WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Financial Statements and Supplementary Information

June 30, 2016 and 2015

(With Independent Auditors' Report Thereon)

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

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KPMG LLP
1 East Pratt Street
Baltimore, MD 21202-1128

Independent Auditors' Report

The Board of Directors
Western Maryland Health System Corporation:

We have audited the accompanying consolidated financial statements of Western Maryland Health System Corporation and subsidiaries, which comprise the consolidated balance sheets as of June 30, 2016 and 2015, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in 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 auditors consider 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 Western Maryland Health System Corporation and subsidiaries as of June 30, 2016 and 2015, and the results of its operations and its cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.

Other Matter

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplementary information in Schedules 1-3 is presented for purposes of additional analysis 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 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 information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

October 20, 2016

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Balance Sheets

June 30, 2016 and 2015

(Dollars in thousands)

Assets		**2016**	**2015**
Current assets:			
Cash and cash equivalents	$	72,949	73,669
Investments		26,145	18,265
Funds on deposit with trustee		17,205	10,340
Accounts receivable, less allowance for doubtful accounts of $3,439 in 2016 and $3,467 in 2015		37,134	38,839
Pledge receivable, net		273	116
Other receivables, less allowance for uncollectible accounts of $1,447 in 2016 and $1,064 in 2015		5,147	4,567
Inventories and other current assets		9,886	10,077
Total current assets		168,739	155,873
Investments		51,134	56,222
Board designated investments		10,150	10,075
Other long-term investments		411	433
Investments restricted by donor or grantor		5,314	5,177
Beneficial interest in trustee held Foundation assets		1,971	2,033
Property and equipment, net		288,845	299,161
Unamortized financing fees		2,208	2,325
Investments in affiliates		24,994	23,552
Other assets		5,097	4,939
Total assets	$	558,863	559,790
Liabilities and Net Assets			
Current liabilities:			
Current portion of long-term debt	$	11,472	2,900
Accounts payable and accrued liabilities		13,859	11,692
Accrued bond interest payable		5,975	7,440
Accrued salaries and benefits		10,800	13,014
Payable to third-party payors		7,623	6,644
Total current liabilities		49,729	41,690
Long-term debt, net of current portion		252,373	266,058
Pension benefits in excess of pension assets		112,152	70,486
Other liabilities		13,671	12,439
Total liabilities		427,925	390,673
Commitments and contingencies			
Net assets:			
Unrestricted:			
Unrestricted net assets		122,106	160,550
Noncontrolling interest in consolidated subsidiaries		1,292	1,294
Total unrestricted net assets		123,398	161,844
Temporarily restricted		5,313	4,980
Permanently restricted		2,227	2,293
Total net assets		130,938	169,117
Total liabilities and net assets	$	558,863	559,790

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Operations

Years ended June 30, 2016 and 2015

(Dollars in thousands)

		2016	2015
Unrestricted revenues, gains and other support:			
Patient service revenue (net of contractual allowances and charity)	$	319,910	312,100
Provision for bad debts		(7,363)	(6,988)
Net patient service revenue		312,547	305,112
Other revenue		7,046	6,854
Total revenues, gains and other support		319,593	311,966
Expenses:			
Salaries and wages		105,284	96,401
Employee benefits		35,862	30,611
Professional fees		18,198	14,569
Purchased services		45,821	41,362
Supplies		53,595	50,488
Utilities		4,705	4,307
Insurance		3,123	3,284
Interest		11,949	13,601
Depreciation and amortization		25,483	25,932
Other		7,863	7,707
Total expenses		311,883	288,262
Operating income		7,710	23,704
Nonoperating income:			
Equity in income of affiliates		1,215	4,068
Investment income, including realized gains on trading portfolio		1,508	2,828
Unrealized gains on trading portfolio		761	1,724
Other		(1,634)	(9,190)
Total nonoperating income (loss)		1,850	(570)
Excess of revenues over expenses	$	9,560	23,134

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2016 and 2015

(Dollars in thousands)

		Unrestricted net assets	Temporarily restricted net assets	Permanently restricted net assets	Total net assets
Balance at June 30, 2014	$	171,419	4,643	2,299	178,361
Excess of revenues over expenses		23,134	—	—	23,134
Investment gain		—	336	—	336
Donations		—	701	—	701
Grants		—	35	—	35
Change in funded status of pension plan		(30,076)	—	—	(30,076)
Net assets released for operations		—	(513)	—	(513)
Net assets released for purchase of property and equipment		222	(222)	—	—
Change in beneficial interest of trustee-held Foundation assets		—	—	(6)	(6)
Distributions to noncontrolling interest in consolidated subsidiaries		(2,855)	—	—	(2,855)
Change in net assets		(9,575)	337	(6)	(9,244)
Balance at June 30, 2015		161,844	4,980	2,293	169,117
Excess of revenues over expenses		9,560	—	—	9,560
Investment gain		—	25	—	25
Donations		—	1,388	—	1,388
Grants		—	72	—	72
Change in funded status of pension plan		(46,237)	—	—	(46,237)
Net assets released for operations		—	(595)	—	(595)
Net assets released for purchase of property and equipment		557	(557)	—	—
Change in beneficial interest of trustee-held Foundation assets		—	—	(66)	(66)
Distributions to noncontrolling interest in consolidated subsidiaries		(2,326)	—	—	(2,326)
Change in net assets		(38,446)	333	(66)	(38,179)
Balance at June 30, 2016	$	123,398	5,313	2,227	130,938

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Cash Flows

Years ended June 30, 2016 and 2015

(Dollars in thousands)

	2016	2015
Cash flows from operating activities:		
Change in net assets	$ (38,179)	(9,244)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	25,483	25,932
Amortization of bond financing costs and premiums	(3,171)	(1,134)
Loss on extinguishment of debt	1,782	9,152
Change in funded status of pension plan	46,237	30,076
Provision for bad debts	7,363	6,988
Distributions to noncontrolling interest holder	2,326	2,855
Loss on sale of assets	173	—
Equity in income of affiliates	(1,215)	(4,068)
Realized and unrealized gains on investments	(333)	(2,955)
Change in beneficial interest in trustee held Foundation assets	66	6
Restricted Contributions	(1,460)	(736)
Changes in assets and liabilities:		
Accounts receivable	(5,658)	(1,777)
Other receivables	(737)	(542)
Inventories and other current assets	191	(52)
Accounts payable and accrued liabilities, accrued bond interest payable and accrued salaries and benefits	(3,493)	1,349
Payable to third-party payors	979	353
Other assets, funded status of pension plan, and other liabilities	(3,497)	(5,271)
Net cash provided by operating activities	26,857	50,932
Cash flows from investing activities:		
Purchase of long-lived assets	(13,890)	(10,774)
Change in funds on deposit with trustee	(6,865)	45,977
Net change in investments	(2,814)	3,830
Investment in related organizations	—	(1,000)
Net cash (used in) provided by investing activities	(23,569)	38,033
Cash flows from financing activities:		
Proceeds from long-term debt	—	269,914
Repayments of long-term debt	(2,900)	(331,556)
Payment of deferred issuance costs	—	(2,392)
Capital lease payments	(176)	(115)
Proceeds from restricted contributions	1,460	736
Restricted investment loss	(66)	(6)
Distributions to noncontrolling interest holder	(2,326)	(2,855)
Net cash used in financing activities	(4,008)	(66,274)
Net (decrease) increase in cash and cash equivalents	(720)	22,691
Cash and cash equivalents at beginning of year	73,669	50,978
Cash and cash equivalents at end of year	$ 72,949	73,669
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 7,440	7,488
Capital additions accrued but not paid	578	777

See accompanying notes to consolidated financial statements.

(1) Mission and Organization

Western Maryland Health System Corporation (the Health System or WMHS) is a not-for-profit community health system. The mission of the Health System is to improve the health status and quality of life of the individuals and the communities served, especially those in need. The Health System provides patient and family centered services through responsible management of human and fiscal resources. The Health System is a values-driven health system that respects and supports life, preserves the dignity of each individual, and promotes a healthy and just society through collaboration with others who share the Health System's values.

The Health System accepts patients regardless of their ability to pay. Those patients who meet certain criteria under its charity care policies receive services at no charge or at an amount less than full charges. Essentially, these policies define charity services as those services for which no payment is anticipated. In addition to providing charity care, the Health System provides other programs and services for the general community. The Health System offers over 90 community health programs that include programs that target health education programs and health screenings to patients. A wide variety of health screenings are offered throughout the year for the general community that are free of charge or offered for a nominal fee. The Health System provides free education programs on a variety of health topics. The Health System also sponsors an annual community health fair, which provides health screenings, education and activities targeted to health and safety.

The Health System comprises the following wholly or partially owned, and controlled, consolidated subsidiaries in Cumberland, Maryland:

(a) Acute Care Hospital

Western Maryland Regional Medical Center – a full service community hospital located in Cumberland, Maryland, licensed for 228 acute care beds, owned and operated by the Health System.

(b) Long-Term Care

Frostburg Nursing and Rehabilitation Center (Frostburg)

(c) Other

Western Maryland Health System Foundation, Inc. (Foundation)

Western Maryland Insurance Company, Ltd. (WMIC)

Haystack Consolidated Services Inc. (Haystack)

Cumberland Properties, Inc. (Cumberland)

Memorial Medical Center Services, Inc. (MMCS)

Johnson Heights Medical Building Partnership (Johnson Heights)

Haystack Imaging Services, LLC (Haystack Imaging)

In addition, the Health System has investments in several unconsolidated affiliates, which are accounted for under the cost or equity methods of accounting, as appropriate (see note 6).

(2) Summary of Significant Accounting Policies

(a) Principles of Consolidation

The consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles, and include the accounts of the Health System and its subsidiaries and controlled entities. Significant intercompany accounts and transactions have been eliminated in consolidation. The Health System's consolidated financial statements reflect the respective interests of the minority investors in the joint ventures' net assets and changes in net assets.

(b) Investments in Affiliates

Investments in certain joint ventures, which are not controlled by the Health System, are accounted for using the cost or equity method of accounting as appropriate (see note 6). These investments are included as investments in affiliates in the accompanying consolidated balance sheets. The Health System's proportionate share of income or loss of the unconsolidated joint ventures is included in nonoperating income in the accompanying consolidated statements of operations.

(c) Cash Equivalents

Cash equivalents consist primarily of temporary investments with maturities of three months or less when purchased and certain overnight repurchase agreements. Overnight repurchases are principally unsecured and are subject to normal credit risk.

(d) Accounts Receivable

Patient accounts receivable are stated at estimated net realizable amounts from patients, third-party payors and other insurers when services are provided. The Health System bills the insurer directly for services provided. Insurance coverage and credit information is obtained from patients when available. No collateral is obtained for accounts receivable.

(e) Inventories

Inventories primarily consist of medical supplies and drugs and are carried at lower of cost or market. Cost is determined principally using the average cost method, which approximates the first-in first-out (FIFO) method.

(f) Investments

The Health System's investment portfolio, including board designated investments and investments restricted by donor or grantor, is considered a trading portfolio and is classified as current or noncurrent assets based on management's intention as to use. Accordingly, realized and unrealized gains and losses are included in investment income in the accompanying consolidated statements of operations. Dividend and interest income, as well as realized gains on sales of securities, are included in investment income.

 (Continued)

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the balance sheet. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities.

The Health System maintains operating reserves in investments equivalent to twelve months of capital asset expenditures and interest payments on the Health System's Series 2014 Revenue Bonds. That balance is maintained in the current asset section of the accompanying consolidated balance sheets.

(g) Property and Equipment

Property and equipment are stated at cost or, if donated, at fair market value at date of gift. Depreciation is determined using a straight-line basis over the estimated useful lives of the related assets. Repairs and maintenance are expensed as incurred.

Gifts of long-lived assets, such as land, building or equipment, or cash gifts to be used for purchase of long-lived assets, are reported as unrestricted support, and are excluded from the excess of revenues over expenses, 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 reported are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted net assets. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported as released from restrictions when the donated or acquired long-lived assets are placed in service.

The Health System opened a 275-bed, state-of-the-art hospital on November 21, 2009. Adjacent to the hospital is a 120,000-square-foot medical office building (MOB) previously owned and operated by a third-party medical office building developer until the purchase of the MOB by WMHS on February 17, 2011. The MOB includes both hospital services and physicians' office space.

(h) Impairment of Long-Lived Assets

Management regularly evaluates whether events or changes in circumstances have occurred that could indicate an impairment in the value of long-lived assets. In accordance with the provisions of Accounting Standards Codification (ASC) Subtopic 360-10, *Accounting for the Impairment or Disposal of Long-Lived Assets*, if there is an indication that the carrying amount of an asset is not recoverable, the Health System projects undiscounted cash flows, excluding interest, to determine if an impairment loss should be recognized. The amount of impairment loss is determined by comparing the historical carrying value of the asset to its estimated fair value. Estimated fair value is determined through an evaluation of recent and projected financial performance using discounted cash flows.

In addition to consideration of impairment upon the events or changes in circumstances described above, management regularly evaluates the remaining lives of its long-lived assets. If estimates are changed, the carrying value of affected assets is allocated over the remaining lives.

In estimating the future cash flows for determining whether an asset is impaired and if expected future cash flows used in measuring assets are impaired, the Health System groups the assets at the lowest level for which there are identifiable cash flows independent of other groups of assets. If such assets are impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets.

(i) Financing Costs

Financing costs incurred in issuing long-term debt have been deferred and are shown separately on the balance sheet. These costs are being amortized using the effective interest method over the term of the related debt. In November 2014, the Health System issued new debt and refunded the previous debt. The unamortized balances were $2,208 and $2,325 at June 30, 2016 and 2015, respectively. Prior unamortized balances were written-off in conjunction with the refunding of prior debt.

(j) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are limited as to use by donors to a specific time period or purpose. Permanently restricted net assets are to be held in perpetuity at the instruction of the donor. Income from permanently restricted net assets is used as defined by the donor.

(k) Net Patient Service Revenue

In 1971, the Health Services Cost Review Commission (HSCRC) adopted a voluntary alternative rate system known as the Total Patient Revenue (TPR) program, initially established as a demonstration project. Under TPR, a prospective, fixed revenue budget is established by the HSCRC for the upcoming year. This fixed revenue budget incorporates all payors and is not adjusted for changes in volume, casemix or mix of inpatient services that occur during the year. The TPR revenue budget is adjusted annually for inflation and for population in a hospital’s service area.

Consistent with the objectives of healthcare reform, the TPR model eliminates “payment for volume” and is designed to encourage hospitals to operate efficiently by reducing utilization and managing patients in the most appropriate care delivery setting. TPR does not include physician services or other kinds of unregulated services (i.e. freestanding ambulatory centers) that fall outside of the jurisdiction of the HSCRC. The TPR agreement allows the Health System to adjust unit rates, within certain limits, to achieve the overall revenue budget for the Health System at year end. Any overcharge or undercharge versus the revenue budget is prospectively added to the subsequent year’s budget. While the TPR cap does not adjust for changes in volume or service mix, the TPR cap is adjusted annually for inflation, and for changes in payor mix, market share and uncompensated care. The HSCRC also may impose various revenue adjustments that could be significant in the future.

Effective July 1, 2013, the Health System and the HSCRC agreed to a three-year TPR contract.

Contractual adjustments, which represent the difference between amounts billed as patient service revenue and amounts paid by third-party payors, are accrued in the period in which the related services are rendered. Because the Health System does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as revenue.

The Maryland Medicaid program is administered primarily through independent licensed managed care organizations. The State of Maryland has contracts with these independent managed care organizations to manage the care to eligible participants. Amounts due from the Medicaid program in Maryland are primarily due from the independent managed care organizations.

Under certain provisions of the American Recovery and Reinvestment Act of 2009 (ARRA), federal incentive payments are available to hospitals, physicians and certain other professionals (Providers) when they adopt, implement or upgrade (AIU) certified electronic health record (EHR) technology or become "meaningful users," as defined under ARRA, of EHR technology in ways that demonstrate improved quality, safety and effectiveness of care. Providers can become eligible for annual Medicare incentive payments by demonstrating meaningful use of EHR technology in each period over four periods. Medicaid providers can receive their initial incentive payment by satisfying AIU criteria, but must demonstrate meaningful use of EHR technology in subsequent years in order to qualify for additional payments. Hospitals may be eligible for both Medicare and Medicaid EHR incentive payments; however, physicians and other professionals may be eligible for either Medicare or Medicaid incentive payments, but not both. The Health System satisfied the CMS AIU and/or meaningful use criteria. As a result, the Health System recognized $531 and $1,616 for the years ended June 30, 2016 and 2015, respectively, of Medicare and Medicaid EHR incentive payments in other operating revenues in the consolidated statement of operations.

(l) Excess of Revenues over Expenses

The consolidated statement of operations includes the performance indicator, excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, include unrealized gains and losses on other than trading securities, change in funded status of the pension plan, permanent transfers of assets to and from affiliates for other than goods and 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).

(m) Charity Care

The Health System, as an integral part of its mission, accepts and treats all patients without regard to their ability to pay. A patient is classified as a charity patient in accordance with established criteria. Charity care is the recognition of services rendered for which no payment is expected.

(n) Donations

Unconditional donations are included in income when pledged or received. Donations restricted as to use by the donor are reflected as additions to temporarily or permanently restricted net assets. Expenditures of temporarily restricted net assets are transferred to unrestricted net assets if for capital additions, or reported as other revenue if for operating purposes.

(Continued)

(o) Income Taxes

The Health System and substantially all of its affiliates are tax exempt organizations under Section 501(c)(3) of the Internal Revenue Code (IRC) and are not subject to income taxes except to the extent it has taxable income from activities that are not related to its exempt purpose. No provision for income taxes was required to be made in the consolidated financial statements for these entities.

Johnson Heights is a general partnership and Haystack Imaging is a limited liability company and both are not directly subject to income taxes. The results of their operations are included in the tax returns of their partners. Haystack and MMCS are taxable for profit entities, which recognized an immaterial amount of taxable losses during 2016 and 2015. There is a full valuation allowance against their deferred tax costs.

The Health System and affiliates account for tax provisions in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 740-10, *Accounting for Uncertainty in Income Taxes*, which creates a single model to address uncertainty in tax positions and clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. Under the requirements of ASC Subtopic 740-10, an entity could be required to record an obligation as the result of a tax position they have historically taken on various tax exposure items. The Health System and affiliates have determined that it did not have any uncertain tax positions as of June 30, 2016 and 2015.

(p) Use of Estimates

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

(q) Western Maryland Health System Foundation

The Foundation is controlled by the Health System and thus its assets, liabilities, net assets and results of operations are consolidated within the Health System's financial statements.

(r) Beneficial Interest in Trustee Held Assets

The Health System records a beneficial interest in several trusts (the assets of which are to be held in perpetuity) for which a portion of the income is to be distributed to the Health System. These changes in the fair value of the trusts are recorded as unrealized gains/losses in permanently restricted net assets.

(s) Trivergent Health Alliance MSO

On July 6, 2014, Western Maryland Health System Corporation, Frederick Regional Health System, and Meritus Health, three regional nonprofit health systems, formed Trivergent Health Alliance, LLC. The three key objectives of the Alliance are to improve the health of the population served by the three hospitals, improve the quality of care rendered by the hospitals and to reduce the cost of healthcare provided as embodied in the Management Services Organization (MSO). A subsidiary, Trivergent Health Alliance MSO, LLC, was created to oversee six key service lines for the three hospitals: supply chain, revenue cycle, laboratory, pharmacy, information systems, and human resources. The Health System incurred $23,192 and $21,424 in expenses related to Trivergent during the years ending June 30, 2016 and 2015, respectively for these services. These amounts are currently recorded in the purchased services caption in the consolidated statement of operations.

(t) Pension Plan

For employees hired prior to July 1, 2011, the Health System has a noncontributory defined benefit pension plan covering substantially all of its employees upon their retirement. Since 2008, the benefits are based on age, years of service and career average pay. Grandfathered employees prior to 2008 are based on age, years of service and final average pay based on their five highest paid years of their last 10 years of service. Effective July 1, 2011, employees hired or rehired will not participate in the plan. These employees will participate in a defined contribution plan that has been developed.

For the defined benefit pension plan, the Health System records annual amounts relating to its pension plan based on calculations that incorporate various actuarial and other assumptions including, discount rates, mortality, assumed rates of return, compensation increases, turnover rates and healthcare cost trend rates. The Health System reviews its assumptions on an annual basis and makes modifications to the assumptions based on current rates and trends when it is appropriate to do so. The Health System believes that the assumptions utilized in recording its obligations under its plans are reasonable based on its experience and market conditions.

(u) New Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Accounting Standards update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity’s contracts with customers. Particularly, that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled for those goods or services. Topic 606 is effective for fiscal year 2019.

The FASB issued ASU 2015-03, *Interest – Imputation of Interest*. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. This ASU requires retrospective application to all prior periods presented in the financial statements. ASU 2015-03 is effective for fiscal year 2017.

The FASB issued ASU No. 2016-02, *Leases (ASU 2016-02),* which will require lessees to recognize most leases on-balance sheet, which will increase their reported assets and liabilities. The adoption of ASU 2016-02 is effective in fiscal year 2020, and will require application of the new guidance at the beginning of the earliest comparable period presented. Early adoption is permitted.

The FASB issued ASU No. 2016-14, *Not-for Profit Entities (ASU 2016-14)*, which amends the requirements for financial statements and notes Topic 958, Not-for Profit Entities (NFP), and requires a NFP to:

- Reduces the number of net asset classes presented from three to two: with donor restrictions and without donor restrictions
- Requires all NFPs to present expenses by their functional and their natural classifications in one location in the financial statements;
- Requires NFPs to provide quantitative and qualitative information about management of liquid resources and availability of financial assets to meet cash needs within one year of the balance sheet date; and
- Retains the option to present operating cash flows in the statement of cash flows using either the direct or indirect method.

The adoption of ASU 2016-14 is effective fiscal year 2019, and is applied retrospectively in the year of adoption.

The FASB issued ASU 2015-07*, Fair Value Measurement (ASU 2015-07) Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share*. This ASU removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. ASU 2015-07 is effective in fiscal year 2017. This ASU requires retrospective application to all prior periods presented.

The Company does not anticipate that the adoption of these ASUs will have a material impact on its financial position and results of operations.

(v) Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation.

(Dollars in thousands)

(3) Accounts Receivable, Allowance for Doubtful Accounts and Business Concentrations

During fiscal years 2016 and 2015, net patient service revenue was received from the following payors:

	2016	2015
Medicare	55%	55%
Medicaid	18	19
Blue Cross	10	10
Self-pay	2	2
Other	15	14
	100%	100%

Gross accounts receivable at June 30, 2016 and 2015 consisted of the following payors:

	2016	2015
Medicare	43%	47%
Medicaid	20	19
Blue Cross	8	9
Self-pay	11	10
Other	18	15
	100%	100%

Patient accounts receivable are reduced by allowances for bad debts. In evaluating the collectability of accounts receivable, the Health System analyzes historical collections and write-offs and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for bad debts and provision for uncollectible accounts. Management regularly reviews its estimate and evaluates the sufficiency of the allowance for bad debts. The Health System analyzes contractual amounts due from patients who have third-party coverage and provides an allowance for doubtful accounts and a provision for bad debts. For patient accounts receivable associated with self-pay patients, which includes those patients without insurance coverage for a portion of the bill, the Health System records a significant provision for bad debts for patients that are unable or unwilling to pay for the portion of the bill representing their financial responsibility. Account balances are charged off against the allowance for doubtful accounts after all means of collection has been exhausted.

The activity in the allowance for bad debts is summarized as follows for the years ended June 30:

		2016	2015
Beginning balance as of July 1	$	3,467	4,353
Provision for uncollectible accounts		7,363	6,988
Less write offs		(7,391)	(7,874)
Ending balance as of June 30	$	3,439	3,467

(Continued)

(Dollars in thousands)

(4) Investments

Investments, which include Funds on deposit with trustees, Board designated investments, Investments restricted by donor or grantor, and other long-term investments consist of the following as of June 30:

		2016	2015
U.S. government obligations	$	5,088	14,158
Money market funds		31,002	27,689
Corporate stocks and other		44,220	29,732
Fixed income securities		30,049	28,933
	$	110,359	100,512

Investments have been classified in the accompanying consolidated balance sheets as follows as of June 30:

		2016	2015
Investments	$	77,279	74,487
Funds on deposit with trustee		17,205	10,340
Board designated investments		10,150	10,075
Other long-term investments		411	433
Investments restricted by donor or grantor		5,314	5,177
	$	110,359	100,512

Investment income and gains for assets limited as to use, cash equivalents, and other investments comprise the following for the years ended June 30:

		2016	2015
Income:			
Investment income	$	1,961	1,933
Realized (losses) gains on trading investment portfolio		(453)	895
Unrealized gains on trading investment portfolio		761	1,724
Restricted investment income		25	336
	$	2,294	4,888

(Continued)

(Dollars in thousands)

(5) Property and Equipment

Property and equipment and estimated useful lives (in years) are summarized as follows as of June 30:

		2016	2015
Land and land improvements (2–25 years)	$	14,851	14,756
Buildings and improvements (5–40 years)		331,997	333,157
Equipment (3–20 years)		198,800	190,568
Construction in progress		576	46
		546,224	538,527
Less accumulated depreciation		257,379	239,366
Property and equipment, net	$	288,845	299,161

Depreciation expense for the year ended June 30, 2016 was $25,367. Depreciation expense for the year ended June 30, 2015 was $25,744.

(6) Investments in Affiliates

Investments in affiliates and equity in income (loss) of affiliates are as follows as of and for the years ended June 30:

				Investment		Equity in income (loss)	
Name	Interest	Business		2016	2015	2016	2015
Maryland Physicians Care, Inc.	25.00%	State of Maryland Medicaid managed care	$	21,418	20,064	1,354	4,058
Other affiliates	0.14% to 33.33%	Supply purchasing and medical equipment		3,576	3,488	(139)	10
			$	24,994	23,552	1,215	4,068

Maryland Physician Care had the following summary financial information as of and for the years ended June 30, 2016 and 2015:

		2016	2015
Total assets	$	220,516	253,701
Total liabilities		134,844	150,931
Net Assets	$	85,672	102,770
Total revenues	$	899,594	875,669
Total expenses		906,587	853,053
Net income (loss)	$	(6,993)	22,616

(Dollars in thousands)

(7) Long-Term Debt

Long-term debt consists of the following as of June 30:

		2016	2015
Maryland Health and Higher Educational Facilities Authority (MHHEFA) Series 2014 Revenue Bonds, interest rate 4.0 to 5.25%	$	233,270	236,170
Capital leases		1,075	—
Net unamortized bond premium		29,500	32,788
Long-term debt		263,845	268,958
Less current portion of long-term debt		11,472	2,900
Long-term debt less current portion	$	252,373	266,058

Scheduled principal repayments on long-term debt for the years ending June 30 are as follows:

2017	$	11,472
2018		12,043
2019		12,640
2020		13,263
2021		13,717
Thereafter		171,210

In November 2006, proceeds from issuance of $348,650 and $2,180 Maryland Health and Higher Education Facilities Authority Series 2006, Series A and B bonds were obtained for the purpose of (1) financing the costs of acquisition, construction and equipping of the Western Maryland Regional Medical Center (see note 1) and (2) to refund prior debt issuances. The Health System redeemed $11,360 of the Series 2006A bonds in conjunction with their final endorsement in 2010.

Principal payments on the Series 2006A revenue bonds commenced on July 1, 2010, and were due semi-annually through January 1, 2035. Interest payments were due semi-annually commencing July 1, 2007. The total outstanding balance on the Series 2006B revenue bonds was paid on July 1, 2010. Interest on the Series 2006A bonds accrued at a rate of 4.0% to 5.0% per annum. As security for WMHS obligations, the Bond Authority has been granted a lien, claim on and a security interest in all of the Receipts of WMHS. The lien, claim and security interest continuously applies for the entire term of the Agreement.

The Federal Housing Authority (FHA) issued a commitment for mortgage insurance with respect to the project. The financing document contains quantitative and qualitative covenants (measured quarterly). The quantitative covenants include a debt service coverage ratio, a day’s cash on hand requirement, current ratio requirement, a net days in accounts receivable requirement, and restrictions on operating losses and revenue over expenses.

In November 2014, MHHEFA issued $236,170 in bonds (Series 2014 Bonds) on behalf of the System. The Series 2014 Bonds were issued as $171,035 serial bonds maturing 2015 through 2035 and $65,135 term bonds maturing 2034. The Series 2014 Bonds maturing on or after July 2025 are subject to redemption at the option of MHHEFA prior to maturity, beginning July 2024. The Series 2014 Bonds were issued at fixed rates. The proceeds from the transaction were used to refund the Series 2006A and B revenue bonds.

Principal payments on the Series 2014 revenue bonds commenced on July 1, 2015, and are due annually through July 1, 2035. Interest payments are due semi-annually commencing July 1, 2015. Interest on the Series 2014 bonds accrues at a rate of 4.0% to 5.25% per annum.

In 2009, the Health System amended their line of credit agreement with a bank that permits the Health System to borrow up to $1,000. There is no expiration date on the line of credit and the interest rate as of June 30, 2016 was 4.5%. The line of credit primarily supports a letter of credit agreement in the amount of $700. There was no outstanding balance as of June 30, 2016.

(8) Charity Care

The Health System utilizes a cost to charge ratio methodology to convert charity care to cost. Costs incurred are estimated based on the ratio of total operating expenses to gross charges applied to charity care charges. The amount of charges foregone for services and supplies furnished under the Health System’s Charity Care policy aggregated approximately $9,670 and $9,705 for the years ended June 30, 2016 and 2015, respectively. The total direct and indirect costs to provide the care amounted to approximately $7,156 and $7,182 for the years ended June 30, 2016 and 2015, respectively.

(9) Retirement Plans

The WMHS Retirement Plan (the Plan) is a noncontributory defined benefit plan, which covers substantially all full-time employees who meet certain age and service requirements. The Plan’s funding policy is to contribute, annually, the pension costs as determined by the Plan’s actuary, subject to adjustment for full funding limitations as defined by the IRC.

The Health System’s investment policy, established by the Investment Committee of the Finance Committee and approved by the Health System’s Board of Directors, is to ensure current and future benefit obligations are adequately funded in a cost effective manner. The investment guidelines are based on a time horizon of greater than five years. In establishing the risk tolerances, the ability to withstand short and intermediate term variability with some interim fluctuations in market value and rates of return may be tolerated in order to achieve the longer-term objectives.

The measurement date of the Plan is June 30.

(Continued)

(Dollars in thousands)

The component of the Plan's funded status, net periodic benefit costs and actuarial assumptions used in accounting for defined benefit plans for the years ended June 30, 2016 and 2015 are as follows:

		2016	2015
Change in projected benefit obligation:			
Projected benefit obligation at beginning of year	$	257,078	225,332
Service cost		5,747	5,453
Interest cost		11,195	9,911
Assumptions		36,197	15,397
Actuarial loss		3,622	9,777
Benefits paid		(9,580)	(8,792)
Projected benefit obligation at end of year		304,259	257,078
Change in plan assets:			
Plan assets at fair value at beginning of year		186,592	180,922
Actual return		95	4,462
Employer contributions		15,000	10,000
Benefits paid		(9,580)	(8,792)
Fair value of plan assets at end of year		192,107	186,592
Funded status at end of year	$	(112,152)	(70,486)

		2016	2015
Amounts recognized in unrestricted net assets:			
Net prior service costs	$	(4,320)	(4,985)
Net actuarial loss		139,547	93,975
Amounts recognized in unrestricted net assets	$	135,227	88,990

		2016	2015
Components of net periodic benefit costs:			
Service cost	$	5,747	5,453
Interest cost		11,195	9,911
Expected return on plan assets		(12,745)	(12,380)
Recognized prior service cost		(665)	(665)
Recognized net loss		6,898	4,995
Curtailment effect		—	(1,314)
Net periodic pension cost	$	10,430	6,000

(Dollars in thousands)

Deferred pension costs, which have not yet been recognized in periodic pension expense but are accrued in unrestricted net assets, are $135,227 and $88,990 at June 30, 2016 and 2015, respectively. Deferred pension costs represents unrecognized actuarial losses or unexpected changes in the projected benefit obligation and plan assets over time primarily due to changes in assumed discount rates and investment experience, unrecognized prior service costs, which is the impact of changes in plan benefits applied retrospectively to employee service previously rendered. The amount of deferred pension costs expected to be recognized as a component of net period pension costs during the year ending June 30, 2017 is $6,444.

	2016	**2015**
Weighted average assumptions – benefit obligations:		
Discount rate	3.51%	4.37%
Salary scale	3.50	3.50
Return on assets	7.00	7.00
Weighted average assumptions – net periodic expense:		
Discount rate	4.37%	4.29%
Salary scale	2.00	3.50
Return on assets	7.00	7.00

The accumulated benefit obligation for the defined benefit pension plan was $301,820 and $236,660 at June 30, 2016 and 2015, respectively.

The Health System's pension plan weighted average asset allocations at the measurement dates of June 30, 2016 and 2015, by asset category, are as follows:

	Percentage of plan assets		
	Target allocation	**2016**	**2015**
Asset class:			
Equities	60%	56%	56%
Fixed	40	44	44

The Health System expects to contribute $16,000 to the Plan for the fiscal year ending June 30, 2017.

The following benefit payments, which reflect expected future employee service, as appropriate, are expected to be paid in the following fiscal years ending June 30:

2017	$ 9,460
2018	9,512
2019	9,749
2020	9,913
2021	9,995
2022–2026	51,465

(Continued)

The expected benefits to be paid are based on the same assumptions used to measure the Health System's benefit obligation as of June 30, 2016.

Effective July 1, 2011, employees hired or rehired will not participate in the Plan. These employees will participate in the Health System sponsored defined contributions plan whereby the Health System will make a contribution on behalf of the employee into a retirement account in the name of the employee. The contribution amount is based on several factors including years of service and salary levels. The Health System recorded expense related to these employees of $778 and $723 for the years ended June 30, 2016 and 2015, respectively. All Health System employees are eligible to contribute a portion of their compensation to the defined contribution plan.

The Health System will match the employee contribution of the employee compensation at some level based on several factors. The Health System's expense related to the matching component of the plan for the years ended June 30, 2016 and 2015 was $1,602 and $1,640, respectively, and is included in employee benefits in the accompanying consolidated statements of operations.

(10) Self-Insurance Programs

(a) General and Professional Liability (GLPL)

On December 14, 2004, the Health System formed a new wholly owned insurance subsidiary, Western Maryland Insurance Company, Ltd. (WMIC), an exempted company under the Companies Law of the Cayman Islands, to provide GLPL insurance to the Health System and certain affiliates. Effective January 1, 2005, this subsidiary insures the Health System for its GLPL risks under a claims-made policy with a limit of $1,000 per claim and $4,000 in the aggregate. Claims in excess of $1,000 per claim and $4,000 in the aggregate, up to a limit of $25,000, have been reinsured with Zurich American Insurance Company, a highly rated independent third-party insurance company. The Health System's retained self-insurance risk under these policies is $1,000 per occurrence.

Management's estimate of the liability for GLPL claims, including incurred but not reported claims, is principally based on actuarial estimates performed by an independent third-party actuary. The Health System's estimated liability for GLPL claims, including incurred but not reported claims, totaled $12,763 and $11,603 as of June 30, 2016 and 2015, respectively. These amounts are included in other noncurrent liabilities in the accompanying consolidated financial statements. While management believes that this liability is adequate as of June 30, 2016, the ultimate liability may exceed the amount recorded. Additionally, the Health System has recorded an additional insurance recoveries receivable of $4,576 and $4,441 as of June 30, 2016 and 2015, respectively, included in other noncurrent assets.

(b) Workers' Compensation Insurance

In 2016 and 2015, the Health System participated in a self-insured plan for workers' compensation claims. Stop-loss coverage has been purchased through a commercial carrier for claims in excess of $500.

(Dollars in thousands)

The Health System has accrued a liability recorded in accrued salaries and benefits of $2,105 and $1,963 as of June 30, 2016 and 2015, respectively, for known and incurred but not reported claims. Management believes this accrual is adequate to provide for all workers' compensation claims that have been incurred through June 30, 2016. Additionally, there are no significant insurance recoveries related to workers' compensation as of June 30, 2016 and 2015.

(c) Health Insurance

The Health System is self-insured for employee health claims. Under these self-insurance plans, the Health System has accrued a liability for salaries and benefits of $1,530 and $1,462 as of June 30, 2016 and 2015, respectively, for known claims and incurred but not reported claims. Management believes this accrual is adequate to provide for all employee health claims that may have been incurred through June 30, 2016. Additionally, there are no material insurance recoveries related to employee health claims as of June 30, 2016 and 2015.

(11) Lease Commitments

Future minimum payments under noncancelable operating leases and service contracts with terms in excess of one year or more for the years ending June 30 are as follows:

2017	$	3,846
2018		3,350
2019		1,096
2020		259
2021		108
Thereafter		—
Total	$	8,659

Rental expense under operating leases amounted to $2,409 and $2,575 for the years ended June 30, 2016 and 2015, respectively.

(12) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets as of June 30, 2016 and 2015 are available for the following purposes:

		2016	2015
Temporary restrictions:			
Specific support of healthcare services	$	5,313	4,980
Permanent restrictions:			
Trustee held assets to be held in perpetuity, the income from which primarily is expendable to support health care services		2,227	2,293

(13) Fair Value of Financial Instruments

(a) Fair Value of Financial Instruments

The following methods and assumptions were used by the Health System in estimating the fair value of their financial instruments:

Cash and cash equivalents, investments, funds on deposit with trustee, board designated investments, patient accounts receivable, other assets, accounts payable, and accrued liabilities, payable to third-party payors, and other long term liabilities – The carrying amounts reported in the consolidated balance sheets approximate the related fair values.

The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Health System's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Health System based on the best information available in the circumstances.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and cash equivalents, accounts receivable, due from affiliates, other assets, line of credit, accounts payable, advances from third-party payors, due to affiliates, and accrued expenses – The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments.

Board designated and other investments – Equity and debt securities classified as trading are measured using quoted market prices at the reporting date multiplied by the quantity held.

(b) Long-Term Debt

The Series 2014 Bonds bear interest at fixed rates and, accordingly, had a carrying amount of $262,770 and $268,958 and a fair value of $260,865 and $266,816 as of June 30, 2016 and 2015 respectively.

The fair value of the Health System's long-term debt is measured using quoted offered-side prices when quoted market prices are available. If quoted market prices are not available, the fair value is determined by discounting the future cash flows of each instrument at rates that reflect, among other things, market interest rates and the Health System's credit standing. In determining an appropriate spread to reflect its credit standing, the Health System considers credit default swap spreads, bond yields of other long-term debt offered by the Health System, and interest rates currently offered for similar debt instruments of comparable maturities by the Health System's bankers as well as other banks that regularly compete to provide financing to the Health System.

(Dollars in thousands)

(c) Fair Value Hierarchy

The Health System adopted ASC Topic 820, *Fair Value Measurement*, on July 1, 2008 for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Health System has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The table below presents assets that are measured at fair value as of June 30, 2016 aggregated by the three level valuation hierarchy:

	2016			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
U.S. government obligations	$ 5,088	—	—	5,088
Money market funds	31,002	—	—	31,002
Corporate stocks and other	44,220	—	—	44,220
Fixed income securities	—	30,049	—	30,049
Total assets	$ 80,310	30,049	—	110,359

(Dollars in thousands)

The table below presents assets that are measured at fair values as of June 30, 2015 aggregated by the three level valuation hierarchy:

	2015			
	Level 1	Level 2	Level 3	Total
Assets:				
U.S. government obligations	$ 14,158	—	—	14,158
Money market funds	27,689	—	—	27,689
Corporate stocks and other	29,732	—	—	29,732
Fixed income securities	—	28,933	—	28,933
Total assets	$ 71,579	28,933	—	100,512

There were no significant transfers of investment assets between levels during the years ended June 30, 2016 and 2015.

The table below presents the pension plan's investable assets as of June 30, 2016 aggregated by the three level valuation hierarchy:

	2016			
	Level 1	Level 2	Level 3	Total
Assets:				
Mutual funds	$ 39,109	—	—	39,109
Fixed income securities	—	40,915	—	40,915
Other funds	—	106,186	5,897	112,083
Total assets	$ 39,109	147,101	5,897	192,107

(Continued)

(Dollars in thousands)

The table below presents the pension plan's investable assets as of June 30, 2015 aggregated by the three level valuation hierarchy:

	2015			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Money market funds	$ 155	—	—	155
Mutual funds	50,942	—	—	50,942
Fixed income securities	—	47,036	—	47,036
Other funds	—	82,151	6,308	88,459
Total assets	$ 51,097	129,187	6,308	186,592

There were no significant transfers of the pension plan's investable assets between levels during the years ended June 30, 2016 and 2015.

The change in the fair value of the pension assets valued using significant unobservable inputs (Level 3) was due to the following:

	Level 3 investment
Ending balance June 30, 2015	$ 6,308
Disbursements	(632)
Variable interest	272
Other adjustments	(51)
Ending balance June 30, 2016	$ 5,897

(14) Commitments and Contingencies

(a) Litigation

From time to time, the Health System and its subsidiaries are involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management believes that these matters will be resolved without a significant adverse effect on the Health System's future financial position or results from operations.

(b) Other Matters

The Health System has contracts with various physician groups to provide certain emergency, obstetric, hospitalists, and surgical services. Those contracts include certain income guarantee levels, which eliminate as volumes related to services provided increase. The Health System paid $4,168 and $3,230 related to the guarantee provisions of the contracts in 2016 and 2015, respectively.

(15) Regulation and Reimbursement

The Health System provides health care services primarily through one general acute care hospital. The Health System and other healthcare providers in Maryland are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the federal Medicare and state Medicaid programs;
- Regulation of hospital rates by the HSCRC;
- 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 Health System's consolidated financial statements and it is reasonably possible that a change in such estimates may occur.

The Medicare and state Medicaid reimbursement programs represent a substantial portion of the Health System's revenues and the Health System'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 Health System.

Change in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on the Health System.

The current rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on an agreement between the Center for Medicaid and Medicare Services (CMS) and the HSCRC. This agreement is based upon a waiver from Medicare prospective pay system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as all third-party payors elect to be reimbursed in Maryland under this program and the rate of increase for costs per hospital inpatient admission in Maryland is below the national average.

In January 2014, CMS approved Maryland's new waiver for a five-year period beginning January 1, 2014 for inpatient and outpatient hospital services. The new waiver ties hospital per capital revenue growth to the state's economic growth of 3.58%. CMS can require the state to submit a corrective action plan if targets for a given performance year are not met. The new waiver also imposes quality measures and encourages population health.

Under TPR, a prospective, fixed revenue budget is established by the HSCRC for the upcoming year. This fixed revenue budget incorporates all payors and is not adjusted for changes in volume, casemix or mix of inpatient services that occur during the year. The TPR revenue budget is adjusted annually for inflation and for population in a hospital's service area.

Consistent with the objectives of healthcare reform, the TPR model eliminates "payment for volume" and is designed to encourage hospitals to operate efficiently by reducing utilization and managing patients in the most appropriate care delivery setting. TPR does not include physician services or other kinds of unregulated services (i.e. freestanding ambulatory centers) that fall outside of the jurisdiction of the HSCRC. The TPR agreement allows the Health System to adjust unit rates, within certain limits, to achieve the overall revenue budget for the Health System at year end. Any overcharge or undercharge versus the revenue budget is prospectively added to the subsequent year's budget.

Effective July 1, 2013, the Health System and the HSCRC agreed to a three-year TPR contract.

(Dollars in thousands)

(16) Noncontrolling Interest

Effective June 30, 2012, the Health System adopted accounting guidance that requires a not-for-profit reporting entity to account for and present noncontrolling interests in a consolidated subsidiary as separate component of the appropriate class of consolidated net assets (equity). The reconciliation of noncontrolling interest reported in unrestricted net assets is as follows:

	WMHS Corporation	Noncontrolling interest	Unrestricted net assets
Balance at June 30, 2014	$ 169,861	1,558	171,419
Operating income	21,113	2,591	23,704
Nonoperating income	(570)	—	(570)
Excess of revenues over expenses	20,543	2,591	23,134
Change in funded status of pension plan	(30,076)	—	(30,076)
Net assets released for purchase of property and equipment	222	—	222
Distributions to noncontrolling interest in consolidated subsidiaries	—	(2,855)	(2,855)
Change in net assets	(9,311)	(264)	(9,575)
Balance at June 30, 2015	160,550	1,294	161,844
Operating income	5,386	2,324	7,710
Nonoperating income	1,850	—	1,850
Excess of revenues over expenses	7,236	2,324	9,560
Change in funded status of pension plan	(46,237)	—	(46,237)
Net assets released for purchase of property and equipment	557	—	557
Distributions to noncontrolling interest in consolidated subsidiaries	—	(2,326)	(2,326)
Change in net assets	(38,444)	(2)	(38,446)
Balance at June 30, 2016	$ 122,106	1,292	123,398

(Continued)

(Dollars in thousands)

(17) Functional Expenses

The Health System considers healthcare services and general and administrative to be its primary functional categories for purposes of expense classification. The Health System's operating expenses by functional classification are as follows for the years ended June 30:

		2016	2015
Healthcare services	$	278,512	256,551
General and administrative		33,371	31,711
	$	311,883	288,262

(18) Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2016 and through October 20, 2016. The Health System did not have any material recognizable subsequent events during this period.

Schedule 1

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Balance Sheet Information

June 30, 2016

(Dollars in thousands)

Assets	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Current assets:						
Cash and cash equivalents	$ 65,728	6,582	46	593	—	72,949
Investments	26,145	—	—	—	—	26,145
Funds on deposit with trustee	17,205	—	—	—	—	17,205
Accounts receivable, net	36,435	699	—	—	—	37,134
Pledge receivable, net	—	—	—	273	—	273
Other receivables, net	6,817	(10)	104	27	(1,791)	5,147
Inventories and other current assets	12,881	1	—	1	(2,997)	9,886
Total current assets	165,211	7,272	150	894	(4,788)	168,739
Investments	44,690	—	1,098	5,346	—	51,134
Board designated investments	10,150	—	—	—	—	10,150
Other long-term investments	78	—	—	333	—	411
Investments restricted by donor or grantor	500	—	—	4,814	—	5,314
Beneficial interest in trustee held and Foundation assets	—	—	—	1,971	—	1,971
Property and equipment, net	288,055	790	—	—	—	288,845
Unamortized financing fees	2,208	—	—	—	—	2,208
Investments in affiliates	25,045	—	(51)	—	—	24,994
Other assets	5,097	—	—	—	—	5,097
Total assets	$ 541,034	8,062	1,197	13,358	(4,788)	558,863

Schedule 1

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Balance Sheet Information

June 30, 2016

(Dollars in thousands)

Liabilities and Net Assets	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Current liabilities:						
Current portion of long-term debt	$ 11,472	—	—	—	—	11,472
Accounts payable and accrued liabilities	13,477	3,277	102	1,791	(4,788)	13,859
Accrued bond interest payable	5,975	—	—	—	—	5,975
Accrued salaries and benefits	10,541	259	—	—	—	10,800
Payable to third-party payors	7,623	—	—	—	—	7,623
Total current liabilities	49,088	3,536	102	1,791	(4,788)	49,729
Long-term debt, net of current portion	252,373	—	—	—	—	252,373
Pension benefits in excess of pension assets	112,152	—	—	—	—	112,152
Other liabilities	13,671	—	—	—	—	13,671
Total liabilities	427,284	3,536	102	1,791	(4,788)	427,925
Net assets:						
Unrestricted:						
Unrestricted net assets	111,958	4,526	1,095	4,527	—	122,106
Noncontrolling interest in consolidated subsidiaries	1,292	—	—	—	—	1,292
Total unrestricted net assets	113,250	4,526	1,095	4,527	—	123,398
Temporarily restricted	245	—	—	5,068	—	5,313
Permanently restricted	255	—	—	1,972	—	2,227
Total net assets	113,750	4,526	1,095	11,567	—	130,938
Total liabilities and net assets	$ 541,034	8,062	1,197	13,358	(4,788)	558,863

See accompanying independent auditors' report.

Schedule 2

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Operations Information

Year ended June 30, 2016

(Dollars in thousands)

	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Unrestricted revenues, gains and other support:						
Patient service revenue (net of contractual allowances and charity)	$ 312,493	7,417	—	—	—	319,910
Provision for bad debts	(7,159)	(204)	—	—	—	(7,363)
Net patient service revenue	305,334	7,213	—	—	—	312,547
Other revenue	7,488	18	—	—	(460)	7,046
Total revenues, gains and other support	312,822	7,231	—	—	(460)	319,593
Expenses:						
Salaries and wages	100,866	4,418	—	—	—	105,284
Employee benefits	34,582	1,280	—	—	—	35,862
Professional fees	18,123	69	—	6	—	18,198
Purchased services	44,892	913	—	436	(420)	45,821
Supplies	52,983	612	—	14	(14)	53,595
Utilities	4,520	185	—	—	—	4,705
Insurance	3,118	3	—	2	—	3,123
Interest	11,949	—	—	—	—	11,949
Depreciation and amortization	25,359	124	—	—	—	25,483
Other	6,906	842	—	141	(26)	7,863
Total expenses	303,298	8,446	—	599	(460)	311,883
Operating income (loss)	9,524	(1,215)	—	(599)	—	7,710

(Continued)

Schedule 2

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Operations Information

Year ended June 30, 2016

(Dollars in thousands)

		Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Nonoperating income:							
Equity in income (loss) of affiliates	$	1,333	—	(118)	—	—	1,215
Investment income		1,285	11	28	184	—	1,508
Unrealized gains (loss) on trading portfolio		936	—	3	(178)	—	761
Other		(1,589)	1	—	(46)	—	(1,634)
Total nonoperating income (loss)		1,965	12	(87)	(40)	—	1,850
Excess (deficiency) of revenues over (under) expenses	$	11,489	(1,203)	(87)	(639)	—	9,560

See accompanying independent auditors' report.

Schedule 3

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Changes in Net Assets Information

Year ended June 30, 2016

(Dollars in thousands)

	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Consolidated
Unrestricted net assets:					
Balance at June 30, 2015	$ 149,767	5,729	1,182	5,166	161,844
Excess of revenues over expenses	11,489	(1,203)	(87)	(639)	9,560
Change in funded status of pension plan	(46,237)	—	—	—	(46,237)
Net assets released for purchase of property and equipment	557	—	—	—	557
Distributions to noncontrolling interest in consolidated interest	(2,326)	—	—	—	(2,326)
Balance at June 30, 2016	113,250	4,526	1,095	4,527	123,398
Temporarily restricted net assets:					
Balance at June 30, 2015	58	—	—	4,922	4,980
Investment gain	—	—	—	25	25
Donations	692	—	—	696	1,388
Grants	72	—	—	—	72
Net assets released for operations	(20)	—	—	(575)	(595)
Net assets released for purchase of property and equipment	(557)	—	—	—	(557)
Balance at June 30, 2016	245	—	—	5,068	5,313
Permanently restricted net assets:					
Balance at June 30, 2015	260	—	—	2,033	2,293
Change in beneficial interest of trustee-held Foundation assets	(5)	—	—	(61)	(66)
Balance at June 30, 2016	255	—	—	1,972	2,227
Net assets at June 30, 2016	$ 113,750	4,526	1,095	11,567	130,938

See accompanying independent auditors' report.