possible resolution of the dispute. The parties did not reach a resolution. CMS and HHSC have submitted legal briefings and await the DAB's review for next steps and (or) a conclusion. It is too early to predict the outcome of this matter.

Deferred revenue represents approximately 10% of advances and anticipated settlements of previously received funds. Beginning on October 1, 2015, THR has recorded additional deferred revenue equal to 50% of the federal portion of UC revenue. At December 31, 2017 and 2016, THR has total deferred revenue of approximately \$47,002,000 and \$21,454,000, respectively included in other accrued liabilities on the consolidated balance sheets.

In June 2017, the 85th Texas Legislature enacted legislation to authorize the TCHD and DCHD to establish and administer a local health care provider participation program (Local Provider Participation Fund or LPPF). The purpose of this program is to generate local revenue from a mandatory payment fee on nonpublic entities that can be used to fund intergovernmental transfers for securing reimbursement in certain Medicaid Supplemental payment programs, including UC and the Uniform Hospital Rate Increase Program (UHRIP) which began March 1, 2018. By the terms of the respective LPPF enabling statutes, the fee cannot exceed 6% of net patient revenue, and the mandatory payment fee must be consistent with CMS rules regarding provider taxes, which rules include the fee must be broad-based and uniform, and there is no hold harmless guarantee from the sponsoring governmental entity. Upon payment of the mandatory fee, funds are considered restricted and included as assets whose use is limited until funds are used for their intended purpose. As of December 31, 2017, THR has recorded \$64,468,000 as a restricted asset whose use is limited and accrued payments of \$49,920,000 included in other accrued liabilities on the consolidated balance sheets, and LPPF expense of \$21,099,000 included in other operating expenses on the consolidated statements of operations and changes in net assets.

5. Charity Care and Community Benefit

In accordance with its mission, the System commits substantial resources to sponsor a broad range of services for the indigent as well as the broader community. Community benefit provided to the indigent includes the cost of providing services to persons who cannot afford health care due to inadequate resources and/or to persons who are underinsured. This category of community benefit, in accordance with Texas law, includes the unreimbursed costs of traditional charity care as well as the estimated unreimbursed costs of care provided to beneficiaries of Medicaid and other indigent public programs. The System also benefits the communities it serves by providing facilities for the education and training of health care professionals and by participating in research activities that offer the potential of improving health care.

The System also promotes access to health care services by providing support for indigent care clinics; promotes community health education and wellness programs; supports other local community based non-profit organizations through charitable donations; and sponsors a variety of health-related support groups and programs. These activities are classified as community benefit under Texas law.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

5. Charity Care and Community Benefit, continued

The System provides care to patients who meet criteria established under its financial assistance policy without charge or at amounts less than their established rates. As the System does not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient service revenue. When the System does not have the information required to properly determine charity status, the amounts owed by these individuals are classified as bad debt expense. The System estimates costs associated with charity care was approximately \$300,670,000 and \$263,980,000 for the years ended December 31, 2017 and 2016, respectively, applying the ratio of cost to gross charges. The System receives certain funds to offset or subsidize financial assistance provided from gifts or grants restricted for charity or indigent care. The amount of such funds recognized in unrestricted operations from such sources totaled approximately \$354,000 and \$705,000 for the years ended December 31, 2017 and 2016, respectively.

THR (through certain wholly controlled tax-exempt and joint venture hospitals), Baylor Health Care System, HCA North Texas Division, and Methodist Hospitals of Dallas have created Dallas County Indigent Care Corporation (DCICC), and Tarrant County Indigent Care Corporation (TCICC), both Texas non-profit corporations, to provide joint community benefit programs and services. DCICC entered into agreements with The University of Texas Southwestern Medical Center (UTSW) to provide services to patients in Dallas County. The term of the agreement with UTSW ended September 30, 2017 and DCICC decided not to renew. TCICC entered into agreements with various provider groups to provide professional healthcare services to indigent persons in Tarrant County. TCICC assigned all of the contracts to TCHD effective September 30, 2017.

In 2013, THR (through certain wholly controlled tax-exempt hospitals) began participating in similar community benefit programs in other counties. These programs include: the Johnson County Community Care Corporation (JCCCC), which has entered into contracts with healthcare providers to pay for the care of indigent county residents; Collin County, where THR has entered into a contract with Primamed Physicians Association to pay for care of indigent county residents; and Denton County to provide hospital care for indigent county residents.

During 2017 and 2016, THR, on behalf of its participating hospitals, recorded expense of approximately \$42,070,000 and \$51,056,000, respectively, representing disbursements made for services listed above through DCICC, TCICC, JCCCC, and Collin and Denton Counties for providing services to indigent patients.

6. Investments

Short-Term Investments

The composition of short-term investments at December 31, 2017 and 2016 is set forth in the following table (dollars in thousands):

	2017	2016
Cash and cash equivalents	\$ 674	\$ 755
U.S. government securities	-	500
Fixed income securities	7,514	4,995
Equity securities	87	-
	\$ 8,275	\$ 6,250

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

6. Investments, continued

Assets Limited as to Use

Assets limited as to use that are required for obligations classified as current liabilities are included in current assets in the consolidated balance sheet. The composition of assets limited as to use at December 31, 2017 and 2016 is set forth in the following table (dollars in thousands):

	<u>2017</u>	<u>2016</u>
Internally designated:		
Cash and cash equivalents	\$ 137,006	\$ 106,103
Fixed income securities	1,527,676	1,285,767
Equity securities	3,000,133	2,581,635
Mutual funds	631	2,031
Other alternative investments	14,979	-
Donor-restricted special purpose and endowment funds:		
Cash and cash equivalents	1,236	1,145
Fixed income securities	46,710	38,050
Equity securities	95,683	93,174
Mutual funds	-	530
Mineral interests	2,890	1,451
Real estate	18	18
Other alternative investments	71	-
Beneficial interest in perpetual trust, held in charitable remainder unitrusts, and held in charitable gift annuities:		
Cash and cash equivalents	392	297
Fixed income securities	1,677	1,558
Equity securities	7,873	5,717
Mutual funds	5,422	6,313
Hedge funds	152	-
Mineral interests	655	599
Real estate	876	718
Other provisions:		
Cash and cash equivalents	101,664	104,355
Fixed income securities	39,598	45,743
Equity securities	<u>9,644</u>	<u>9,968</u>
	4,994,986	4,285,172
Less: Assets limited as to use - required for current liabilities	<u>(504,341)</u>	<u>(353,161)</u>
	<u>\$ 4,490,645</u>	<u>\$ 3,932,011</u>

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

6. Investments, continued

Assets Limited as to Use, continued

Excluded from the above table are internally designated restricted cash related to cash held for use of intergovernmental transfers and estimated settlement payments (see footnote 4) of \$64,468,000 and \$0 at December 31, 2017 and 2016, respectively, and promises to give of approximately \$9,882,000 and \$13,887,000 at December 31, 2017 and 2016, respectively. Both the internally designated restricted cash and the promises to give are included in assets limited as to use in the accompanying consolidated balance sheets.

These promises to give are comprised of the following at December 31, 2017 and 2016 (dollars in thousands):

	<u>2017</u>	<u>2016</u>
Unconditional promises to give before unamortized discount and allowance for uncollectibles	\$ 10,088	\$ 14,263
Less: Unamortized discount	<u>(83)</u>	<u>(177)</u>
	10,005	14,086
Less: Allowance for uncollectibles	<u>(123)</u>	<u>(199)</u>
Net unconditional promises to give	<u>\$ 9,882</u>	<u>\$ 13,887</u>
Schedule of future amounts due:		
Less than one year	\$ 4,979	\$ 6,452
One to five years	3,428	6,251
Over five years	<u>1,681</u>	<u>1,560</u>
Total	<u>\$ 10,088</u>	<u>\$ 14,263</u>

Discount rates for these promises to give ranged from 1.19% to 1.80% and from 0.67% to 1.97% for the years ended December 31, 2017 and 2016, respectively.

THR and its wholly-controlled affiliates participate in a pooled, long-term investment fund administered by THR. Amounts internally designated represent THR and its wholly-controlled affiliates pro rata share of the fund. These funds exist to provide liquidity for the System, to support its capital program, and to backstop short-term reserves as a buffer against interruption of business operations due to catastrophic events. The fund's asset allocation is a reflection of the System's investment objectives as stated in its investment policy statement. Prior to July 16, 2012, the fixed income securities in the pool, which are primarily U.S. government obligations, were designated as other-than-trading securities while the equity securities were designated as trading. As a result of modifications to THR's investment policy statement effective July 16, 2012, all purchases of fixed income securities in the pool after this date are designated as trading securities.

Management evaluates THR and its wholly-controlled affiliates' fixed income securities purchased prior to July 16, 2012 to determine whether any are deemed to be other-than-temporarily impaired due to credit worthiness of the bond issuers. There were no securities deemed to be other-than-temporarily impaired at December 31, 2017 or 2016.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

6. Investments, continued

Assets Limited as to Use, continued

At December 31, 2017, the fair value and gross unrealized losses on THR and its wholly-controlled affiliates' fixed income securities that were purchased prior to July 16, 2012 and have been in a continuous unrealized loss position for twelve months or greater were approximately \$10,465,000 and \$71,000, respectively. Because THR has the ability and intent to hold these investments until a market price recovery, which may be maturity, these investments are not considered other-than-temporarily impaired.

Investment Income

Net realized investment income, included in revenue and gains in excess of expenses and losses in the consolidated statements of operations and changes in net assets, is comprised of the following for the years ended December 31, 2017 and 2016 (dollars in thousands):

	2017	2016
Interest and dividends	\$ 75,655	\$ 62,547
Realized gains, net	208,761	40,600
Total net realized investment income	284,416	103,147
Less: Net realized investment gain related to restricted funds	(5,534)	(2,017)
Net realized investment income, other than amount related to restricted funds	\$ 278,882	\$ 101,130

7. Property and Equipment

A summary of property and equipment at December 31, 2017 and 2016 is as follows (dollars in thousands):

	2017	2016
Land	\$ 170,234	\$ 149,223
Buildings and improvements	2,314,068	2,307,795
Fixed equipment	553,522	467,908
Major movable equipment	1,159,541	1,083,341
Building and equipment under capital lease obligations	576	565
	4,197,941	4,008,832
Less: Accumulated depreciation and amortization	(2,318,000)	(2,149,025)
	1,879,941	1,859,807
Construction and renovation in progress	109,533	147,938
	\$ 1,989,474	\$ 2,007,745

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

7. Property and Equipment, continued

Depreciation and amortization expense related to property and equipment from continuing operations for the years ended December 31, 2017 and 2016 was approximately \$226,274,000 and \$217,782,000, respectively. Included in the above table is the cost, approximately \$403,348,000 and \$380,269,000, and accumulated depreciation, approximately \$205,702,000 and \$193,377,000, of land, buildings, and equipment held out for lease at December 31, 2017 and 2016, respectively.

The System has several construction projects in progress, which include renovation and modernization of existing facilities and construction of new facilities. Total remaining estimated costs of these projects is approximately \$398,775,000, of which the System has outstanding commitments of approximately \$270,198,000 at December 31, 2017. Total interest capitalized during the years ended December 31, 2017 and 2016 was approximately \$1,419,000 and \$1,822,000, respectively.

The System recognizes a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. This applies to legal obligations to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The fair value of a liability for a legal obligation associated with the retirement of long-lived assets is recognized in the period in which it is incurred. The fair value, which approximates the cost a third party would incur in performing the tasks necessary to retire such assets, is recognized at the present value of expected future cash flows and is added to the carrying value of the associated asset and depreciated over the asset's useful life.

Asset retirement obligations related to asbestos removal are recorded as other non-current liabilities in the accompanying consolidated balance sheets and totaled approximately \$7,341,000 and \$7,158,000 at December 31, 2017 and 2016, respectively. As a result of changes in estimated costs to abate certain types of asbestos, the System recorded increases to the liability and an increase in asbestos abatement expenses of approximately \$148,000 and \$230,000 during the years ended December 31, 2017 and 2016, respectively. Depreciation expense related to the associated assets was approximately \$30,000 and \$34,000 in 2017 and 2016, respectively. Additional accretion costs were approximately \$318,000 for the years ended December 31, 2017 and 2016.

8. Long-Term Debt

A summary of long-term debt at December 31, 2017 and 2016 is as follows (dollars in thousands):

	2017	2016
System Revenue Bonds (Texas Health Resources), Series 2017A and 2017B, variable interest rates, due through 2051, (interest rates ranged from 1.25% to 1.27% at December 31, 2017)	\$ 133,470	\$ -
System Revenue Bonds (Texas Health Resources), Series 2016A fixed interest rates of 2.25% to 5.00%, due through 2047	631,105	631,105
System Revenue Bonds (Texas Health Resources), Series 2015 (Taxable), fixed interest rate of 4.33%, due through 2055	300,000	300,000
System Revenue Bonds (Texas Health Resources), Series 2015A fixed interest rates of 4.25% and 5.00%, due through 2052	60,000	60,000
System Tax-Exempt Loan (Texas Health Resources), The Northern Trust Company Private Loan, variable interest rates, due through 2033, (interest rate was 1.41% and 0.91% at December 31, 2017 and 2016, respectively)	67,500	67,500

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

8. Long-Term Debt, continued

	<u>2017</u>	<u>2016</u>
System Tax-Exempt Loan (Texas Health Resources), UMB Bank N.A. Private Loan, variable interest rates, due through 2035, (interest rate was 1.58% and 1.09% at December 31, 2017 and 2016, respectively)	66,780	67,025
System Revenue Bonds (Texas Health Resources), Series 2012A (Taxable), fixed interest rate of 4.366%, due through 2047	100,000	100,000
System Revenue Bonds (Texas Health Resources), Series 2012B, variable interest rates, due through 2047 (interest rates were 1.20% and 0.63% at December 31, 2017 and 2016, respectively)	50,000	50,000
System Revenue Bonds (Texas Health Resources), Series 2010, fixed interest rate of 5.00%, due through 2040	157,550	157,550
System Revenue Bonds (Texas Health Resources), Series 2008A, 2008B, and 2008C, variable interest rates, due through 2033, (interest rates ranged from 1.20% to 1.22% at December 31, 2017, and 0.63% to 0.66% at December 31, 2016)	149,180	176,055
System Revenue Bonds (Texas Health Resources), Series 2007A and 2007B, fixed interest rate of 5.00% due through 2047		
Term and Revolving Loans (Rockwall Regional Hospital, L.L.C.), fixed and variable interest rates, due through 2023, (interest rates ranging from 2.56% to 3.52% and 2.37% to 3.52% at December 31, 2017 and 2016, respectively)	-	122,235
Term and Revolving Loans (Flower Mound Hospital Partners, L.L.C.), fixed and variable interest rates, due through 2022, (interest rates ranging from 2.24% to 3.46% and 1.87% to 3.32% at December 31, 2017 and 2016, respectively)	32,066	34,487
Term and Revolving Loans (AMH Cath Labs, L.L.C.), variable interest rates, due through 2021, (interest rates ranging from 2.16% to 2.56% and 1.47% to 1.87% at December 31, 2017 and 2016, respectively)	77,836	83,999
Term Loan (Health Imaging Partners, LLC), fixed interest rate of 3.87%, due through 2020	17,360	18,228
Notes Payable (Health Imaging Partners, LLC), varying rates of interest, due through 2024, (interest rates ranging from 3.60% to 5.24% at December 31, 2017 and 2016)	7,860	12,031
Capital Lease Obligations, collateralized by leased equipment, at an imputed interest range rate of 0.00% to 5.00% at December 31, 2017 and an imputed interest rate of 5.00% at December 31, 2016	6,200	8,933
Other loans and notes payable, fixed and variable interest rates due through 2032 (interest rates ranging from 2.01% to 4.00% at December 31, 2017 and 2016)	145	253
	<u>37,189</u>	<u>36,743</u>
	1,894,241	1,926,144
Add:		
Unamortized original issue premium/discount, net	69,630	74,530
Less:		
Costs of Issuance	(11,665)	(12,475)
Current portion of long-term debt	<u>(351,226)</u>	<u>(268,628)</u>
Long-term debt, net of current portion	<u>\$ 1,600,980</u>	<u>\$ 1,719,571</u>

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

8. Long-Term Debt, continued

THR issued variable rate demand bonds, Series 2017A bonds (Series 2017A Bonds) and 2017B (Series 2017B Bonds) bonds (collectively the Series 2017 Bonds) through Tarrant County Cultural Education Facilities Finance Corporation (official statement dated October 11, 2017) in the amount of \$133,470,000. The proceeds of the Series 2017 Bonds were used to (a) currently refund the Tarrant County Cultural Education Facilities Finance Corporation Texas Health Resources System Refunding Revenue Bonds, Series 2007B, (b) finance and (or) refinance the costs of acquisition, construction, renovation, remodeling and (or) equipping of capital improvements, and (c) payment of certain expenses incurred in connection with the issuance of the Series 2017 Bonds. The Series 2017 Bonds are tax-exempt variable rate demand bonds, and are as such subject to periodic tender and remarketing provisions. The interest rates at which the bonds are remarketed are determined in accordance with the remarketing agreement applicable to the Series 2017 Bonds. Liquidity for payment of the Series 2017 Bonds tendered for purchase and not remarketed is provided by THR under a self-liquidity program. As a result, THR has classified the Series 2017 Bonds as a current liability in the current portion of long-term debt. Actual scheduled principal repayment dates range from 2048 – 2051.

THR issued Series 2016A bonds (Series 2016A Bonds) through Tarrant County Cultural Education Facilities Finance Corporation (official statement dated October 5, 2016) in the amount of \$631,105,000. The proceeds of the Series 2016A Bonds were used to (a) refund a portion of the Tarrant County Cultural Education Facilities Finance Corporation Texas Health Resources System Refunding Revenue Bonds, Series 2007A, (b) finance and (or) reimburse certain capital projects of THR, and (c) pay costs of issuance of the Series 2016A Bonds.

THR issued Series 2015 Taxable (Series 2015 Taxable Bonds) and 2015A (Series 2015A Bonds) bonds (collectively the Series 2015 Bonds) through Tarrant County Cultural Education Facilities Finance Corporation (official statements dated April 28 and May 6, 2015) in the amounts of \$300,000,000 and \$60,000,000, respectively. The proceeds of the Series 2015 Bonds were used (a) to finance and or reimburse certain capital projects of THR, (b) to pay costs of issuance of the Series 2015 Bonds, and (c) for other eligible corporate purposes.

Effective July 31, 2015, THR refinanced tax-exempt advancing term loan agreements (Bank Loans) with Kansas City Financial Corporation, an affiliate of UMB Bank, N.A. (UMB) and The Northern Trust Company (Northern). The UMB bank loan was issued for \$67,375,000 with a final maturity date of September 1, 2035, and an optional tender date of July 31, 2030. The Northern bank loan was issued for \$67,500,000 with a final maturity date of December 1, 2033, and a mandatory tender date of July 31, 2025. The Bank Loans bear interest at variable rates calculated as a percentage of LIBOR plus a spread. The refinanced notes were effective November 2010, with Bank of America, N.A. and Compass Mortgage Corporation in the aggregate principal amount of \$135,000,000. The proceeds of these Bank Loans were used to (a) pay costs of acquiring, constructing, renovating, remodeling and (or) equipping capital improvements for certain THR tax-exempt health facilities and (b) pay certain costs incurred in connection with the issuance of the Bank Loans.

THR issued variable rate demand bonds, Series 2012A (Series 2012A Bonds) and 2012B (Series 2012B Bonds) bonds (collectively the Series 2012 Bonds) through Tarrant County Cultural Education Facilities Finance Corporation (official statements dated September 27, 2012) in the amounts of \$100,000,000 and \$50,000,000, respectively. The proceeds of the Series 2012 Bonds were used to (a) finance and reimburse THR for the costs of the acquisition, construction, renovation, remodeling and (or) equipping of capital improvements and (b) pay certain costs incurred in connection with the issuance of the Series 2012 Bonds. The Series 2012B Bonds are tax-exempt variable rate demand bonds, and are as such subject to periodic tender and remarketing provisions. The interest rates at which the bonds are remarketed are determined in accordance with the remarketing agreement applicable to the Series 2012B Bonds. Liquidity for payment of the Series 2012B Bonds tendered for purchase and not remarketed is provided by THR under a self-liquidity program. As a result, THR has classified the Series 2012B Bonds as a current liability in the current portion of long-term debt. Actual scheduled principal repayment dates range from 2041 – 2047.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

8. Long-Term Debt, continued

In December 2012, THR entered into credit agreements with Wells Fargo Bank N.A. and U.S. Bank N.A. for lines of credit of \$75,000,000 each bearing interest at a variable rate calculated as a percentage of LIBOR plus a spread. In December 2016, the Wells Fargo agreement was amended to extend the term date to December 31, 2019. In December 2017, the U.S. Bank agreement was amended to extend the term date to December 31, 2020. At December 31, 2017 and 2016, there were no outstanding balances.

THR issued Series 2010 bonds (the Series 2010 Bonds) through the Tarrant County Cultural Education Facilities Finance Corporation (official statement dated November 11, 2010) in the amount of \$157,550,000. The proceeds of the Series 2010 Bonds were used to (a) to refund the Tarrant County Cultural Education Facilities Finance Corporation Texas Health Resources System Revenue Bonds, Series 2008D, 2008F, and 2008G; and (b) to pay certain costs incurred in connection with the issuance of the Series 2010 Bonds and the provisions for payment of the refunded Series 2008D, 2008F, and 2008G Bonds.

THR issued variable rate demand bonds, Series 2008A-G bonds (the Series 2008 Bonds) through the Tarrant County Cultural Education Facilities Finance Corporation (official statement dated October 27, 2008) in the amount of \$366,120,000. The proceeds of the Series 2008 Bonds were used (a) to refund the Tarrant County Health Facilities Development Corporation Texas Health Resources System Revenue Bonds, Series 2003 (the Series 2003 Bonds) (\$300,000,000) and the Plano Health Facilities Development Corporation Unit Priced Demand Adjustable Revenue Bonds (Children's and Presbyterian Healthcare Center of North Texas Project) Series 1989 (the Series 1989 Bonds) (\$27,900,000), (b) to finance or refinance the purchase, development, construction, reconstruction, renovation, rehabilitation and (or) equipping of certain THR tax-exempt health facilities (\$35,900,000), and, (c) pay certain costs incurred in connection with the issuance of the Series 2008 Bonds and the provisions for payment of the refunded Series 2003 and Series 1989 Bonds. As previously discussed, THR defeased all of the outstanding Series 2008D, 2008F, and 2008G Bonds in November 2010, with proceeds from the issuance of the Series 2010 Bonds. In addition, THR redeemed all of the outstanding Series 2008E Bonds on November 22, 2010 at a purchase price equal to the principal amount (\$36,140,000) thereof plus interest accrued thereon to the redemption date. THR used available cash to redeem the Series 2008E Bonds. In May 2015, THR remarketed the Series 2008C Bonds converting them from a daily to a weekly rate and converting the liquidity provision from a Standby Bond Purchase Agreement (SBPA) to self-liquidity. On October 17, 2017, THR used available cash to redeem a portion of the outstanding Series 2008A, 2008B, and 2008C Bonds in the aggregate principal amount of \$26,875,000 plus interest accrued through the redemption date.

The Series 2008 Bonds are subject to periodic tender and remarketing provisions. The interest rates at which the bonds are remarketed are determined in accordance with the remarketing agreement applicable to each series of the Series 2008 Bonds. Liquidity for payment of the outstanding Series 2008 Bonds tendered for purchase and not remarketed is provided by THR under a self-liquidity program. As a result, THR has classified these series as current liabilities in the current portion of long-term debt. Actual scheduled principal repayment dates range from 2027 – 2033. Prior to the May 2015 remarketing, liquidity for payment of the Series 2008C Bonds tendered for purchase and not remarketed was provided by an SBPA with JPMorgan Chase Bank, N.A.

Concurrent with the issuance of the Series 1997 Bonds and amended in connection with the issuance of the Series 2008, Series 2012, Series 2015 Bonds, Series 2016A Bonds, and Series 2017 Bonds, THR entered into the Second Amended and Restated Master Trust Indenture (the Master Indenture). Among other requirements, THR granted a security interest in (a) certain of its revenue (as defined in the Master Indenture) and accounts receivable of the grantor, (b) all money and investments held or required to be held for the credit of the funds and accounts established by or under the Master Indenture, and (c) any and all property that may, from time to time, be subjected to the lien and security interest of the Master Indenture.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

8. Long-Term Debt, continued

In April and May 2007, at THR's request, Tarrant County Cultural Education Facilities Finance Corporation issued \$597,840,000 of Refunding Revenue Bonds and \$100,000,000 of Revenue Bonds, Series 2007A and 2007B, respectively. The proceeds of the Series 2007A Bonds were used (a) to provide payment of principal, redemption premium, and interest to redemption or maturity on \$366,985,000 outstanding Series 1997A Bonds, \$157,090,000 outstanding Series 1997B Bonds, and \$68,745,000 outstanding Series 1997C Bonds, and (b) to pay certain costs incurred in connection with the issuance of the Series 2007A Bonds and the provisions for the refunded bonds. In November 2016, THR refunded a portion of the outstanding Series 2007A Bonds from the issuance of the Series 2016A Bonds with the remainder refunded in February 2017 at principal of \$22,235,000 plus premium and accrued interest. At December 31, 2017, the remaining outstanding balance of the Series 2007A Bonds was \$0. The proceeds of the sale of the Series 2007B Bonds were used (a) to pay or reimburse THR for the costs of acquiring, constructing, renovating, remodeling, and/or equipping capital improvements for THR and its tax-exempt controlled affiliates, and (b) to pay certain costs incurred in connection with the issuance of the Series 2007B Bonds. As previously discussed, in October 2017, THR refunded the Series 2007B Bonds outstanding principal balance of \$100,000,000 from the issuance of the Series 2017 Bonds, plus premium and accrued interest, resulting in a gain on extinguishment of long-term debt of \$2,098,000 for the year ended December 31, 2017.

On December 21, 2010, Rockwall Regional Hospital, L.L.C. (Rockwall) entered into a credit agreement (the Rockwall Agreement) with JPMorgan Chase Bank N.A. (Chase). The Rockwall Agreement provided Rockwall with a Real Estate Term Loan of \$42,000,000 and an Equipment Term Loan of \$13,000,000 bearing interest at one-, two-, or three-month LIBOR plus 1.95%, and also provided a Revolving Loan Commitment of \$5,000,000 to be used as working capital. On April 26, 2013, the Rockwall Agreement was amended to add an Improvement Loan of \$5,150,000. On March 31, 2016, Rockwall refinanced its Real Estate Term Loan and Equipment Term Loan, as well as amended and restated the Revolving Loan Commitment, all included in the Rockwall Agreement, by entering into a new credit agreement with Chase (the 2016 Rockwall Agreement). The 2016 Rockwall Agreement provides Rockwall with a term loan of \$36,302,000 (previously the Real Estate Term Loan and Equipment Term Loan), comprised of a fixed rate term loan of \$25,550,000 bearing interest at 3.52% and a variable rate term loan of \$10,752,000 bearing interest based on one-, two-, three-, or six-month LIBOR plus 1.75%. The amount outstanding on the term loan at December 31, 2017 and 2016 was \$32,066,000 and \$34,487,000, respectively. The 2016 Rockwall Agreement amended and restated the \$5,000,000 Revolving Loan Commitment with a commitment fee of 0.20% and bears interest at a variable rate of LIBOR plus 1.75%. The original maturity date of September 30, 2016 was later extended to September 30, 2018 per the First Amendment to the 2016 Rockwall Agreement. There was no outstanding balance at December 31, 2017 and 2016.

On January 13, 2011, Rockwall entered into a Forward Starting swap agreement with Chase related to the \$42,000,000 Real Estate Term Loan. This swap was intended to reduce the financial risk related to rising LIBOR interest by executing a cash flow hedge that will convert the floating rate exposure to a fixed-rate hedge instrument. The fixed rate on this hedge was 2.70%, with a start date of January 31, 2011 and ending date of December 31, 2017. On March 31, 2016, the Company terminated the interest rate swap agreement as part of the refinancing of the Company's long-term debt. The payment at the date of the termination was \$1,087,000, of which \$56,000 was a payment of accrued interest and \$1,031,000 was to settle the outstanding swap liabilities.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

8. Long-Term Debt, continued

On February 28, 2008, Flower Mound Hospital Partners, L.L.C. entered into a Credit Agreement (the Flower Mound Agreement) with various lending institutions with JP Morgan Chase Bank, N.A. acting as agent for the lenders for an Advancing Term Loan Commitment of \$105,000,000 and a Revolving Loan Commitment of \$20,000,000. On July 18, 2014, the Flower Mound Agreement was amended to provide additional term loans of \$11,280,000, comprised of \$7,896,000 fixed rate term loan bearing interest at 3.46%, and a \$3,384,000 variable term loan bearing interest at LIBOR plus 1.43%. Amounts outstanding on the additional term loans as of December 31, 2017 and 2016 were \$8,836,000 and \$9,588,000, respectively. On December 22, 2015, the Flower Mound Agreement was amended and restated to provide a term loan of \$81,176,000 comprised of a fixed rate term loan of \$57,400,000 bearing interest at 3.32% and a variable rate term loan of \$23,776,000 bearing interest based on one-, two-, three-, or six-month LIBOR plus 1.43%. The amount outstanding on the term loan was \$69,000,000 and \$74,411,000 at December 31, 2017 and 2016, respectively. Additionally, there were no amounts outstanding related to the Revolving Loan commitment as of December 31, 2017 and 2016.

On December 28, 2011, ACL entered into three loan agreements with Bank of America, N.A., collectively (the ACL Agreements). The ACL Agreements are secured by the THR guaranty (discussed below) as well as the revenues and substantially all the assets of ACL. The first agreement provides ACL with a ten year floating rate Service Line Term Loan of \$15,300,000 bearing interest at LIBOR plus a credit spread. The credit spread at inception of the loan was at the maximum rate of 1.3%; however, the spread can be reduced to 1.15% if ACL's Funded Debt to EBITDA ratio declines to specific agreed upon levels. The interest rates at December 31, 2017 was 2.56% with balances outstanding of \$12,240,000 and \$12,852,000 as of December 31, 2017 and 2016, respectively. The second agreement provides ACL with a seven year floating rate Equipment Term Loan of \$6,400,000 bearing interest at LIBOR plus a credit spread. The credit spread at inception of the loan was at the maximum rate of 0.9%; however, the spread can be reduced to 0.75% if ACL's Funded Debt to EBITDA ratio declines to specific agreed upon levels. The interest rate at December 31, 2017 was 2.16% with balances outstanding of \$5,120,000 and \$5,376,000 as of December 31, 2017 and 2016, respectively. The third agreement provides ACL with a five year floating rate Revolving Line of Credit of \$10,000,000 which was amended to reduce the amount of available funding to \$2,000,000 and extend the maturity date to December 28, 2021. The Revolving Line of Credit bears interest at LIBOR plus a credit spread. The credit spread at inception of the loan was at the maximum rate of 0.9%; however, the spread can be reduced to 0.80% if ACL's Funded Debt to EBITDA ratio declines to specific agreed upon levels. The Revolving Line of Credit can be priced at daily LIBOR, one, three, six, nine or twelve month LIBOR plus the applicable credit spread. There were no balances outstanding on the Revolving Line of Credit as of December 31, 2017 and 2016.

On December 22, 2011, ACL entered into Interest Rate Swap Agreements collectively, (the ACL Swap Agreements) with Bank of America, N.A., with respect to the Service Line Term Loan and Equipment Term Loan. These swaps are intended to reduce the financial risk related to rising LIBOR interest rates by executing a cash flow hedge that will convert the floating rate exposure to a synthetic fixed-rate. So long as the associated swaps are outstanding, the Service Line Term Loan and the Equipment Term Loan will be priced at one-month LIBOR plus the applicable credit spread mentioned in the paragraphs above. The fixed-rate on the Service Line Term Loan hedge is 2.0025%, with a start date of December 28, 2011 and ending date of January 1, 2022. The fixed-rate on the Equipment Term Loan hedge is 1.6470%, with a start date of December 28, 2011 and ending date of January 1, 2019. The fair value of the interest rate swap agreements at December 31, 2017 and 2016 is \$53,000 and (\$164,000), respectively, and disclosed separately in the noncurrent assets or liabilities section of the accompanying balance sheets.

In December 2013, Health Imaging Partners, LLC (HIP) entered into a Senior Secured Credit Facility with KeyBank National Association (the Credit Facility). The Credit Facility provides HIP with a seven year fixed rate Term Loan of \$28,500,000 bearing interest at 3.87%. The balance outstanding on the Term Loan as of December 31, 2017 and 2016 was approximately \$7,860,000 and \$12,031,000, respectively.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

8. Long-Term Debt, continued

Scheduled principal repayments on long-term debt are as follows (dollars in thousands):

<u>Year Ending December 31,</u>	<u>Scheduled Principal Payments</u>	<u>Principal Based on Liquidity Provisions</u>
2018	\$ 18,576	\$ 351,226
2019	20,275	20,275
2020	10,441	10,441
2021	15,861	15,861
2022	60,420	60,420
Thereafter	<u>1,768,668</u>	<u>1,436,018</u>
Total	<u>\$ 1,894,241</u>	<u>\$ 1,894,241</u>

Unamortized bond and debt issuance costs at December 31, 2017 and 2016 were approximately \$11,665,000 and \$12,475,000, respectively, and are included as a component of long-term debt in the accompanying consolidated balance sheets.

The Master Indenture, Bank Loans and Credit Agreements contain various covenants which require, among other things, the maintenance of certain financial ratios and certain other restrictions. Management believes THR is in compliance with its covenants as of December 31, 2017.

9. Net Assets

Temporarily Restricted Net Assets

Temporarily restricted net assets at December 31, 2017 and 2016 were restricted for the following purposes (dollars in thousands):

	<u>2017</u>	<u>2016</u>
Education and training	\$ 24,661	\$ 19,312
Patient care	24,469	24,282
Capital improvements	18,735	19,923
Research	12,738	11,071
Community outreach	7,935	8,021
Other restricted purposes	<u>10,138</u>	<u>9,153</u>
	<u>\$ 98,676</u>	<u>\$ 91,762</u>

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

9. Net Assets, continued

Permanently Restricted Net Assets

Permanently restricted net assets at December 31, 2017 and 2016 were restricted by donors to be maintained by THR in perpetuity for the following purposes (dollars in thousands):

	2017	2016
Education and training	\$ 25,576	\$ 25,075
Patient care	12,991	12,765
Research	12,629	12,477
Capital improvements	3,765	3,705
Community outreach	2,919	2,643
Other restricted purposes	14,640	12,978
	\$ 72,520	\$ 69,643

10. Endowment

The System's endowments consist of donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments. Net assets associated with endowment funds, including funds designated by the Board of Trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

Based on the interpretation of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) by the Board of Trustees, the guidance in FASB ASC 958-205, *Not-for-Profit Entities Presentation of Financial Statements*, and absent explicit donor stipulations to the contrary, the System classifies the original value of gifts donated to the permanent endowment as well as accumulations to the permanent endowment made at the direction of the donor or by policy as permanently restricted net assets. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the System in a manner consistent with the standard of prudence prescribed in UPMIFA.

In accordance with UPMIFA, the System considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the Foundation and the donor-restricted endowment fund
- (3) General economic conditions
- (4) The possible effect of inflation and deflation
- (5) The expected total return from income and the appreciation of investments
- (6) Other resources of the Foundation
- (7) The investment policies of the Foundation

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

10. Endowment, continued

Changes in the System's invested endowment assets for the years ended December 31, 2017 and 2016 are as follows (dollars in thousands):

	Board			Total	
	Designated	Donor- Restricted			Endowment
	Endowment	Endowment Funds			
Funds	Temporarily	Permanently	Endowment		
Unrestricted	Restricted	Restricted		Funds	
Balance at December 31, 2015	\$ 55,274	\$ 32,317	\$ 56,983	\$ 144,574	
Contributions collected	-	-	355	355	
Interest and dividends	578	1,147	-	1,725	
Realized and unrealized gains, net	2,468	2,990	525	5,983	
Amounts appropriated for expenditure	(245)	(1,152)	-	(1,397)	
Balance at December 31, 2016	58,075	35,302	57,863	151,240	
Contributions collected	-	-	153	153	
Interest and dividends	724	1,455	-	2,179	
Realized and unrealized gains, net	7,099	11,460	861	19,420	
Amounts appropriated for expenditure	(204)	(2,768)	-	(2,972)	
Balance at December 31, 2017	<u>\$ 65,694</u>	<u>\$ 45,449</u>	<u>\$ 58,877</u>	<u>\$ 170,020</u>	

From time to time, the fair value of assets associated with an individual donor-restricted endowment fund may fall below the original value of the fund. There were no deficiencies of this nature as of December 31, 2017 and 2016.

The System has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Under this policy, the endowment assets are invested in securities and other instruments which compliment or balance one another, thereby reducing risk without significantly reducing average returns.

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

The System has spending policies that allow up to 4% of the endowment to be appropriated for expenditure unless otherwise stipulated in the donor agreement, calculated after the endowment principal has been increased by the annual Consumer Price Index. This is consistent with the System's objectives to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term, as well as to provide additional real growth.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

11. Non-Controlling Interests

The System controls and therefore consolidates certain investments in its joint ventures with physicians and non-physicians to operate hospitals and other health related ventures. The activity for non-controlling interests for the years ended December 31, 2017 and 2016 is summarized below (dollars in thousands):

	2017	2016
Non-controlling ownership interest in equity of consolidated affiliates, beginning of year	\$ 110,697	\$ 102,000
Revenue and gains in excess of expenses and losses attributable to non-controlling interest	83,643	83,284
Non-controlling interest in change in fair value of interest rate swap agreements	100	507
Contributions from non-controlling interest holders	5,508	3,380
Distributions to non-controlling interest holders	(79,821)	(78,474)
Non-controlling ownership interest in equity of consolidated affiliates, end of year	\$ 120,127	\$ 110,697

12. Retirement Plans

The System has various plans, primarily defined contribution plans, which cover eligible full-time and part-time employees of the System. Plan contributions, included in salaries, wages, and employee benefits in the consolidated statement of operations and changes in net assets, were approximately \$68,142,000 and \$60,788,000 for the years ended December 31, 2017 and 2016, respectively.

13. Federal and State Income Taxes

The System has certain subsidiaries and operations such as joint venture interests, retail pharmacies and outside laboratory services that are taxable for federal income tax purposes. On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act") was signed into law. The Tax Act amends the Internal Revenue Code to reduce tax rates and modify policies, credits and deductions for individuals and businesses. For businesses, the Tax Act makes broad and complex changes to the U.S. Tax code, including but not limited to, (1) reducing the corporate federal tax rate from a maximum of 35% to a flat 21% rate, effective January 1, 2018, (2) repealing the corporate alternative minimum tax (AMT) and changing how existing AMT credits may be realized, (3) implementing a separate calculation for unrelated business taxable income for each trade or business, (4) allowing full expensing of certain capital expenditures, (5) eliminating tax exemption for interest related to the advance refunding of private activity bonds issued after 2017, and (6) implementing an excise tax on a portion of certain key employee compensation. As a result of the reduction in the corporate income tax rate for THR from 34% to 21% under the Tax Act, THR has revalued the net deferred tax assets at December 31, 2017, resulting in a reduction in the value of the deferred tax asset of approximately \$261,000 (prior to the valuation allowance). The taxable activities of all includible entities have approximately \$422,000 and \$2,491,000 in net deferred tax assets, against which a 100% valuation allowance has been recorded, for the years ended December 31, 2017 and 2016, respectively. The reduction in the deferred tax assets as well as the change in the valuation allowance was recorded in income tax expense in the accompanying consolidated statement of operations and changes in net assets. While the System expects to generate taxable income from certain activities in the future, the valuation allowance has been recorded because the System does not believe taxable income will be incurred by the entities that generated the net deferred tax assets.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

13. Federal and State Income Taxes, continued

The Texas franchise tax applies to certain of the System's consolidated for-profit and joint venture interests. Under this law, tax is calculated on a margin base and is therefore reflected in the System's statements of operations and changes in net assets as income tax expense.

Federal and state income tax expense of approximately \$4,880,000 and \$3,606,000 is included in the consolidated statements of operations and changes in net assets for the years ended December 31, 2017 and 2016, respectively.

14. Concentrations of Credit Risk

Financial institutions that potentially subject the System to concentrations of credit risk consist of deposits in banks and investments in excess of the Federal Deposit Insurance Corporation, Securities Investor Protection Corporation and other privately insured limits. The System maintains cash and cash equivalents in excess of the federally insured limits at financial institutions with strong credit ratings and has not experienced any credit losses on these financial instruments.

The hospitals and physician practices grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor agreements. The concentrations of gross patient receivables on a percentage basis at December 31, 2017 and 2016 are as follows:

	2017	2016
Medicare	16%	17%
Medicare Managed Care	12%	11%
Medicaid	1%	1%
Medicaid Managed Care	4%	5%
Managed care organizations	42%	41%
Other third-party payors	4%	4%
Private Pay	21%	21%
	100%	100%

15. Commitments and Contingencies

Management evaluates contingencies based upon available evidence. In addition, allowances for losses are provided each year for disputed items which have continuing significance. Management believes that allowances for losses have been provided to the extent necessary and that its assessment of contingencies is reasonable. Due to the inherent uncertainties and subjectivity involved in accounting for contingencies, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. To the extent that the resolution of contingencies results in amounts which vary from management's estimates, future operating results will be charged or credited. The principal commitments and contingencies are described below:

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

15. Commitments and Contingencies, continued

Professional and General Liability Insurance

The System has known professional and general liability claims and incidents that may result in the assertion of claims, as well as exposure from unknown incidents that may be asserted. In connection with these risks, THR maintains a self-insurance program for the professional and general liabilities of THR and its wholly-controlled affiliates whereby undiscounted reserves are recorded based on actuarial estimates from an independent third-party actuary. The self-insurance program includes coverage for general liability exposure of THPG. In connection with the self-insurance program, THR formed Grace Indemnity Company, Ltd., a wholly-owned captive insurance company in December 2014, for the purpose of paying professional liability and general liability claims. Prior to January 1, 2015, THR maintained trust funds, which held assets for the purpose of paying potential professional liability and general liability claims. The System also purchases insurance for professional liability and general liability claims in excess of THR's self-insurance retention level.

The System purchased claims-made professional liability coverage from commercial carriers for providers employed by THPG until December 31, 2014. The captive is also used to pay historical professional liabilities of THPG that occurred and are unknown prior to December 31, 2015, and all known and unknown liabilities that occur on or after January 1, 2015. The System's consolidated joint ventures each maintain separate professional and general liability insurance programs covering their risks individually.

The System's established liability for professional and general liability claims was approximately \$35,019,000 and \$34,462,000 at December 31, 2017 and 2016, respectively, and is recorded in other accrued liabilities and other non-current liabilities in the accompanying consolidated balance sheets.

Workers' Compensation Insurance

The System purchases workers' compensation insurance from commercial carriers with per claim deductibles and aggregate limits. Accrued claims include estimates for known claims and incidents incurred but not reported at December 31, 2017 and 2016, respectively. The System's established liability for workers' compensation claims was approximately \$4,326,000 and \$4,493,000 at December 31, 2017 and 2016, respectively, and is recorded in other accrued liabilities in the accompanying consolidated balance sheets.

Employee Health Insurance

THR maintains a self-insurance medical plan for the employees of THR and its wholly-controlled affiliates. Accrued claims include estimates for known claims and services incurred but not reported at December 31, 2017 and 2016, respectively. THR also purchases stop-loss insurance to limit its losses on claims for medical expenses. The System's consolidated joint ventures each maintain separate employee health insurance programs. The System's established liability for employee health claims was approximately \$20,713,000 and \$20,527,000 at December 31, 2017 and 2016, respectively, and is recorded in accrued salaries, wages, and employee benefits in the accompanying consolidated balance sheets.

Guarantees of Indebtedness

The Tax-Exempt Hospitals guaranteed approximately \$20,710,000 and \$21,243,000 of patient notes purchased by banks at December 31, 2017 and 2016, respectively. The System recorded a contingent liability of approximately \$5,556,000 and \$5,848,000 at December 31, 2017 and 2016, respectively, for these guarantees based on historical default rates.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

15. Commitments and Contingencies, continued

Guarantees of Indebtedness, continued

In February, 2013, THR entered into a limited guaranty agreement with JPMorgan Chase Bank, N.A. (JPM) for 51% of any indebtedness outstanding between JPM and USMD Arlington. In May, 2013, THR entered into a limited guaranty agreement with Southwest Bank for 51% of any indebtedness outstanding between Southwest Bank and USMD Fort Worth up to a maximum guaranty amount of \$6,150,000. In September 2015, the limited guaranty agreement for USMD Arlington was amended in conjunction with their debt refinancing. At December 31, 2017 and 2016, THR's share of principal on USMD Arlington's and USMD Fort Worth's outstanding indebtedness was approximately \$13,276,000 and \$3,343,000, and \$14,278,000 and \$3,773,000, respectively. Payments are due from THR if USMD Arlington or USMD Fort Worth is unable to fulfill its obligations at the scheduled payment dates. As of December 31, 2017, it is not probable that THR will be required to make significant payments under the limited guaranty agreements. No amounts have been recorded in the accompanying consolidated financial statements for these guarantees.

Litigation

The System is a party to several legal actions arising in the ordinary course of its business. In management's opinion, the System has adequate legal defenses, insurance coverage, and (or) self-insured retention for each of these actions, and management estimates that these matters will be resolved without material adverse effect on the System's future financial position, results of operations, or cash flows.

Regulatory Compliance

The health care industry is subject to numerous laws and regulations of federal, state, and local governments and compliance can be subject to future review and interpretation as well as the possible emergence of regulatory actions unknown or unasserted at this time. Management believes that the System is in substantial compliance with applicable government laws and regulations. Regulatory inquiries and voluntary reports may be made from time-to-time. It is management's policy to cooperate fully in resolving any such reports or inquiries.

In May 2013, THR learned sheets of microfiche containing records for patients treated at Texas Health Harris Methodist Hospital Fort Worth from 1980-1990 were not securely handled by the outside vendor with which THR contracted for all of its document destruction. THR has made all legally required notifications of the incident, including letters to the patients involved, a notice posted on THR's public website, and a press release. The Office of Civil Rights has closed this matter; however, to date, the State of Texas has not responded. THR does not anticipate a material financial impact due to this incident.

In March 2015, the System made a disclosure to the Office of Inspector General (OIG) regarding THPG billing of certain PET scan tests and nuclear stress tests that did not meet Medicare medical necessity requirements. Management believes it is too early to predict with certainty the outcome of this matter; however, management does not anticipate a material financial impact.

THR's Corporate Compliance Department investigates all compliance matters reported through its compliance program. As of the date of these financial statements, there was no additional pending or, to the knowledge of System management, threatened litigation, including professional liability claims, or reported compliance issues which in the opinion of System management involves any substantial risk of material liability for the System, and where applicable, in excess of available reserves and insurance coverage. In management's opinion, the System does not expect the resolution of any known regulatory compliance matters to have a material adverse effect on the System's future financial position, results of operations, or cash flows.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

15. Commitments and Contingencies, continued

Operating Leases

The System leases various equipment and facilities under operating leases expiring at various dates through 2030. Total rental expense, included in other operating expenses in the consolidated statements of operations and changes in net assets, was approximately \$71,567,000 and \$69,437,000 for the years ended December 31, 2017 and 2016, respectively.

The following is a five year schedule, by year, of future minimum lease payments under non-cancelable operating leases that have initial terms in excess of one year as of December 31, 2017 (dollars in thousands):

<u>Year Ending December 31,</u>	
2018	\$ 48,302
2019	38,948
2020	32,015
2021	24,133
2022	21,432
Thereafter	<u>41,002</u>
	<u>\$ 205,832</u>

The System leases office space and land at fair market value to non-THPG physicians, health care related businesses, and others under operating leases expiring at various dates through 2072. Total rental income, included in other operating revenue and other non-operating gains in the consolidated statements of operations and changes in net assets, was approximately \$34,709,000 and \$33,402,000 for the years ended December 31, 2017 and 2016, respectively.

The following is a five-year schedule, by year, of future minimum rental income payments under non-cancelable leases that have initial terms in excess of one year as of December 31, 2017 (dollars in thousands):

<u>Year Ending December 31,</u>	
2018	\$ 26,045
2019	21,578
2020	17,548
2021	13,365
2022	10,233
Thereafter	<u>158,315</u>
	<u>\$ 247,084</u>

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

16. Functional Operating Expenses

The System provides general and comprehensive health care services to residents within its geographic locations. Operating expenses related to providing these services for the years ended December 31, 2017 and 2016 were as follows (dollars in thousands):

	2017	2016
Patient care services	\$ 3,612,405	\$ 3,509,160
General and administrative	712,642	630,028
Research and physician education	37,848	37,377
Fundraising	6,186	6,374
	\$ 4,369,081	\$ 4,182,939

17. Fair Value Measurements

The System follows the provisions of FASB ASC 820, *Fair Value Measurements and Disclosures*, for its financial assets and liabilities that are measured and reported at fair value each reporting period. The financial assets recorded at fair value on a recurring basis primarily relate to investments, assets limited as to use, interest rate swap agreements, and contributions receivable from split-interest agreements. FASB ASC 820 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

The following tables present information about the System's assets and liabilities (dollars in thousands) that are measured at fair value as of December 31, 2017 and 2016, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize data points that are observable, such as quoted prices, interest rates and yield curves. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The System's assets limited as to use that are categorized as Level 3, or valued using significant unobservable inputs, primarily represent an investment in the Texas Methodist (formerly Central Texas Methodist) Foundation, contributions receivable from split-interest agreements and an endowment fund primarily holding mineral interests that are valued based on a multiple of annual revenues.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

17. Fair Value Measurements, continued

	<u>2017</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Financial Assets:				
Domestic equity securities	\$ 2,246,324	\$ 2,246,324	\$ -	\$ -
International equity securities	293,172	293,172	-	-
Fixed income securities:				
U.S. Government, including agency mortgage-backed securities	1,272,798	-	1,272,798	-
Corporate bonds and other	344,686	-	344,686	-
Mutual funds (blended securities)	6,053	631	5,422	-
Hedge fund	152	-	152	-
Texas Methodist Foundation	1,200	-	-	1,200
Real estate	894	-	876	18
Mineral interests	3,545	-	-	3,545
Contributions receivable from split-interest agreements	1,656	-	-	1,656
Other alternative investments	71	-	71	-
Total Investments	<u>\$ 4,170,551</u>	<u>\$ 2,540,127</u>	<u>\$ 1,624,005</u>	<u>\$ 6,419</u>
Held for sale real estate	\$ 8,000	\$ -	\$ 8,000	\$ -
Interest rate swap agreements	\$ 53	\$ -	\$ 53	\$ -
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
	<u>2016</u>			
Financial Assets:				
Domestic equity securities	\$ 2,021,866	\$ 2,014,103	\$ 7,763	\$ -
International equity securities	228,589	228,589	-	-
Fixed income securities:				
U.S. Government, including agency mortgage-backed securities	1,062,233	-	1,062,233	-
Corporate bonds and other	309,942	-	309,942	-
Mutual funds (blended securities)	8,874	2,561	6,313	-
Texas Methodist Foundation	1,188	-	-	1,188
Real estate	736	-	718	18
Mineral interests	2,050	-	-	2,050
Contributions receivable from split-interest agreements	1,510	-	-	1,510
Total Investments	<u>\$ 3,636,988</u>	<u>\$ 2,245,253</u>	<u>\$ 1,386,969</u>	<u>\$ 4,766</u>
Financial Liabilities:				
Interest rate swap agreements	\$ (164)	\$ -	\$ (164)	\$ -

Included in short-term investments and assets limited as to use in the accompanying consolidated balance sheets, but excluded from total investments in the above fair value tables include approximately \$8,226,000 and \$12,377,000 of pledges receivable, \$4,500,000 and \$3,250,000 of short-term investments not subject to fair value measurement, \$588,894,000 and \$440,039,000 of international equity common collective trust investments and other alternative investments that determined the fair market value of the investments using net asset value as the practical expedient, and \$240,972,000 and \$212,654,000 of cash and cash equivalents recorded at cost or cost plus accrued interest at December 31, 2017 and 2016, respectively. Of the total cash and cash equivalents excluded from the above table, \$87,581,000 and \$49,859,000 relate to residual cash in the allocated fixed income portfolio and \$49,199,000 and \$55,634,000 relate to the residual cash in the allocated equity securities portfolio as of December 31, 2017 and 2016, respectively.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

17. Fair Value Measurements, continued

The System's policy is to recognize transfers between levels of the fair value hierarchy on the date of the event or change in circumstances that caused the transfer. There were no transfers into or out of Level 1, Level 2, or Level 3 during fiscal year 2017.

The change in the fair value of the System's assets limited as to use valued using significant unobservable inputs (Level 3) is shown below (dollars in thousands):

	2017	2016
Fair value recorded at beginning of year	\$ 4,766	\$ 5,836
Adjustment to record increase in estimated fair value due to realized investment gains	12	9
Adjustment to record increase (decrease) in estimated fair value due to unrealized gains (losses)	1,494	(1,015)
Change in value of split-interest agreements	147	(64)
Fair value recorded at end of year	\$ 6,419	\$ 4,766

The adjustment to record the increase (decrease) in estimated fair value due to realized and unrealized gains (losses) on the investments valued using significant unobservable inputs is included in changes in temporarily and permanently restricted net assets in the accompanying consolidated statements of operations and changes in net assets. The change in value of split-interest agreements on the investments valued using significant unobservable inputs is included in changes in unrestricted and temporarily restricted net assets in the accompanying consolidated statements of operations and changes in net assets. The increase in unrealized gains (losses) relating to assets still held at December 31, 2017 and 2016 is approximately \$1,494,000 and \$(1,015,000), respectively.

The following methods and assumptions were used by the System in estimating the fair value of its financial instruments on a recurring and non-recurring basis, as well as financial assets and liabilities stated at a measure other than fair value:

Cash and Cash Equivalents

The carrying amounts, at cost or cost plus accrued interest, approximate fair value due to the short maturity of these instruments.

Equity Securities

Equity securities held by THR or held in trust controlled by THR are measured using quoted market prices. Equity securities held in trust not controlled by THR are measured using the net asset value of the trust based on the fair value of underlying securities, which are measured using quoted market prices.

Fixed Income Securities

Fixed income securities are measured using quoted market prices, if available, or estimated using quoted market prices for similar assets.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

17. Fair Value Measurements, continued

Common Collective Trusts

Investments in common collective trusts may be accessed at any time at the net asset value as reported by the manager on a daily basis. THR's interest in these trusts contains no other rights or obligations. As such, net asset value represents fair value for these investments. Each common collective trust invests in either equity or fixed income securities. The domestic equity common collective trust is an exchange traded collective trust, thus the net asset value of the trust is based on the fair value of the underlying securities, which are measured using quoted market prices.

Mutual Funds

Values of investments in mutual funds are based on quoted market prices for publicly traded funds and net asset values for funds that are not publicly traded. THR's interest in these funds contains no other rights or obligations. As such, net asset value represents fair value for these investments. Each fund invests in either equity or fixed income securities.

Hedge Funds

Investments in hedge funds are transacted through publicly traded mutual funds. See mutual fund valuation above.

Texas Methodist Foundation

The value of the investment in the Texas Methodist Foundation is estimated by the manager of the foundation based on the valuation of loans made by the foundation.

Real Estate

Investments in real estate, including real estate held for sale, are measured by private valuations.

Mineral Interests

Investments in mineral interests are estimated based on a multiple of annual revenues.

Contributions Receivable from Split-Interest Agreements

The fair value of the contribution is measured at the present value of the estimated future cash receipts from the trust's assets.

Other Alternative Investments

Where available, fair value is based on observable market prices or parameters, or derived from such prices or parameters. Where observable prices or inputs are not available, valuation models are applied. These valuation models involve some level of management estimation and judgement, the degree of which is dependent on the price transparency for the assets or liabilities or market, and the assets' or liabilities' complexity. The following factors may where relevant be taken into consideration in determining the fair value of such investments: the enterprise value of a portfolio company, the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings and discounted cash flows, the markets in which the portfolio company does business, comparisons to publicly traded securities, and changes in the interest rate environment and the credit markets generally that may affect the price at which similar investments may be made and other relevant factors.

Interest Rate Swap Agreements

Current market pricing models were used to estimate fair values of interest rate swap agreements.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

18. Investments in Unconsolidated Affiliates

THR and its controlled affiliates participate with other organizations, physicians, and non-physicians to provide health care related services. At December 31, 2017, THR and its controlled affiliates own interests in Community Hospice of Texas (Hospice), a provider of hospice services; North Central Texas Services (d/b/a CareFlite) (CareFlite), a provider of helicopter, fixed wing and ground ambulance services; North Texas Health Care Laundry Cooperative Association (NTHC Laundry), a provider of laundry services; USMD Arlington and USMD Fort Worth, short-stay hospitals; Imaging Center Partnership, L.L.P. (d/b/a Southwest Diagnostic Imaging Center) (SDIC), a provider of outpatient diagnostic imaging services; Texas Health Huguley, Inc. (d/b/a Texas Health Huguley Hospital Fort Worth South) (Huguley), an acute care hospital; Southwestern Health Resources Network (SWHR Network), multiple legal entities consisting of UTSW's network of faculty and community-based physicians, Texas Health's employed physicians, and independent physicians affiliated with both organizations, and a Joint Operating Company formed to integrate the three Dallas hospitals (UTSW's William P. Clements Jr. University Hospital and Zale Lipshy University Hospital, and Texas Health Presbyterian Hospital Dallas); FTH DFW Partners L.L.C. (d/b/a Adeptus Health), freestanding emergency rooms; 19 ambulatory surgery centers; one endoscopy center; and other joint ventures.

On May 25, 2016, THR announced the creation of a jointly owned health plan company, Texas Health Aetna, with Aetna Health. THR invested approximately \$114,800,000 for a 50% interest in the joint venture as of December 31, 2017. Beginning July 1, 2017, Texas Health Aetna began offering fully-insured and self-insured commercial products to employers and consumers in 16 counties in North Texas. Aetna Health will provide administrative services.

The ownership interests, carrying amounts, and equity in earnings of investments in unconsolidated affiliates at December 31, 2017 and 2016 were as follows (dollars in thousands):

	Ownership Interest		Carrying Value		Equity in Earnings	
	2017	2016	2017	2016	2017	2016
Surgery Centers	51.0% - 75.5%	51.0% - 84.0%	\$ 80,078	\$ 69,447	\$ 47,410	\$ 38,281
Huguley	51.0%	51.0%	68,898	58,648	10,250	6,888
USMD Arlington	51.0%	51.0%	34,501	28,062	10,831	11,264
Endoscopy Centers	51.0%	51.0%	24,310	24,455	9,476	9,086
Hospice	50.0%	50.0%	23,359	21,557	1,802	1,404
USMD Fort Worth	51.0%	51.0%	15,775	14,739	2,097	2,354
CareFlite	50.0%	50.0%	6,786	7,137	(352)	(2,412)
NTHC Laundry	45.6%	45.6%	5,878	5,441	569	484
Texas Health Aetna	50.0%	50.0%	120,521	2,500	8,221	(2,500)
SDIC	50.0%	50.0%	1,850	1,982	2,643	3,146
SWHR Network	49.0% - 51.0%	49.0% - 51.0%	(13,752)	(11,229)	(16,624)	(11,730)
Others	1.2% - 51.0%	1.2% - 30.0%	1,713	1,761	2,563	3,699
			<u>\$ 369,917</u>	<u>\$ 224,500</u>	<u>\$ 78,886</u>	<u>\$ 59,964</u>

The equity in earnings of unconsolidated affiliates providing services that the System does not provide as part of its routine services are included in nonoperating gains (losses) in the accompanying consolidated statements of operations and changes in net assets. All others are included in operating revenue.

TEXAS HEALTH RESOURCES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, Continued

19. Related-Party Transactions

THR incurred expenses for purchased services from NTHC Laundry of approximately \$9,781,000 and \$9,786,000 for the years ended December 31, 2017 and 2016, respectively, which is recorded in other operating expenses in the accompanying consolidated statements of operations and changes in net assets. Amounts due to NTHC Laundry, which total approximately \$810,000 and \$838,000 at December 31, 2017 and 2016, respectively, are reflected in current liabilities in the accompanying consolidated balance sheets. THR recorded management services and purchased workforce revenue from SWHR Network totaling approximately \$15,867,000 and \$8,239,000 for the years ended December 31, 2017 and 2016, respectively, which is recorded in other operating revenue in the accompanying consolidated statements of operations and changes in net assets. In addition, THR recorded managed care contract expense from SWHR Network totaling approximately \$2,662,000 and \$1,887,000 for the years ended December 31, 2017 and 2016, respectively, which is recorded in other operating expense in the accompanying consolidated statements of operations and changes in net assets. Net amounts due from SWHR Network, which total approximately \$18,150,000 and \$5,626,000 at December 31, 2017 and 2016, respectively, are reflected in other receivables in the accompanying consolidated balance sheets. Additionally, THR has various other immaterial transactions with certain of its nonconsolidated affiliates throughout the year.

20. Subsequent Events

The System evaluated events subsequent to December 31, 2017 and through April 23, 2018, the date on which the financial statements were issued.