

Virginia Hospital Center Arlington Health System and Affiliated Organizations

**Consolidated Financial Statements and
Supplementary Consolidating Information**

Years Ended December 31, 2017 and 2016

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Independent Auditors' Report

Board of Directors
Virginia Hospital Center Arlington Health System and Affiliated Organizations
Arlington, Virginia

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

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes 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 auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Virginia Hospital Center Arlington Health System and Affiliated Organizations as of December 31, 2017 and 2016, and the consolidated results of their operations and changes in their net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Report on Consolidating Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information on pages 25 - 27 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual companies, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Dixon Hughes Goodman LLP

Tysons, Virginia
April 27, 2018

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidated Balance Sheets
December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 14,407,465	\$ 19,942,431
Current portion of assets whose use is limited	2,498,600	2,643,600
Accounts receivable, less allowances for uncollectible accounts of \$26,582,122 and \$25,067,835 in 2017 and 2016, respectively	47,764,873	46,889,766
Inventories	12,664,645	12,028,629
Prepaid expenses and other assets	11,615,716	16,853,080
	<u>88,951,299</u>	<u>98,357,506</u>
Total current assets	88,951,299	98,357,506
Investments	798,875,450	702,887,083
Assets whose use is limited:		
Held by trustee under bond indenture	2,501,888	2,643,692
Self-insurance trust	8,869,416	8,805,034
By donors	21,745,610	19,319,554
	<u>33,116,914</u>	<u>30,768,280</u>
Less, assets available for current liabilities	<u>(2,498,600)</u>	<u>(2,643,600)</u>
	30,618,314	28,124,680
Property and equipment:		
Land and land improvements	5,205,891	5,205,891
Buildings and fixed equipment	311,518,526	301,084,448
Movable equipment	344,625,765	365,405,316
Construction in progress	36,215,181	7,272,156
	<u>697,565,363</u>	<u>678,967,811</u>
Less, accumulated depreciation	<u>(446,571,562)</u>	<u>(448,210,079)</u>
	250,993,801	230,757,732
Other assets	2,808,084	1,635,576
Total assets	<u>\$ 1,172,246,948</u>	<u>\$ 1,061,762,577</u>

See accompanying notes.

**Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidated Balance Sheets
December 31, 2017 and 2016**

(Continued)

	<u>2017</u>	<u>2016</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 41,092,488	\$ 33,466,837
Accrued salaries, wages and related items	10,731,415	9,451,002
Settlements due to third-party payor programs	14,085,430	9,996,104
Interest payable	2,498,600	2,643,600
Other liabilities	230,727	233,496
Current portion of long-term debt	<u>6,125,000</u>	<u>5,800,000</u>
Total current liabilities	74,763,660	61,591,039
Other long-term liabilities	10,926,710	11,615,121
Long-term debt, net, less current portion	<u>99,968,133</u>	<u>106,232,801</u>
Total liabilities	<u>185,658,503</u>	<u>179,438,961</u>
Net assets:		
Unrestricted	964,842,835	863,004,062
Temporarily restricted	20,008,781	17,584,592
Permanently restricted	<u>1,736,829</u>	<u>1,734,962</u>
	<u>986,588,445</u>	<u>882,323,616</u>
Total liabilities and net assets	<u>\$ 1,172,246,948</u>	<u>\$ 1,061,762,577</u>

See accompanying notes.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidated Statements of Operations
Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Operating revenue:		
Patient service revenue (net of contractual adjustments and discounts)	\$ 481,687,303	\$ 469,641,945
Less provision for bad debts	(24,652,183)	(20,049,385)
	457,035,120	449,592,560
Other operating revenue	15,274,620	12,692,080
Total operating revenue	472,309,740	462,284,640
Operating expenses:		
Salaries, wages and benefits	251,962,192	229,118,645
Supplies and other	179,175,440	167,087,590
Professional fees	6,413,741	5,996,237
Depreciation	29,738,409	29,864,213
Interest	5,003,877	5,273,319
Total operating expenses	472,293,659	437,340,004
Operating income	16,081	24,944,636
Nonoperating gains (losses):		
Investment income, net	50,277,415	36,353,601
Change in market value of investments and assets whose use is limited, net	50,085,520	(3,130,060)
Other	(290,676)	(68,515)
Net nonoperating gains	100,072,259	33,155,026
Excess of revenues and gains over expenses and losses	\$ 100,088,340	\$ 58,099,662

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidated Statements of Changes in Net Assets
Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Unrestricted net assets:		
Excess of revenues and gains over expenses and losses	\$ 100,088,340	\$ 58,099,662
Other changes in unrestricted net assets:		
Net assets released from restrictions for property and equipment	<u>1,750,432</u>	<u>754,085</u>
Increase in unrestricted net assets	101,838,772	58,853,747
Temporarily restricted net assets:		
Contributions	10,659,939	7,469,349
Investment income, net realized and unrealized gains on restricted investments	1,884,428	521,611
Net assets released from restrictions	<u>(10,123,310)</u>	<u>(4,882,668)</u>
Increase in temporarily restricted net assets	2,421,057	3,108,292
Permanently restricted net assets:		
Contribution	<u>5,000</u>	<u>10,000</u>
Increase in permanently restricted net assets	<u>5,000</u>	<u>10,000</u>
Change in net assets	104,264,829	61,972,039
Net assets, beginning of year	<u>882,323,616</u>	<u>820,351,577</u>
Net assets, end of year	<u>\$ 986,588,445</u>	<u>\$ 882,323,616</u>

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidated Statements of Cash Flows
Years Ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Cash flows from operating activities:		
Change in net assets	\$ 104,264,829	\$ 61,972,039
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Net realized and unrealized gains on investments	(59,452,999)	(17,070,652)
Equity in earnings of limited partnerships	(36,760,379)	(12,172,185)
Provision for bad debts	24,652,183	20,049,385
Depreciation	29,738,409	29,864,213
Amortization of debt issuance costs	55,293	58,272
Amortization of bond premium and discount	(194,961)	(205,463)
Restricted contributions received	(12,549,367)	(8,000,960)
Net changes in operating assets and liabilities:		
Accounts receivable	(25,527,290)	(30,072,064)
Settlements due to third-party payor programs	4,089,326	3,274,631
Inventories, prepaid expenses and other assets	4,601,348	(9,331,895)
Accounts payable and accrued expenses, interest payable and other current and long-term liabilities	9,639,857	(2,374,695)
Net cash provided by operating activities	<u>42,556,249</u>	<u>35,990,626</u>
Cash flows from investing activities:		
Net change in assets whose use is limited	(2,348,634)	(6,030,144)
Acquisitions of property and equipment	(51,544,451)	(29,873,705)
Net change in investments	225,011	(4,542,370)
Decrease in other long-term assets	(1,172,508)	828,018
Net cash used in investing activities	<u>(54,840,582)</u>	<u>(39,618,201)</u>
Cash flows from financing activities:		
Repayment of long-term debt	(5,800,000)	(5,750,000)
Restricted contributions and restricted investment income	12,549,367	8,000,960
Net cash provided by financing activities	<u>6,749,367</u>	<u>2,250,960</u>
Change in cash and cash equivalents	(5,534,966)	(1,376,615)
Cash and cash equivalents at beginning of period	<u>19,942,431</u>	<u>21,319,046</u>
Cash and cash equivalents at end of period	<u>\$ 14,407,465</u>	<u>\$ 19,942,431</u>

Noncash investing and financing activities:

In 2017 and 2016, the consolidated financial statements include \$356,722 and \$1,926,695 respectively, in accounts payable relating to the purchase of property and equipment.

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

1. Organization and Nature of Operations

Virginia Hospital Center Arlington Health System (the Corporation) is a tax-exempt, nonstock, not-for-profit corporation established under the laws of the Commonwealth of Virginia.

The Corporation owns or controls certain subsidiaries, which include AHV Group, Inc.; South Arlington, LLC; Arlington Urgent Care, LLC; Arlington Pediatric Center, Inc.; Virginia Hospital Center Foundation and Virginia Hospital Center Physician Group, LLC. The Corporation maintains control over these related organizations principally through certain powers which include the power to elect the boards of directors, approve amendments to the articles of incorporation, articles of organization, by-laws or operating agreements and approve annual budgets.

Real estate

AHV Group, Inc., a Virginia for-profit stock corporation, owns and operates certain commercial real estate located in Virginia.

South Arlington, LLC, a Virginia limited liability company, manages certain commercial real estate at Carlin Springs Road located in Arlington, Virginia.

Community outreach

Arlington Urgent Care, LLC, a Virginia limited liability company, provides urgent nonemergency healthcare services from a single site in Virginia.

Arlington Pediatric Center, Inc., a Virginia not-for-profit 501(c)(3) corporation, operates a pediatric clinic which provides comprehensive medical services to under-served children whose family income is below 200% of the poverty level.

Foundation

Virginia Hospital Center Foundation, a Virginia not-for-profit 501(c)(3) corporation, supports and maintains the programs, services and facilities of the Corporation in part through solicitation, receipt, administration and distribution of philanthropic gifts on behalf of its affiliates.

Virginia Hospital Center Physician Groups:

Virginia Hospital Center Physician Group LLC, a Virginia limited liability company, employs physicians providing primary care, medical specialty and surgical specialty services in various locations in Northern Virginia.

2. Significant Accounting Policies

Basis of presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) and reflect the operations of the Corporation and its controlled subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates

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

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

Cash and cash equivalents

The Corporation considers all highly liquid investments purchased with an original maturity of three months or less to be cash and cash equivalents, including overnight investments. Temporary cash and cash equivalents held in investments are excluded from cash and cash equivalents for consolidated statements of cash flow purposes.

Allowance for uncollectible accounts

The allowance for uncollectible accounts is based upon management's judgmental assessment of historical and expected net collections considering business and general economic conditions in its service area, trends in healthcare coverage, and other collection indicators. Throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon its review of accounts receivable payor composition and aging, taking into consideration recent write-off experience by payor category, payor agreement rate changes and other factors. The results of these assessments are used to make modifications to the provision for bad debts and to establish an appropriate allowance for uncollectible accounts receivable.

For self-pay patients, the allowance is based on an analysis of past experience related to the collection rate of self-pay balances. The Corporation follows established guidelines for placing certain past-due patient balances with external collection agencies. At December 31, 2017 and 2016, the allowance for uncollectible accounts represented approximately 91% and 92% of the past due accounts receivable balance, respectively. The past due accounts receivable balance represents the estimated uninsured portion of accounts receivable. For accounts receivable associated with services provided to patients with third party coverage, the Corporation analyzes contractually due amounts and provides an allowance for uncollectible accounts and provision for bad debt as necessary.

Investments

Investments include marketable equity securities with readily determinable fair values which are deemed to be trading securities. These investments are reported at fair value as determined by quoted market prices. The common collective trusts are valued at the net asset value units of the collective trust. The net asset value is used as a practical expedient to estimate fair value. The net asset value is based on the fair value of the underlying investments held by the fund less its liabilities. Investment income or loss is included in the excess of revenues and gains over expenses and losses unless the income is restricted by donor or law.

Investments also include investments in limited partnerships and other alternative investments (collectively, Alternative Investments), which are made in accordance with the Corporation's investment policies and are monitored through quarterly performance reviews. The Alternative Investments acquire, hold, invest, manage, dispose of, and otherwise deal in and with securities of all kinds and descriptions. Publicly traded securities within the Alternative Investments are generally valued by reference to closing market prices on one or more national securities exchanges or generally accepted pricing services selected by the custodial trustee of the Alternative Investments. Securities not valued by such pricing services will be valued based upon bid quotations obtained from independent dealers in the securities. In the absence of any independent quotations, securities will be valued by the limited partnership's custodial trustee on the basis of data obtained from the best available sources. Alternative Investments are accounted for under the equity method. The equity in earnings or losses from these investments is recorded as a component of investment income in the consolidated statements of operations.

Alternative investments for which the partnership, fund or other have placed restrictions (other than in the normal course of operations of the partnerships, fund or other) are evaluated for impairment caused by the illiquid nature of the restricted alternative investment. Any alternative investments determined to be impaired are reduced to a net realizable value based on the best information available.

Inventories

Inventories consist primarily of drugs and medical supplies and are carried at the lower of cost or market, as determined principally by the first-in, first-out method.

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

Property and equipment

Property and equipment are carried at cost. Depreciation of land improvements, buildings, and equipment is recorded on the straight-line basis over the estimated useful lives of the associated assets. The general range of estimated useful lives is 10 years for land improvements, 40 years for buildings, and 5 to 15 years for equipment. Depreciation expense for the years ended December 31, 2017 and 2016 was \$29,738,409 and \$29,864,213 respectively.

Gifts of long-lived assets, such as land, buildings, or equipment are reported as unrestricted support, and are excluded from the excess of revenues and gains over 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.

Revenue recognition

Operating revenues are recognized in the period services are performed and consist primarily of net patient service revenue that is reported at estimated net realizable amounts from patients, third-party payors, and others for services rendered. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known.

Patient service revenue, net of contractual allowances and discounts, is recognized from these major payor sources for the years ended December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Patient service revenue (net of contractual adjustments and discounts)		
Third-party payors	\$ 457,962,053	\$ 447,168,923
Self-pay	<u>23,725,250</u>	<u>22,473,022</u>
	<u>\$ 481,687,303</u>	<u>\$ 469,641,945</u>

Service to the community

Virginia Hospital Center (the Hospital) is a 394-bed acute care facility providing exceptional medical services to the Washington, D.C. metropolitan area. Established in 1944, the Hospital offers comprehensive healthcare and multiple centers of excellence including cardiology and cardiovascular surgery, oncology and women and infant health. The Hospital is accredited by the Joint Commission and licensed by the Commonwealth of Virginia Department of Health. The Hospital is a member of the Mayo Clinic Care Network (Mayo) which provides the community Mayo expertise at no cost to the patient. The Hospital also operates the Arlington Urgent Care Center for nonemergency conditions that require prompt medical attention. Arlington Urgent Care Center is run by physicians board-certified in family practice or emergency medicine, backed by a team of registered nurses, licensed radiology technicians and ancillary staff. Virginia Hospital Center Physician Group consists of over 100 employed physicians providing primary and specialty care to the community.

Uncompensated care

It is the Corporation's vision to build a healthier community by promoting and providing access to healthcare services to low income residents in its service area. Regardless of the ability to pay, the Corporation provides a full spectrum of inpatient and outpatient services to members of its community, including over 6,800 visits per year to the Hospital's indigent clinic in both 2017 and 2016. The indigent clinic is committed to providing access to quality healthcare services to low-income, uninsured county residents.

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

Additionally, the Corporation provides subsidized services to patients seen by the Arlington Free Clinic for indigent patients that require breast and colon screening and treatment services. The Corporation also accommodated the need for over 16,000 pediatric visits in both 2017 and 2016 at the Arlington Pediatric Center. The Arlington Pediatric Center provides low-cost healthcare services for families at or below 200% of the federal poverty level. In conjunction with the Arlington Medical Society, the Corporation sponsors an annual trip to Honduras by members of the medical and nursing staff of the Hospital to provide medical care and surgical services.

The Corporation accepts all patients regardless of their ability to pay. Patients are classified as charity care patients according to the established policies of the Corporation. Amounts determined to qualify as charity care are not pursued for collections, and accordingly are not reported as patient revenue. The Corporation provided approximately \$33,766,000 and \$32,874,000 in gross uncompensated charges for charity care for the years ended December 31, 2017 and 2016, respectively. The total direct and indirect costs of charity care provided for the years ended December 31, 2017 and 2016 were \$10,443,780 and \$10,303,707, respectively. The cost of charity care is calculated on a ratio of costs to charges.

The Corporation has a program for discounting services to patients who do not have insurance and whose income is greater than 200% of published federal poverty guidelines. The cost of the discount currently extended, calculated on a ratio of cost to charges, is \$1,173,179 and \$1,104,726 in 2017 and 2016, respectively.

Support for medical education programs

In 1948, the Hospital established the first medical residency program in the country, in partnership with Georgetown University. Today, the Hospital continues to assist with the education of future physicians through its affiliation with Georgetown University.

Other community services

Some of the other important community services provided by the Corporation are as follows:

- a) Rent-free space to PRS Crisis Link, a nonprofit, crisis hotline serving Northern Virginia residents,
- b) Clinic eligibility workers who assist indigent patients to obtain healthcare services,
- c) Health promotion programs and services, such as smoking cessation, blood pressure screenings and wellness programs, and
- d) Social services to assist patients in arranging for nonhospital healthcare services.

Excess of revenues and gains over expenses and losses

The consolidated statements of operations include excess of revenues and gains over expenses and losses. Changes in unrestricted net assets that are excluded from excess of revenues and gains over expenses and losses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, unrealized gains and losses on qualifying hedging instruments, cumulative effect of changes in accounting principles, permanent transfers of assets to and from affiliates for other than goods or services, and contributions of long lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

Activities that result in gains or losses unrelated to the Corporation's primary operations are considered to be nonoperating. All investment income is included in nonoperating gains, net of related costs. Nonoperating gains and losses include income and expenses associated with investments, bequests and other nonrecurring items.

Donor-restricted gifts

Unconditional promises to give cash and other assets to the Corporation are reported at fair value at the date the promise is received. Conditional promises to give are recorded at the time they become unconditional. 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

Virginia Hospital Center Arlington Health System and Affiliated Organizations

Notes to Consolidated Financial Statements

donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

Estimated malpractice costs

The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Income taxes

The Corporation is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code as a not-for-profit corporation. Federal tax law requires that the Corporation be operated in a manner consistent with its initial exemption application in order to maintain its exempt status. Management has analyzed the operations of the Corporation and concluded that it remains in compliance with the requirements for exemption.

The state in which the Corporation operates also provides general exemption from state income taxation for organizations that are exempt from federal income taxation. However, the Corporation is subject to both federal and state income taxation at corporate tax rates on its unrelated business income. Exemption from other state taxes, such as real and personal property taxes, is separately determined.

Current accounting standards define the threshold for recognizing uncertain income tax return positions in the financial statements as “more likely than not” that the position is sustainable, based on technical merits, and also provide guidance on the measurement, classification, and disclosure of tax return positions in the financial statements. Management believes there is no impact on the Corporation’s accompanying consolidated financial statements related to uncertain income tax provisions.

Meaningful use

Under the provisions of the American Recovery and Reinvestment Act of 2009, incentive payments are available to certain healthcare providers that can demonstrate “meaningful use” of certified electronic health records technology. The Corporation recognizes these incentive payments when it is reasonably assured that they will successfully demonstrate compliance with the meaningful use criteria.

Subsequent events

Management evaluated all events and transactions that occurred after December 31, 2017 through April 27, 2018 at which time the consolidated financial statements were issued. The Corporation did not have any material recognizable subsequent events during this period.

Recent accounting pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, which provides a principle-based approach for recognizing revenues through a five-step process. The ASU will be effective for the Corporation beginning January 1, 2018. The guidance allows for either a full retrospective or a modified retrospective transition method. The Corporation is currently evaluating the impact of this guidance, including the transition method, on its consolidated financial position, results of operations and cash flows. At the present time, management has not yet determined what the effects of adopting this ASU will be on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases*. The amendments in this ASU revise the accounting related to lessee accounting. Under the new guidance, lessees will be required to recognize a lease liability and a right-of-use asset for all leases. The amendments in this ASU are effective for the Corporation beginning on January 1, 2019 and should be applied through a modified retrospective transition approach for leases existing at, or entered

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

into after, the beginning of the earliest comparative period presented in the financial statements. Management has not yet determined what the effects of adopting this ASU will be on its consolidated financial statements.

In August 2016, FASB issued ASU 2016-14, *Not-For-Profit Entities, Presentation of Financial Statements of Not-for Profit Entities*. Under the new guidance, financial statements and noted disclosures requirements for not-for-profit (NFP) entities include the following:

1. Present on the face of the statement of financial position net assets with and without donor restrictions.
2. Improved disclosures for NFP entities that choose to present an operating measure.
3. Requirement to present information about its expenses by their nature and function either in the statement of activities, a separate statement, or in the notes to the financial statements.
4. Continue to present on the face of the statement of cash flows the net amount for operating cash flows using either the direct or indirect method of reporting but no longer require the presentation or disclosure of the indirect method (reconciliation) if using the direct method.
5. Enhanced disclosures that provide quantitative and qualitative information about liquidity management.

The amendments in ASU 2016-14 are effective for the Corporation beginning on January 1, 2018. Management has not yet determined what the effects of adopting this ASU will be on its consolidated financial statements.

In November 2016, FASB issued ASU 2016-18, *Statement of Cash flow, Restricted Cash*. This ASU addresses the diversity that exists in the classification and presentation of changes in restricted cash on the statement of cash flows. The amendments in this ASU apply to all entities that have restricted cash or restricted cash equivalents and are required to present a statement of cash flows. The amendments in ASU 2016-18 are effective for the Corporation beginning on January 1, 2018 and should be applied using a retrospective transition method to each period presented. Management has not yet determined what the effects of adopting this ASU will be on its financial statements.

3. Net Patient Service Revenue

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

Medicare

Under the Medicare program, the Corporation receives reimbursement under a prospective payment system (PPS) for inpatient services. Under the hospital inpatient PPS, fixed payment amounts per inpatient discharge are established based on the patient's assigned diagnosis related group (DRG). When the estimated cost of treatment for certain patients is higher than the average, providers may receive additional "outlier" payments. A prospective payment system provides for payment for outpatient services based on service groups called ambulatory payment classifications.

The Corporation has recorded approximately \$2,013,000 and \$1,867,000 of revenues related to Medicare outlier payments for the years ended December 31, 2017 and 2016, respectively. These amounts represent approximately 1.4% and 1.5% of Medicare net revenues for 2017 and 2016, and approximately 1.4% in 2017 and 0.4% in 2016 of total net patient service revenues. There can be no assurances that the Corporation will continue to receive these levels of Medicare outlier payments in future periods.

The Hospital is an academic teaching hospital and, as such, receives additional payments from Medicare for certain direct and indirect costs related to its graduate medical education (GME) programs. GME payments accounted for 1% of the Hospital's operating revenue in calendar years 2017 and 2016. The payment methodologies used do not necessarily reflect the actual costs of graduate medical education, and the federal government is continually re-evaluating its policy on graduate medical education and teaching hospital payments. Accordingly, there can be

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

no assurance that the payments received by the Hospital will be sufficient to cover the costs of its medical education programs.

Medicaid

The Commonwealth of Virginia reimburses providers for inpatient services through fixed payment amounts per inpatient discharge that are adjusted based on the patient's assigned case mix intensity similar to a Medicare DRG. Outpatient services are reimbursed by the Commonwealth of Virginia under the Enhanced Ambulatory Patient Groups (EAPG) prospectively determined payment system. The Commonwealth of Virginia also separately reimburses providers for direct medical and indirect medical education, and disproportionate share amounts, if qualified. These reimbursements are retroactively settled through the annual cost report.

Other third-party payors

All other third-party payors, principally Blue Cross, other private insurance companies, health maintenance organizations (HMOs), preferred provider organizations (PPOs) and other managed care plans, negotiate payment rates directly with the Corporation. Such arrangements include DRG-based payment systems, per diems, case rates and percentage of billed charges. If such rates are not negotiated, then the payors are billed at the Corporation's established charges.

Other third-party payor reimbursement considerations

Both federal and Commonwealth of Virginia regulations provide for certain adjustments to current and prior years' payment rates based on industry-wide and hospital-specific data. The Corporation has established estimates based on information presently available of the amounts due to or from Medicare, Medicaid, other third-party payors, workers compensation and no-fault payors.

Certain services rendered by the Corporation are reimbursed by third-party payors at cost, based upon cost reports filed after year-end. Contractual allowances are recorded based upon preliminary estimates of reimbursable costs. The Corporation's net patient service revenue recorded under cost-based reimbursement programs for the current and prior years are subject to audit and retroactive adjustment by certain third-party payors. Net patient service revenue increased approximately \$802,000 and \$6,257,000 during 2017 and 2016, respectively, due to prior-year retroactive adjustments in excess of amounts previously estimated.

There are various other proposals at the federal and Commonwealth of Virginia levels that could, among other things, reduce reimbursement rates, modify reimbursement methods or increase managed care penetration, including Medicare and Medicaid. The ultimate outcome of these proposals and other market changes cannot presently be determined.

Revenue from the Medicare and Medicaid programs accounted for approximately 37% of the Corporation's net patient revenue for the years ended December 31, 2017 and 2016. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future government review and interpretation. Noncompliance with such laws and regulations could result in repayments of amounts improperly reimbursed, substantial monetary fines, civil and criminal penalties and exclusion from the Medicare and Medicaid programs. As a result, there is a reasonable possibility that recorded estimates could change by a material amount in the near term. The Corporation believes that it is in compliance, in all material respects, with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential noncompliance.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

The following table summarizes the sources of gross patient charges for the Corporation for the years ended December 31:

	<u>2017</u>	<u>2016</u>
Medicare	39%	37%
Medicaid	5%	5%
HMO/PPO	49%	50%
Other commercial payors	2%	2%
Other	<u>5%</u>	<u>6%</u>
	<u>100%</u>	<u>100%</u>

4. Investments and Assets Whose Use is Limited

Investments

A summary of investments reported at fair value in the accompanying consolidated financial statements as of December 31 is as follows:

	<u>2017</u>		<u>2016</u>	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
Cash and cash equivalents	\$ 10,933,485	\$ 10,933,485	\$ 13,876,548	\$ 13,876,548
Short-term investments	129,314,279	124,510,403	124,173,010	120,049,685
Marketable equity securities	232,591,604	268,509,276	211,259,812	225,006,003
Common collective trusts	217,506,310	288,716,978	229,284,936	250,609,497
Accrued income	<u>342</u>	<u>342</u>	<u>3,113</u>	<u>3,113</u>
	<u>\$590,346,020</u>	<u>\$692,670,484</u>	<u>\$578,597,419</u>	<u>\$609,544,846</u>

The Corporation also has unrestricted investments in limited partnerships and other alternative investments as of December 31, 2017 and 2016 of \$106,204,966 and \$93,342,237, respectively. Investments in limited partnerships and other alternative investments represent multi-strategy hedge funds. These funds invest in other hedge funds that use various types of debt and equity securities and derivative instruments in their strategies. The Corporation utilizes the equity method of accounting to record these investments. For substantially all investments in alternative investments, the carrying amount approximates the net asset value of the respective fund. Income and losses on these funds are included in nonoperating gains, net in the consolidated statements of operations.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

The total restricted and unrestricted alternative investments as of December 31, 2017 and 2016 are as follows:

	<u>2017</u>	<u>2016</u>
Hedge funds	\$ 71,134,853	\$ 62,117,796
Private equity funds	18,888,244	14,647,869
Real assets	<u>19,072,798</u>	<u>19,142,177</u>
	109,095,895	95,907,842
Less – amounts included in assets whose use is limited	<u>(2,890,929)</u>	<u>(2,565,605)</u>
	<u>\$ 106,204,966</u>	<u>\$ 93,342,237</u>

Hedge fund investments include investments with fund of fund managers and direct individual managers incorporating multiple strategies, including capital structure arbitrage, event arbitrage, fixed income arbitrage, long shot investing, and distressed debt. As of December 31, 2017, approximately \$71,135,000 is redeemable before December 2018.

Private equity funds include investments in private equity consisting primarily of venture capital funds, leveraged buyout funds, mid-stage growth capital funds and international private equity funds. As of December 31, 2017, approximately \$2,951,000 is redeemable in less than one year and the balance of approximately \$15,937,000 is redeemable from 2019 through 2027.

Real assets include global investments in private and publicly listed entities investing in timber, natural resources, commodities, metals and mining companies. As of December 31, 2017, approximately \$1,388,000 is redeemable in less than one year and the balance of approximately \$17,685,000 is redeemable from 2022 through 2026.

Assets whose use is limited

Assets whose use is limited that are required for obligations classified as current liabilities are reported as current assets. The composition of assets whose use is limited as of December 31 is as follows:

	<u>2017</u>		<u>2016</u>	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
Held by trustee under bond indenture				
Cash and cash equivalents	<u>\$ 2,501,888</u>	<u>\$ 2,501,888</u>	<u>\$ 2,643,692</u>	<u>\$ 2,643,692</u>
Held by trustee for self- insurance				
Cash and cash equivalents	<u>\$ 8,853,416</u>	<u>\$ 8,853,416</u>	<u>\$ 8,789,034</u>	<u>\$ 8,789,034</u>
Held by trustee for environment				
Cash and cash equivalents	<u>\$ 16,000</u>	<u>\$ 16,000</u>	<u>\$ 16,000</u>	<u>\$ 16,000</u>

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

	<u>2017</u>		<u>2016</u>	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
Externally restricted by donors:				
Cash and cash equivalents	\$ 3,686,820	\$ 3,686,820	\$ 3,681,096	\$ 3,681,096
Marketable securities	6,331,208	7,308,897	5,806,687	6,184,515
Common collective trusts	5,290,582	7,858,956	6,302,126	6,888,252
Accrued income	<u>8</u>	<u>8</u>	<u>86</u>	<u>86</u>
	<u>\$ 15,938,618</u>	<u>\$ 18,854,681</u>	<u>\$ 15,789,995</u>	<u>\$ 16,753,949</u>

The Corporation also has investments externally restricted by donors in limited partnerships and other alternative investments as of December 31, 2017 and 2016 of \$2,890,929 and \$2,565,605, respectively. Investments in limited partnerships and other alternative investments represent multi-strategy hedge funds. These funds invest in other hedge funds that use various types of debt and equity securities and derivative instruments in their strategies. The Corporation utilizes the equity method of accounting to record these investments. The carrying amount approximates the net asset value of the respective fund. Income and losses on these funds are included in nonoperating gains, net in the consolidated statements of operations.

The following schedules summarize investment return and its classification in the consolidated statements of operations and the consolidated statement of changes in net assets for the year ended December 31:

	<u>2017</u>		
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Dividends and interest	\$ 5,934,495	\$ 99,491	\$ 6,033,986
Equity in earnings of limited partnerships	36,096,994	663,384	36,760,379
Realized gains on sales of investments	<u>8,245,926</u>	<u>125,096</u>	<u>8,371,022</u>
Investment income – net	50,277,415	887,971	51,165,387
Unrealized gains on trading securities	<u>50,085,520</u>	<u>996,457</u>	<u>51,081,977</u>
Total investment return	<u>\$100,362,935</u>	<u>\$ 1,884,428</u>	<u>\$102,247,364</u>
	<u>2016</u>		
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Dividends and interest	\$ 4,427,772	\$ 74,543	\$ 4,502,315
Equity in earnings of limited partnerships	12,005,504	166,681	12,172,185
Realized gains on sales of investments	<u>19,920,325</u>	<u>308,393</u>	<u>20,228,718</u>
Investment income – net	36,353,601	549,617	36,903,218
Unrealized losses on trading securities	<u>(3,130,060)</u>	<u>(28,006)</u>	<u>(3,158,066)</u>
Total investment return	<u>\$ 33,223,541</u>	<u>\$ 521,611</u>	<u>\$ 33,745,152</u>

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

5. Pledges Receivable

Unconditional promises to give cash and other assets are recorded at fair value in the year that they are made net of an allowance for uncollectible accounts and discounted to their present value. Promises to give that are expected to be received in future years are discounted at 2.82% at both December 31, 2017 and 2016. Conditional promises to give are recorded at the time they become unconditional and are reported in prepaid expenses and other assets in the current and long-term assets of the accompanying consolidated balance sheets.

The payment terms of the pledges receivable are as follows:

	<u>2017</u>	<u>2016</u>
Receivable in less than one year	\$ 4,739,501	\$ 3,867,246
Receivable in one to five years	2,836,928	1,780,982
Receivable in more than five years	<u>5,000</u>	<u>35,000</u>
Total promises to give	7,581,429	5,683,228
Less – allowance for uncollectible accounts and discount	<u>(138,145)</u>	<u>(143,529)</u>
	<u>\$ 7,443,284</u>	<u>\$ 5,539,699</u>

6. Long-Term Debt

Long-term debt is comprised of the following as of December 31:

	<u>2017</u>	<u>2016</u>
Hospital Revenue Refunding Bonds (Series 2010) issued through the Industrial Development Authority of Arlington County, Virginia (the Authority) dated March 24, 2010. Principal payments ranging from \$1,000,000 in July 2011 to \$9,875,000 in July 2031 are due annually	\$ 105,035,000	\$ 110,835,000
Net unamortized bond premium	1,867,855	2,114,402
Net unamortized bond discount	(390,820)	(442,406)
Net unamortized debt issuance costs	<u>(418,902)</u>	<u>(474,195)</u>
	106,093,133	112,032,801
Less – current portion	<u>6,125,000</u>	<u>5,800,000</u>
	<u>\$ 99,968,133</u>	<u>\$ 106,232,801</u>

On March 24, 2010, the Corporation obtained a loan of \$139,410,000 representing proceeds of tax exempt revenue bonds issued by the Authority (Series 2010 Bonds). The Series 2010 Bonds were issued at a net premium of \$3,215,577.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

Principal repayments due in each of the next five years are as follows:

2018	\$ 6,125,000
2019	6,255,000
2020	5,985,000
2021	6,225,000
2022	6,475,000
Thereafter	<u>73,970,000</u>
	<u>\$ 105,035,000</u>

The Series 2010 Bonds have a fixed interest rate of 4.5% per annum. Interest expense for the years ended December 31, 2017 and 2016 was \$5,003,877 and \$5,273,319, respectively. Interest paid during the years ended December 31, 2017 and 2016 was \$5,287,200 and \$5,551,200, respectively.

7. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes as of December 31:

	<u>2017</u>	<u>2016</u>
Clinical programs	\$ 14,778,070	\$ 12,489,514
Training and education	<u>5,230,711</u>	<u>5,095,078</u>
	<u>\$ 20,008,781</u>	<u>\$ 17,584,592</u>

Permanently restricted net assets as of December 31, 2017 and 2016 consist of investments to be held in perpetuity, the income from which is expendable to support Hospital programs. Permanently restricted net assets totaled \$1,736,829 and \$1,734,962 as of December 31, 2017 and 2016, respectively.

Current accounting standards require certain disclosures for donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA). The Commonwealth of Virginia has adopted UPMIFA. In management's opinion, the adoption of UPMIFA had no impact on the accounting for the Corporation's endowment.

Net assets released from donor restrictions during 2017 and 2016 by expending funds satisfying the restricted purposes or by occurrence of other events specified by donors are as follows:

	<u>2017</u>	<u>2016</u>
Purchase of property and equipment	\$ 1,750,432	\$ 754,085
Research, professional education, faculty support, uncompensated care and other (included in other operating revenue)	<u>8,372,878</u>	<u>4,128,583</u>
	<u>\$ 10,123,310</u>	<u>\$ 4,882,668</u>

8. Employees' Retirement Plans

The Corporation has 401(k) and 403(b) defined contribution retirement plans (the Plans) that cover substantially all employees who meet certain age and service requirements. The Plans provide that the Corporation make a matching contribution of 100% for each \$1.00 contributed by a participant not to exceed 8% of the participant's compensation. The Corporation's total contributions related to the Plans for the years ended December 31, 2017 and 2016 were approximately \$5,778,000 and \$5,431,000, respectively.

9. Operating Leases

The Corporation leases various facilities under operating leases with expiration dates ranging from December 2017 to March 2021. Future minimum lease payments under noncancelable operating leases as of December 31, 2017 are as follows:

2018	\$ 1,442,385
2019	1,326,324
2020	1,355,153
2021	1,401,798
2022	1,295,004
Thereafter	<u>1,920,973</u>
	<u>\$ 8,741,637</u>

Rental expense totaled \$5,142,524 and \$4,962,026 for the years ended December 31, 2017 and 2016, respectively.

10. Insurance

Professional and general liability

Effective October 2002, the Corporation is self-insured through a revocable trust for professional and general liability claims that are funded annually based upon an actuarial determination. In addition, the Corporation maintains umbrella coverage from a commercial carrier in excess of the basic self-insurance protection. The Corporation has purchased "tail" coverage for claims arising prior to October 2002. The Corporation accrues the estimated cost of asserted and unasserted professional and general liability claims in the period in which the healthcare services are rendered. It is the opinion of management, based on the advice of actuarial and legal counsel, that the consolidated financial statements adequately provide for losses resulting from potential unasserted claims and pending or threatened litigation. Amounts accrued as of December 31, 2017 and 2016 were \$9,559,200 and \$9,902,400, respectively.

Worker's compensation

The Corporation is self-insured with respect to employee worker's compensation costs. Losses from worker's compensation claims identified under the Corporation's incident reporting system, as well as provisions for estimated losses from incurred but not reported incidents, are accrued based on estimates that incorporate the Corporation's past experience as well as other considerations, including the nature of claims or incidents and relevant trend factors. Amounts accrued as of December 31, 2017 and 2016 were \$1,367,510 and \$1,712,721, respectively.

Health insurance

The Corporation is self-insured with respect to employee health benefit costs. Health benefit costs are accrued based on past experience and other factors such as healthcare cost trend factors. Amounts accrued as of December 31, 2017 and 2016 were \$3,041,562 and \$3,259,081 respectively.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

11. Concentrations of Credit Risk

The Corporation maintains cash balances in various financial institutions. The balances at the financial institutions are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. At various times there were balances in the financial institutions in excess of the FDIC limit. The Corporation has not experienced any loss in such accounts.

The Corporation grants credit without collateral to its patients, many of whom are insured under third-party agreements. The mix of accounts receivable from patients and third-party payors as of December 31, 2017 and 2016 is as follows:

	<u>2017</u>	<u>2016</u>
Medicare	28%	27%
Medicaid	6%	8%
HMO/PPO	47%	50%
Other commercial payors	3%	1%
Other	<u>16%</u>	<u>14%</u>
	<u><u>100%</u></u>	<u><u>100%</u></u>

12. Fair Value of Financial Instruments

The three-level hierarchy for fair value measurements is based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Corporation's market assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1:** Quoted prices for *identical* instruments in active markets;
- Level 2:** Quoted prices for *similar* instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose significant inputs are observable;
- Level 3:** Instruments whose significant inputs are *unobservable*.

The following is a description of the Corporation's valuation methodologies used to measure and disclose the fair value of its financial assets and liabilities on a recurring basis:

Cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, accrued salaries, wages and related items, settlements due to third-party payor programs, and interest payable – the carrying amount reported in the consolidated balance sheets approximates fair value due to the short-term nature of these instruments.

Investments – These assets consist primarily of cash and cash equivalents, short-term investments, marketable equity securities, common collective trusts, and accrued income. The carrying amount of cash and cash equivalents and accrued income reported in the consolidated balance sheets approximates fair value due to the short-term nature of these instruments. Short-term investments include certificates of deposit and U.S. T-bills. Valuation of marketable equity securities is determined by external pricing agencies, over which management exercises oversight to ensure materially accurate valuations. The fair values are based on quoted market prices, if available, or estimated using quoted market prices for similar investments.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

Assets limited as to use – These assets consist primarily of cash, marketable equity securities, common collective trusts, and accrued income. The carrying amount of cash and accrued income reported in the consolidated balance sheets approximates fair value due to the short-term nature of these instruments. Valuation of marketable equity securities is determined by external pricing agencies, over which management exercises oversight to ensure materially accurate valuations. The fair values are based on quoted market prices. Common collective trusts are valued at the net asset value units of the collective trust. Net asset value is used as a practical expedient to estimate fair value. Net asset value is based on the fair value of the underlying investments held by the fund less its liabilities.

Long-term debt – Fair value is determined based on interest rates currently available to hospitals for debt with similar terms and remaining maturities. As of December 31, 2017 and 2016, the fair value of long-term debt approximates \$110,952,000 and \$118,008,000, respectively.

Following is a summary of investments measured at fair value on a recurred basis by the level of significant input as of December 31, 2017:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Investments:				
Cash and cash equivalents	\$ 10,933,485	\$ -	\$ -	\$ 10,933,485
Short-term investments	117,407,444	7,102,959	-	124,510,403
Marketable equity securities				
Equity securities	102,064,912	-	-	102,064,912
Mutual funds	166,444,364	-	-	166,444,364
Accrued income	342	-	-	342
Assets limited as to use:				
Cash and cash equivalents	11,668,915	-	-	11,668,915
Short-term investments	3,195,864	193,345	-	3,389,208
Marketable securities				
Equity securities	2,778,235	-	-	2,778,235
Mutual funds	4,530,662	-	-	4,530,662
Accrued income	<u>8</u>	<u>-</u>	<u>-</u>	<u>8</u>
	<u>\$419,024,231</u>	<u>\$ 7,296,304</u>	<u>\$ -</u>	426,320,535
Common collective trusts at net asset value:				
Investments				288,716,978
Assets limited as to use				<u>7,858,956</u>
				<u>\$722,896,469</u>

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Notes to Consolidated Financial Statements

Following is a summary of investments measured at fair value on a recurring basis by the level of significant input as of December 31, 2016:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Investments:				
Cash and cash equivalents	\$13,876,548	\$ -	\$ -	\$ 13,876,548
Short-term investments	104,448,667	15,601,018	-	120,049,685
Marketable equity securities				
Equity securities	79,809,519	-	-	79,809,519
Mutual funds	145,196,484	-	-	145,196,484
Accrued income	3,113	-	-	3,113
Assets limited as to use:				
Cash and cash equivalents	11,830,137	-	-	11,830,137
Short term investments	2,870,876	428,810	-	3,299,686
Marketable securities				
Equity securities	2,193,644	-	-	2,193,644
Mutual funds	3,990,870	-	-	3,990,870
Accrued income	86	-	-	86
	<u>\$364,219,944</u>	<u>\$16,029,828</u>	<u>\$ -</u>	<u>\$380,249,772</u>
Common collective trusts at net asset value:				
Investments				250,609,497
Assets limited as to use				<u>6,888,252</u>
				<u>\$637,747,521</u>

13. Functional Expenses

The Corporation provides healthcare services to residents of Arlington, Virginia and the surrounding communities. Expenses related to providing those services are as follows for the years ended December 31:

	<u>2017</u>	<u>2016</u>
Healthcare services	\$ 450,516,173	\$ 415,505,523
General and administrative	<u>21,777,486</u>	<u>21,834,481</u>
	<u>\$ 472,293,659</u>	<u>\$ 437,340,004</u>

14. Commitments and Contingencies

Certificate of public need commitment

On December 15, 2006, the Corporation purchased land, building, and fixed equipment located at 601 South Carlin Springs Road, Arlington, Virginia. This facility houses the Arlington Urgent Care Center and the Arlington Pediatric Center and other departments of the Corporation.

The property is currently subject to the terms of a Certificate of Public Need (CPN) issued to the seller by the Virginia Department of Health. The CPN requires that an urgent care facility be maintained and operated on the property. As a part of the agreement to purchase the property, the Corporation has committed to operate an urgent care facility on the property subject to ongoing operating subsidies provided by the seller. The Corporation's commitment

Virginia Hospital Center Arlington Health System and Affiliated Organizations Notes to Consolidated Financial Statements

to operate the urgent care center will terminate upon withdrawal of the urgent care facility requirement by the Virginia Department of Health or abandonment by the seller. As of December 31, 2017, the urgent care facility obligation had not been terminated.

Electronic health record

In 2017, the Corporation began a two-year implementation of a new electronic health record (EHR). During 2017, nonrecurring operating expenses related to the EHR conversion were approximately \$15,300,000, and capitalized costs were approximately \$20,700,000. Future commitments related to this project at December 31, 2017 were approximately \$44,400,000.

Risk factors

The Corporation provides general acute healthcare services in the Commonwealth of Virginia. The Corporation and other healthcare providers in Virginia are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the federal Medicare and state Medicaid programs;
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging malpractice and related claims.

Such inherent risks require the use of certain management estimates in the preparation of the Corporation's consolidated financial statements, and it is reasonably possible that a change in such estimates may occur.

The federal Medicare and state Medicaid reimbursement programs represent a substantial portion of the Corporation's revenues, and the Corporation's operations are subject to a variety of other federal, state and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on the Corporation.

The Commonwealth of Virginia must operate with balanced budgets and since the Medicaid program is one of the state's largest programs, it is possible that Virginia will enact or consider enacting legislation designed to reduce its Medicaid expenditures. The effect of the change in federal and state reimbursement funding mechanisms and related government budgetary constraints on the Corporation cannot be reasonably estimated at this time.

The healthcare industry is subject to numerous laws and regulations from federal, state and local governments. The Corporation's compliance with these laws and regulations can be subject to periodic governmental review and interpretation, which can result in regulatory action unknown or unasserted at this time. The Corporation is subject to legal claims and regulatory matters arising in the ordinary course of business. Management is not aware of any legal claim or regulatory matter that would result in losses in excess of insurance limits or have a materially adverse effect on the Corporation's financial position, results of operations or liquidity.

As a result of enacted and pending federal healthcare reform legislation, substantial changes are occurring in the United States healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement of healthcare providers and the legal obligations of health insurers, providers and employers. These provisions are currently slated to take effect at specified times over the next few years.

Supplementary Consolidating Information

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidating Balance Sheet Information
December 31, 2017

ASSETS	Virginia Hospital Center	Physician Services	Community Services	Real Estate	Foundation	Eliminations	Consolidated
Current assets:							
Cash and cash equivalents	\$ 14,405,915	\$ 900	\$ 650	\$ -	\$ -	\$ -	\$ 14,407,465
Current portion of assets whose use is limited	2,498,600	-	-	-	-	-	2,498,600
Accounts receivable, net	45,409,838	2,131,019	224,016	-	-	-	47,764,873
Inventories	12,664,645	-	-	-	-	-	12,664,645
Prepaid expenses and other assets	5,426,868	228,982	316,493	1,144,517	4,498,856	-	11,615,716
Total current assets	80,405,866	2,360,901	541,159	1,144,517	4,498,856	-	88,951,299
Investments	798,875,450	-	-	-	-	-	798,875,450
Assets whose used is limited:							
Held by trustee under bond indenture	2,501,888	-	-	-	-	-	2,501,888
Self-insurance trust	8,869,416	-	-	-	-	-	8,869,416
By donors	21,745,610	-	-	-	-	-	21,745,610
	33,116,914	-	-	-	-	-	33,116,914
Less assets available for current liabilities	(2,498,600)	-	-	-	-	-	(2,498,600)
	30,618,314	-	-	-	-	-	30,618,314
Property and equipment:							
Land and land improvements	2,857,208	-	-	2,348,683	-	-	5,205,891
Buildings and fixed equipment	303,109,831	2,745,740	298,912	5,356,412	7,631	-	311,518,526
Movable equipment	341,419,559	2,657,539	439,011	67,191	42,465	-	344,625,765
Construction in progress	36,215,181	-	-	-	-	-	36,215,181
	683,601,779	5,403,279	737,923	7,772,286	50,096	-	697,565,363
Less accumulated depreciation	439,840,361	3,210,009	544,073	2,935,558	41,561	-	446,571,562
	243,761,418	2,193,270	193,850	4,836,728	8,535	-	250,993,801
Interest in net assets of Foundation	7,315,475	-	-	-	-	(7,315,475)	-
Other assets	-	-	-	-	2,808,084	-	2,808,084
Total assets	\$1,160,976,523	\$ 4,554,171	\$ 735,009	\$ 5,981,245	\$ 7,315,475	\$ (7,315,475)	\$1,172,246,948

See independent auditors' report.

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidating Balance Sheet Information
December 31, 2017

(Continued)

	Virginia Hospital Center	Physician Services	Community Services	Real Estate	Foundation	Eliminations	Consolidated
LIABILITIES AND NET ASSETS							
Current liabilities:							
Accounts payable and accrued expenses	\$ 38,737,898	\$ 2,243,606	\$ 76,419	\$ 34,565	\$ -	\$ -	\$ 41,092,488
Accrued salaries, wages and related items	9,439,746	1,291,669	-	-	-	-	10,731,415
Settlement due to third-party payment programs	14,085,430	-	-	-	-	-	14,085,430
Interest payable	2,498,600	-	-	-	-	-	2,498,600
Other liabilities	220,227	-	-	10,500	-	-	230,727
Current portion of long-term debt	6,125,000	-	-	-	-	-	6,125,000
Total current liabilities	71,106,901	3,535,275	76,419	45,065	-	-	74,763,660
Inter company amounts	(1,256,337)	-	-	1,256,337	-	-	-
Other long-term liabilities	10,926,710	-	-	-	-	-	10,926,710
Long-term debt, net - less current portion	99,968,133	-	-	-	-	-	99,968,133
Total liabilities	180,745,407	3,535,275	76,419	1,301,402	-	-	185,658,503
Net assets:							
Unrestricted	958,879,762	1,018,896	264,334	4,679,843	47,539	(47,539)	964,842,835
Temporary restricted	19,614,525	-	394,256	-	7,267,936	(7,267,936)	20,008,781
Permanently restricted	1,736,829	-	-	-	-	-	1,736,829
	980,231,116	1,018,896	658,590	4,679,843	7,315,475	(7,315,475)	986,588,445
Total liabilities and net assets	\$1,160,976,523	\$ 4,554,171	\$ 735,009	\$ 5,981,245	\$ 7,315,475	\$ (7,315,475)	\$1,172,246,948

Virginia Hospital Center Arlington Health System and Affiliated Organizations
Consolidating Schedule of Operations Information
Years Ended December 31, 2017

	Virginia Hospital Center	Physician Services	Community Services	Real Estate	Foundation	Eliminations	Consolidated
Operating revenue:							
Patient service revenue (net of contractual allowances and discounts)	\$ 448,968,560	\$ 29,290,802	\$ 3,427,941	\$ -	\$ -	\$ -	\$ 481,687,303
Less: provision for bad debts	(24,263,256)	(361,090)	(27,837)	-	-	-	(24,652,183)
	424,705,304	28,929,712	3,400,104	-	-	-	457,035,120
Other operating revenue	12,022,890	-	1,527,844	1,132,994	2,079,493	(1,488,601)	15,274,620
Total operating revenue	436,728,194	28,929,712	4,927,948	1,132,994	2,079,493	(1,488,601)	472,309,740
Operating expenses:							
Salary, wages and benefits	208,388,817	36,972,688	4,780,169	696,332	1,124,186	-	251,962,192
Supplies and other	166,418,058	10,960,819	1,438,452	1,178,065	668,647	(1,488,601)	179,175,440
Professional fees	5,717,156	696,585	-	-	-	-	6,413,741
Depreciation	28,882,295	589,175	36,821	227,832	2,286	-	29,738,409
Interest	5,003,877	-	-	-	-	-	5,003,877
Total operating expenses	414,410,203	49,219,267	6,255,442	2,102,229	1,795,119	(1,488,601)	472,293,659
Operating income (loss)	22,317,991	(20,289,555)	(1,327,494)	(969,235)	284,374	-	16,081
Nonoperating gains (losses):							
Investment income, net	50,277,415	-	-	-	-	-	50,277,415
Unrealized losses on trading investments	50,085,520	-	-	-	-	-	50,085,520
Other	(63,103)	-	-	(227,573)	-	-	(290,676)
Total nonoperating gains (losses)	100,299,832	-	-	(227,573)	-	-	100,072,259
Excess (deficiency) of revenue and gains over expenses and losses	\$ 122,617,823	\$ (20,289,555)	\$ (1,327,494)	\$ (1,196,808)	\$ 284,374	\$ -	\$ 100,088,340

See independent auditors' report.