Mercy Health Services, Inc. and Subsidiaries

Consolidated Financial Statements as of and for the Years Ended June 30, 2017 and 2016, and Independent Auditors' Report

DIXON HUGHES GOODMAN LLP

Audited Consolidated Financial Statements and Other Financial Information

Mercy Health Services, Inc. and Subsidiaries

June 30, 2017 and 2016

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DIXON HUGHES GOODMAN LLP

Independent Auditors' Report

Board of Trustees
Mercy Health Services, Inc. and Subsidiaries
Baltimore, Maryland

We have audited the accompanying consolidated financial statements of ***Mercy Health Services, Inc. and Subsidiaries***, which comprise the consolidated balance sheets as of June 30, 2017 and 2016, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of 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 did not audit the financial statements of Greenleaf Insurance Company, Ltd., a wholly owned subsidiary, which statements reflect total assets constituting 8% and 7% of consolidated total assets at June 30, 2017 and 2016, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Greenleaf Insurance Company, Ltd., is based solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

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

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

DHG

DIXON HUGHES GOODMAN LLP

Opinion

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ***Mercy Health Services, Inc. and Subsidiaries***, as of June 30, 2017 and 2016 and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in United States of America.

Change in Accounting Principle

As discussed in Note A to the financial statements, the Company adopted new accounting guidance on the presentation of debt issuance costs in 2017. Our opinion is not modified with respect to that matter.

Report on Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information on pages 52-59 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies, and is not a required part of the consolidated financial statements. Such information is the responsibility of management, 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, which insofar as it related to Greenleaf Insurance Company, Ltd., is based on the report of other auditors, 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
September 7, 2017

Mercy Health Services, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands)

June 30, 2016 and 2017

	2017	As Adjusted 2016
ASSETS		
CURRENT ASSETS		
Cash, cash equivalents	$ 114,444	$ 134,466
Short-term investments	33,402	448
Current portion of funds held by trustee or authority -- *Note E*	8,711	7,562
Resident prepayment deposits	608	764
Patient accounts receivable, net -- *Note B*	63,282	66,703
Other amounts receivable, net	7,377	7,005
Current pledges receivable, net -- *Note C*	2,907	4,235
Inventory	9,190	9,055
Other current assets	6,147	5,302
TOTAL CURRENT ASSETS	246,068	235,540
PROPERTY AND EQUIPMENT, net -- *Note D*	524,310	536,497
INVESTMENTS AND OTHER ASSETS		
Funds held by trustee or authority, less current portion -- *Note E*	10,127	10,305
Board designated and donor restricted investments -- *Note F*	172,521	154,883
Restricted cash, cash equivalents and investments	69,004	54,724
Long-term investments	6,998	6,945
Long-term pledges receivable, net -- *Note C*	5,139	6,450
Investments in and advances to affiliates -- *Note G*	3,097	916
Reinsurance balances receivable or recoverable -- *Note I*	3,374	5,810
Other assets -- *Note H*	14,114	16,353
TOTAL ASSETS	$ 1,054,752	$ 1,028,423

Consolidated Balance Sheets - Continued
(Dollars in thousands)

June 30, 2016 and 2017

	June 30, 2017	June 30, As Adjusted 2016
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Current maturities of long-term debt -- *Note J*	$ 8,844	$ 7,431
Accounts payable and accrued expenses	88,316	89,369
Advances from third-party payers	25,227	27,050
Resident prepayment deposits	610	764
Construction retainage	12	888
Line of credit -- *Note J*	-	7,875
TOTAL CURRENT LIABILITIES	123,009	133,377
Long-term debt -- *Note J*	402,216	411,372
Provision for outstanding losses -- *Note I*	66,266	59,359
Post-retirement obligation -- *Note M*	5,590	5,471
Interest rate swap liabilities -- *Note J*	17,976	28,531
Other long-term liabilities -- *Note W*	13,782	14,300
TOTAL LIABILITIES	628,839	652,410
NET ASSETS		
Unrestricted	394,131	344,067
Temporarily restricted -- *Note P*	29,604	29,768
Permanently restricted -- *Notes P and V*	2,178	2,178
TOTAL NET ASSETS	425,913	376,013
COMMITMENTS AND CONTINGENCIES -- *Notes I, J, L, M, N, R and U*		
TOTAL LIABILITIES AND NET ASSETS	$ 1,054,752	$ 1,028,423

See notes to the consolidated financial statements.

Mercy Health Services, Inc. and Subsidiaries

Consolidated Statements of Operations
(Dollars in thousands)

June 30, 2016 and 2017

	Year Ended June 30, 2017	As Adjusted 2016
REVENUE		
Patient service revenue (net of allowances and discounts) -- *Notes B and S*	$ 686,038	$ 662,053
Provision for bad debts	(15,856)	(12,886)
Net patient service revenue	670,182	649,167
Other operating revenue	30,588	34,440
Net assets released from restriction used for operations	4,711	3,590
TOTAL REVENUE	705,481	687,197
EXPENSES -- *Note Q*		
Salaries and benefits	382,241	379,876
Medical and surgical supplies	64,195	65,077
Pharmacy supplies	45,901	40,681
Other expendable supplies	28,504	27,011
Professional fees	17,599	16,521
Insurance	22,934	21,543
Other purchased services	53,382	52,738
Interest expense	16,268	17,246
Repairs	16,385	14,287
Depreciation and amortization	39,976	37,928
TOTAL EXPENSES	687,385	672,908
OPERATING INCOME	18,096	14,289
OTHER INCOME (LOSSES)		
Investment income -- *Note F*	9,325	1,078
Net unrealized gains (losses) on trading securities -- *Note F*	7,844	(1,032)
Unrealized gain (loss) on interest rate swaps	10,555	(6,638)
Gain on termination of interest rate swaps	373	-
Loss on early extinguishment of debt	-	(10,914)
Equity in joint ventures -- *Note G*	579	557
Other	(46)	42
NET OTHER INCOME (LOSS)	28,630	(16,907)
EXCESS OF REVENUE OVER EXPENSES (EXPENSES OVER REVENUE)	46,726	(2,618)
Changes to post retirement plans obligations -- *Notes M and N*	1,759	(431)
Net assets released from restrictions for the purchase of property and equipment	1,579	2,389
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$ 50,064	$ (660)

See notes to the consolidated financial statements.

Consolidated Statements of Changes in Net Assets
(Dollars in thousands)

June 30, 2016 and 2017

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Net assets, June 30, 2015	$ 344,727	$ 26,872	$ 2,178	$ 373,777
Excess of expenses over revenue	(2,618)	-	-	(2,618)
Net assets released from restrictions for the purchase of property and equipment	2,389	(2,389)	-	-
Restricted gifts, bequests, and contributions	-	8,875	-	8,875
Changes to post retirement plans obligations	(431)	-	-	(431)
Net assets released from restrictions used for operations	-	(3,590)	-	(3,590)
Change in net assets	(660)	2,896	-	2,236
Net assets, June 30, 2016	$ 344,067	$ 29,768	$ 2,178	$ 376,013
Excess of revenue over expenses	46,726	-	-	46,726
Net assets released from restrictions for the purchase of property and equipment	1,579	(1,579)	-	-
Restricted gifts, bequests, and contributions	-	6,126	-	6,126
Changes to post retirement plans obligations	1,759	-	-	1,759
Net assets released from restrictions used for operations	-	(4,711)	-	(4,711)
Change in net assets	50,064	(164)	-	49,900
Net assets, June 30, 2017	$ 394,131	$ 29,604	$ 2,178	$ 425,913

See notes to the consolidated financial statements.

Mercy Health Services, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Dollars in thousands)

June 30, 2016 and 2017

	Year Ended June 30, 2017	Year Ended June 30, As Adjusted 2016
OPERATING ACTIVITIES		
Change in net assets	$ 49,900	$ 2,236
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities		
Depreciation and amortization	39,976	37,928
Amortization of debt issuance cost	200	118
(Gain) loss on interest rate swaps	(10,555)	6,638
Gain on asset disposal	(49)	(42)
Realized and unrealized gains on investments	(14,936)	1,159
Restricted gifts, bequests, and contributions and restricted investment income	(3,487)	(6,958)
Loss on early extinguishment of debt	-	10,914
Provision for bad debts	15,856	12,886
Decrease (increase) in:		
Patient accounts receivable, net	(12,435)	(16,744)
Other amounts receivable and investments in and advances to affiliates	2,064	772
Pledges receivable	2,639	(1,917)
Inventory	(135)	(1,284)
Other assets	1,597	1,759
Restricted cash	(14,280)	(252)
Trading portfolio	(36,681)	16,816
Increase (decrease) in:		
Accounts payable and accrued expenses	(2,878)	5,953
Provision for outstanding losses	6,907	1,327
Post-retirement obligation	119	(829)
Other long-term liabilities	(516)	715
NET CASH AND CASH EQUIVALENTS PROVIDED BY OPERATING ACTIVITIES	23,306	71,195
INVESTING ACTIVITIES		
Purchases of property and equipment	(28,816)	(43,620)
Investment in joint venture	(2,181)	-
Increase in other assets	-	(1,847)
NET CASH AND CASH EQUIVALENTS USED IN INVESTING ACTIVITIES	(30,997)	(45,467)

Consolidated Statements of Cash Flows - Continued
(Dollars in thousands)

June 30, 2016 and 2017

(continued)

	Year Ended June 30, 2017	2016
FINANCING ACTIVITIES		
Proceeds from restricted gifts, bequests, contributions, and restricted investment income	$ 3,487	$ 6,958
Proceeds from (payments on) line of credit agreement	(7,875)	2,125
Repayment of long term debt	(7,943)	(21,379)
NET CASH AND CASH EQUIVALENTS USED IN FINANCING ACTIVITIES	(12,331)	(12,296)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(20,022)	13,432
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	134,466	121,034
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 114,444	$ 134,466

See notes to the consolidated financial statements.

June 30, 2016 and 2017

Note A – Organization and Summary of Significant Accounting Policies

Organization, Basis of Presentation and Principles of Consolidation

Mercy Health Services, Inc. (MHS) was formed for the purpose of supporting, benefiting, or carrying out some or all of the purposes of Mercy Medical Center, Inc. (Medical Center or MMC), Stella Maris, Inc. (SMI), the physician practice group comprising the Physician Enterprise (as further described below) and Mercy Health Foundation (MHF). MHS is the sole member of the Medical Center, SMI, the Physician Enterprise and MHF. MHS prepares its consolidated financial statements on the accrual basis of accounting. The accompanying consolidated financial statements include MMC, SMI, the Physician Enterprise, and MHF. All material intercompany balances and transactions have been eliminated.

1. **Mercy Medical Center, Inc.**

   The Medical Center, a subsidiary of MHS, provides inpatient, outpatient, and emergency care services primarily for the citizens of the Baltimore metropolitan area. In addition, the following entities are wholly owned subsidiaries of the Medical Center:

Name of Subsidiary	Tax Status
Mercy Transitional Care Services, Inc. (MTC) *Provider of subacute services*	Tax Exempt
Greenleaf Insurance Company, Ltd. (GIC) *Provider of self-insured general and malpractice coverage to MHS*	Foreign Subsidiary

2. **Stella Maris, Inc.**

   SMI, a subsidiary of MHS, is the sole member of the Stella Maris Operating Corporation, as well as the Cardinal Sheehan Center, Incorporated (CSC). SMI provides sub-acute, hospice, long-term care, skilled homecare, personal care, and adult day care to patients in the central Maryland service area within its 412-bed long-term care facility. CSC is engaged in maintaining and providing care and housing of aged and infirmed persons. CSC owns St. Elizabeth Hall, a 200-unit apartment complex for the elderly.

3. **Physician Enterprise**

   The Physician Enterprise includes Maryland Family Care, Inc. (MFC), St. Paul Place Specialists, Inc. (SPPS), and Maryland Specialty Services, LLC (MSS). MSS is the sole member of Lutherville Hematology and Oncology, LLC and North Calvert Anesthesiology Services, LLC, and is the sole stockholder of Vascular Specialty Services, Inc. These entities provide primary care and specialty services within the Baltimore area. MFC, SPPS and MSS are wholly owned/controlled subsidiaries of MHS.

4. Mercy Health Foundation, Inc.

MHF, a subsidiary of MHS, was formed to coordinate and strengthen the fundraising function on behalf of MHS.

Income Taxes

MHS, MMC, SMI, MFC, SPPS, MHF, and MSS are not-for-profit organizations exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code, and are therefore not subject to federal income tax under current income tax regulations. MHS subsidiaries otherwise exempt from federal and state taxation are nonetheless subject to taxation at corporate tax rates at both the federal and state level on their unrelated business income.

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 its 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 MHS’ accompanying consolidated financial statements related to uncertain income tax positions.

Unrestricted, Temporarily Restricted, and Permanently Restricted Net Assets

Unrestricted net assets represent contributions, gifts, and grants which have no donor-imposed restrictions or which arise as a result of operations. Temporarily restricted net assets are subject to donor-imposed stipulations that may or will be met either by satisfying a specific purpose and/or the passage of time. Permanently restricted net assets are subject to donor-imposed stipulations that they be maintained in perpetuity. Generally, the donors of these assets permit the use of all or part of the income earned on related investments for specific purposes (see Notes P and V).

Cash Equivalents and Short-Term Investments

MHS and certain of its subsidiaries invest in money market funds and U.S. Treasury Bills, which are highly liquid and have an original maturity of ninety days or less. These financial instruments are considered cash and cash equivalents and are recorded at cost, which approximates fair value. Short-term investments are highly liquid assets that have an original maturity between three months and one year.

Restricted Cash, Cash Equivalents, and Investments

Restricted cash, cash equivalents and investments represent funds that have been set aside to cover a portion of GIC’s estimated outstanding claims, and donor restricted funds from permanently and temporarily restricted net assets. At June 30, 2017, restricted cash, cash equivalents and investments of $69,004 was set aside to cover estimated outstanding claims and donor restricted funds. At June 30, 2016, restricted cash, cash equivalents and investments of $54,724 was set aside to cover estimated outstanding claims and donor restricted funds.

Investments

Investments include marketable securities with readily determinable fair values based on quoted market prices. Unrestricted investment income or losses are reported in the consolidated statements of operations as part of excess of revenue over expenses (expenses over revenue) unless the income is restricted by donor or law. Investments received by gift or bequest are reported at fair value at the date of the donation. Investment income and changes in the fair value of temporarily restricted and permanently restricted investments are recorded as increases or decreases in unrestricted, temporarily restricted or permanently restricted net assets in accordance with the terms of the donor's original gift or bequest.

Investments also include investments in limited partnerships and other alternative investments, which are made in accordance with the investment policies of MHS and are monitored through quarterly performance reviews. The limited partnerships acquire, hold, invest, manage, dispose of, and otherwise deal in and with securities of all kinds and descriptions. Publicly traded securities are valued using generally accepted pricing services selected by the fund managers of the limited partnerships. Securities not valued by such pricing services are valued upon bid quotations obtained from independent dealers in the securities. In the absence of any independent quotations, securities are valued by the fund managers on the basis of data obtained from the best available sources.

Although the various fund managers use their best judgment at estimating the fair value of the alternative investments, there are inherent limitations in any valuation technique. Therefore, the value is not necessarily indicative of the amount that could be realized in a current transaction. Future events will also affect the estimates of fair value, and the effect of such events on the estimates of the fair value could be material (see Note K).

Donor-Restricted Gifts

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

Inventories

Inventories are stated at the lower of cost, determined by the first-in, first-out method, or market.

Advance from Third-Party Payers

The Medical Center receives advances from third-party payers to provide working capital for services rendered to the beneficiaries of such services. These advances are subject to periodic adjustment, and are principally determined based on the timing difference between the provision of care and the anticipated payment date of the claim for service.

(Dollars in thousands)

Net Patient Service Revenue and Allowances

Net patient service revenue are reported at the estimated net realizable amounts from patients, third-party payers, and others for services rendered. MMC charges are based on rates established by the State of Maryland Health Services Cost Review Commission; accordingly, revenue reflects actual charges to patients based on rates in effect during the period in which the services are rendered (see Note S). SMI and Physician Enterprise are paid for services based on negotiated contracts with commercial payers and fee schedules with Medicare and Medicaid.

Contractual adjustments represent the difference between amounts billed as patient service revenue and amounts allowed by third-party payers, and are accrued in the period in which the related services are rendered.

The provision for bad debts is based upon management's assessment of historical and expected net collections. This estimate considers business and general economic conditions, 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 and collections to date. Other factors, such as account aging and payment cycles, are considered when estimating the allowances. The results of these assessments are used to determine the provision for bad debts and to estimate an appropriate allowance for uncollectible accounts. MHS follows established guidelines for placing its self-pay patient accounts with an outside collection agency. After collection efforts are exhausted, the uncollected balances are returned to the appropriate MHS entities to be written off to bad debts. MHS does not maintain a material allowance for uncollectible accounts from third-party payers, nor did it have significant write offs from third-party payers.

Medicare reimburses MTC and SMI under a prospective payment system (PPS) for skilled nursing facility services, under which facilities are paid a fixed fee for virtually all covered services. Under PPS, each patient's clinical status is evaluated and placed into a payment category. The patient's payment category dictates the amount that the provider will receive to care for the patient on a daily basis. The per diem rate covers (i) all routine inpatient costs currently paid under Medicare Part A; (ii) certain ancillary and other items and services previously covered separately under Medicare Part B on a "pass-through" basis; and (iii) certain capital costs.

The composition of patient service revenue (net of contractual allowances and discounts) as of June 30 is as follows:

	2017	2016
Federal programs (Medicare/Medicaid)	$ 364,629	$ 344,338
Other third-party payers	301,090	293,609
Self pay	20,319	24,106
	$ 686,038	$ 662,053

Charity Care

The Medical Center provides medically necessary services without charge or at amounts less than its established rates, to patients who qualify for charity care under its financial assistance policy. Because the Medical Center does not pursue collection of those amounts determined to qualify as charity care, they are reported as a net component of net patient service revenue and are not included in patient accounts receivable (see Note B).

The criteria for qualifying for charity care applied by the Medical Center include family income, net assets and the size of the patient's bill relative to the patient's ability to pay. Discounts are provided to patients who are unable to pay based on a sliding scale that is applied for family incomes up to approximately 400% above the U.S. Department of Health and Human Services (HHS) Poverty Guidelines. Free care is provided to patients with family incomes up to approximately 200% above the HHS Poverty Guidelines.

Charity care will be provided to patients who qualify under the Medical Center's financial assistance policy at any time. Once the Medical Center determines that the patient qualifies for charity care, the Medical Center makes no further attempt to collect on the amount qualifying for charity care.

Certain other controlled subsidiaries of MHS also provide services without charge or at amounts less than their established rates to patients who qualify for charity care under their respective financial assistance policies.

Impairment of Long-Lived Assets

MHS accounts for long-lived assets in accordance with applicable guidance on accounting for impairment or disposal of long-lived assets. Such guidance requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Management believes that no asset impairment existed at June 30, 2017 and 2016.

Property and Equipment

Property and equipment are recorded at cost. Donated property and equipment are recorded at fair value at the date of the donation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, which is forty years for buildings and the parking center and ranges from three to ten years for machinery and equipment.

The cost of software is capitalized provided the cost of the project is at least $5 and the expected life is at least three years. Costs include payment to vendors for the purchase and assistance in its installation, payroll costs of employees directly involved in the software installation, and interest costs of the software project if financed by debt. Preliminary costs to document system requirements, vendor selection, and any costs before software purchase are expensed. Capitalization of costs will generally end when the project is completed and the software is ready to be used. Where implementation of the project is in phases, only those costs incurred which further the development of the project will be capitalized. Costs incurred to maintain the applications are expensed.

Resident Prepayment Deposits

SMI's private pay residents are required to make a non-interest bearing prepayment of two months' room and board at the time of admission. St. Elizabeth Hall obtains an interest bearing security deposit, which is the lesser of one month rent or the resident responsibility. At the time of discharge or acceptance by Medical Assistance or similar government assistance programs, any prepayment remaining after application to the resident's outstanding bill will be refunded. At June 30, 2017 and 2016, resident prepayment deposits of approximately $610 and $764, respectively, were invested in short-term investments.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from those estimates.

Derivative Instruments

Current accounting standards require that an entity recognize all derivative instruments as either assets or liabilities in the statement of financial position and measure those instruments at fair value. MHS has entered into interest rate swap agreements to manage its interest rate risk (see Notes J and K). The interest rate swaps do not qualify for hedge accounting under current accounting standards; therefore, management accounts for the derivative instruments as speculative derivative instruments with the change in the fair value reflected in the accompanying consolidated statements of operations as a component of other non-operating income. Net settlement payments are reported as a component of interest cost, with the exception of the payments associated with construction activities that are capitalized. Entering into interest rate swap agreements involves varying degrees and elements of credit, default, prepayment, market and documentation risk in excess of the amounts recognized on the consolidated balance sheets. Such risks involve the possibility that there will be no liquid market for these agreements, the counterparty to these agreements may default on its obligation to perform, and there may be unfavorable changes in interest rates.

Meaningful Use Incentives

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 when they adopt, implement or upgrade 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. Incentive payments have been paid out over varying transitional schedules depending on the type of incentive (Medicare and Medicaid) and recipient (hospital or eligible provider). Eligible hospitals can attest for both Medicare and Medicaid incentives, while physicians must select to attest for either Medicare or Medicaid incentives. For Medicare incentives, eligible hospitals receive payments over four years while eligible physicians receive payments over five years. For Medicaid incentives, eligible hospitals receive payments based on the relevant State adopted payment structure and physicians receive payments over six years.

MHS recognized EHR incentives since it was reasonably assured that MHS successfully demonstrated compliance with the meaningful use criteria. During the years ended June 30, 2017 and 2016, the Hospital and physicians of MHS satisfied the meaningful use criteria. As a result, MHS recognized $534 and $1,338 of EHR incentives during fiscal year 2017 and 2016, respectively, in other operating revenue.

Excess of Revenue over Expenses (Expenses over Revenue)

The consolidated statements of operations include excess of revenue over expenses (expenses over revenue). Changes in unrestricted net assets which are excluded from excess of revenue over expenses (expenses over revenue), consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, 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 primary operations of MHS are considered to be nonoperating.

Reclassifications

Certain 2016 amounts have been reclassified to conform to the 2017 presentation in the accompanying consolidated financial statements. Such reclassifications did not impact the 2016 consolidated change in unrestricted net assets.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-9, *Revenue from Contracts with Customers,* which provides a principles–based standard for recognizing revenue through a five-step process. This standard is effective for MHS, for fiscal years ending June 30, 2019. Management is currently evaluating the effects the adoption of this standard will have on MHS' consolidated financial statements and disclosures. Accordingly, the impact upon adoption of this standard is unknown.

In May 2015, the FASB issued ASU 2015-07, Fair Value Measurement (Topic 820): *Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)*. The ASU removes certain disclosures and the requirement to categorize within the fair value hierarchy investments for which fair value is measured using the net asset value (NAV) per share practical expedient provided by Topic 820, *Fair Value Measurement*. The ASU is effective for fiscal years beginning after December 15, 2015, with early adoption permitted. The ASU should be applied retrospectively to all periods presented. Management has elected to adopt this guidance for the year ended June 30, 2017. As a result of the retrospective application of this guidance, certain amounts previously reported as of and for the year ended June 30, 2016, have been properly amended, as applicable. The impact of this adoption is the exclusion of investments measured at NAV within the fair value hierarchy table presented in Note K and expanded disclosure around the redemption restrictions associated with NAV investments.

In November 2015, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 23): Restricted Cash*. The ASU requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash and restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flow. The ASU is effective for fiscal years beginning after December 15, 2017. The ASU should be applied retrospectively to all periods presented. Accordingly, the impact upon adoption of this standard is unknown.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. 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 MHS beginning on January 1, 2019, with early adoption permitted, and should be applied through a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. Early adoption is permitted. 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 (Topic 842), Presentation of Financial Statements of Not-for Profit Entities*. The amendments in this ASU make certain improvements that address many, but not all, of the identified issues about the current financial reporting for Not-for-Profit (NFP) entities. Under the new guidance, financial statements and noted disclosures requirements for NFP entities include the following:

1. Present on the face of the statement of financial position net assets with and without donor restrictions.
2. Present on the statement of activities additional operation measures.
3. Continue to present on the face of the statement of cash flows the net amount for operating cash flows using either the direct or the indirect method of reporting but no longer require the presentation or disclosure of the indirect method (reconciliation) if using the direct method.
4. Enhanced disclosures that provide quantitative and qualitative information about liquidity management.

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

(Dollars in thousands)

Effective July 1, 2017, MHS has adopted ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*, which amends presentation guidance by requiring deferred financing costs related to a recognized debt obligation be presented in the balance sheet as a direct deduction from the carrying amount of that debt obligation, consistent with the presentation of debt discounts. ASU 2015-03 does not change the recognition and measurement requirements for debt issuance costs. Prior to the issuance of this ASU, an entity would present debt issuance costs as an asset.

The balance sheet as of June 30, 2016 has been adjusted to reflect retrospective application of the new accounting guidance as follows:

	Balance Sheet As of June 30, 2016		
	As Previously Reported	**Retrospective Adjustment**	**As Adjusted**
Assets			
Other assets	$ 18,913	$ (2,560)	$ 16,353
Total assets	1,030,983	(2,560)	1,028,423
Liabilities and members' equity			
Long-term debt	413,932	(2,560)	411,372
Total Liabilities	654,970	(2,560)	652,410
Total liabilities and members' equity	1,030,983	(2,560)	1,028,423
Expenses			
Depreciation and amortization	38,046	(118)	37,928
Interest	17,128	118	17,246
Total expenses	672,908	-	672,908

Unamortized deferred financing fees represent costs incurred in obtaining and issuing the Maryland Health and Higher Educational Facilities Authority bonds. These costs are capitalized and amortized over the expected lives of the respective notes payable on a straight-line basis, which approximates the effective interest rate method. Amortization of deferred financing fees are recorded as interest expense on the consolidated statements of operations. MHS has recorded $200 and $118 of interest expense related to amortization of deferred financing fees during the years ended June 30, 2017 and 2016, respectively.

(Dollars in thousands)

Note B – Patient Accounts Receivable, Allowances, and Charity Care

Patient accounts receivable consist of the following at June 30:

	2017	2016
Gross patient accounts receivable	$ 136,747	$ $138,535
Less:		
Allowance for doubtful accounts and contractual adjustments	(70,062)	(71,095)
Medicare Periodic Interim Payment	(3,403)	(737)
	$ 63,282	$ 66,703

Approximately 44% and 43% of gross patient accounts receivable were due from Medicare and Medicaid at both June 30, 2017 and 2016, respectively.

The net cost of charity care provided by MHS totaled $12,318 and $16,268 for the years ended June 30, 2017 and 2016, respectively. The cost of charity care was calculated by applying the cost-to-charge ratio to the total amount of charges foregone for each of the controlled subsidiaries of MHS that provide charity care. The net cost of charity care was determined net of any patient-related revenue due to sliding scale payments or other patient-specific sources, and includes both direct and indirect cost of rendering care. The net cost of charity care is excluded from the uncompensated care fund, net receipts (see Note S).

Additionally, MHS and certain of its controlled subsidiaries provide structured repayment plans to patients without collateral.

Note C - Pledges Receivable, Net

At June 30, 2017 and 2016, pledges receivable were $8,557 and $11,292, respectively, less an allowance for uncollectible pledges of $330 and $387, respectively, and a discount of $182 and $220, respectively. The expected payment of the pledges receivable less the uncollectible pledges at June 30, 2017 are as follows:

2018	$ 2,907
2019	2,918
2020	979
2021	286
Thereafter	956
	8,046
Less current portion	2,907
Long-term portion	$ 5,139

(Dollars in thousands)

Note D - Property and Equipment

Property and equipment, at cost, consists of the following at June 30:

	2017	2016
Buildings and improvements	$ 619,784	$ 598,447
Machinery and equipment	195,687	213,508
Parking center	41,234	41,234
Construction-in-progress	11,998	23,668
Land	18,973	18,976
	887,676	895,833
Accumulated depreciation	(363,366)	(359,336)
	$ 524,310	$ 536,497

Note E - Funds Held by Trustee or Authority

Funds held by trustee or authority, which consist primarily of cash and government obligations (at fair value), are limited as to use as follows at June 30:

	2017	2016
Debt service reserve	$ 8,711	$ 9,089
Debt service fund	9,070	7,562
Reserve for replacements and residual receipts	1,057	1,216
	18,838	17,867
Less current portion	8,711	7,562
Long-term portion	$ 10,127	$ 10,305

(Dollars in thousands)

Note F - Board Designated and Donor Restricted Investments

Board designated investments are set aside by the board of trustees for costs relating to replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs. All board-designated investments are unrestricted, as the board at its discretion may undesignated the use of such funds. Donor restricted investments have been limited by donors to a specific purpose.

Board designated and donor-restricted investments consist of the following at June 30:

	2017	2016
Equity	$ 97,774	$ 72,899
Fixed maturity	38,140	46,346
Cash	9,753	13,333
Alternatives	1,661	1,780
Pooled Investments	25,193	20,525
	$ 172,521	$ 154,883

Each of the alternative investments owned by MHS represents less than three-quarters of one percent of each respective alternative investment fund as of June 30, 2017 and 2016.

The investments above have been allocated, by source, as follows at June 30:

	2017	2016
Board designated	$ 150,963	$ 135,801
Donor restricted (temporary)	21,558	19,082
	$ 172,521	$ 154,883

Permanently restricted donor investments at June 30, 2017 and 2016 of $2,178 are reported as restricted cash.

Earnings on investments are as follows for the years ended June 30:

	2017	2016
Unrestricted:		
Interest and dividends	$ 2,233	$ 1,205
Net realized gains (losses)	7,092	(127)
	9,325	1,078
Unrealized gains (losses) on trading securities	7,844	(1,032)
	$ 17,169	$ 46

(Dollars in thousands)

Note G - Investments In and Advances to Affiliates

Investments in and advances to affiliates include a joint venture in which MHS or its subsidiaries have an ownership interest of 50%. Investments in which the ownership interest is less than 20% are carried at cost, and investments in which the ownership interest is at least 20% and less than 51% are generally carried on the equity method.

MHS has investments totaling $3,096 and $916 at June 30, 2017 and 2016, respectively, in the following joint ventures:

		Percentage of Ownership		Investment	
Joint Venture	**Business Purpose**	**2017**	**2016**	**2017**	**2016**
Premier Purchasing Partners, Inc.	Capital balance in group purchasing organization	n/a	n/a	$ 916	$ 916
John Hopkins Medicare Advantage	Medicare Advantage plan	6%	0%	2,181	0
Mercy Ridge, Inc.	Continuing care retirement community	50%	50%	0	0
				$ 3,097	$ 916

MHS recorded non-operating income of $579 and $557 related to the operations of these investments for the years ended June 30, 2017 and 2016, respectively. MHS receives rebates from Premier Purchasing Partners, Inc., which are netted with associated supplies expense in the accompanying consolidated financial statements.

In September 2016, MHS invested in the Maryland Health Advantage Medicare Advantage Plan (the MA Plan) as a minority owner, acquiring a six percent ownership stake. The MA Plan is comprised of various Maryland healthcare providers to deliver comprehensive provider, physician, prescription medicine, wellness and other coverage to participating Medicare beneficiaries in Maryland through a health care network. MHS and the Physician Enterprise are also contracted as participating providers in the MA Plan.

MHS recognizes its ownership in the MA Plan using the cost basis of accounting. MHS' current committed capital is $2,180 and the mandatory capital is limited to $3,000. Any additional capital requirements are optional, but electing not to contribute will dilute MHS' ownership percentage accordingly. All net revenue from providing services to MA Plan beneficiaries is recognized at expected reimbursable amounts in the accompanying consolidated statements of operations. Members are allocated a portion of profits or losses in accordance with their participation in the MA Plan based on the terms of the membership agreement. The amount of such allocated profits or losses cannot be estimated at the present time. Accordingly, they will be recognized in the period the amount of such allocations become known.

(Dollars in thousands)

Note H - Other Assets

Other assets consist of the following at June 30:

	2017	2016
Amortizable assets, net	$ 7,248	$ 9,551
Deferred compensation plan assets (see Note L)	4,823	4,636
Health insurance prepayment	1,332	1,209
Other investments	664	773
Notes receivable	47	183
	$ 14,114	$ 16,353

Amortizable assets primarily consist of capitalizable software expenditures of $22,883 and $22,873 for the years ended June 30, 2017 and 2016, respectively. MHS has recorded accumulated amortization of $15,635 and $13,321 for the years ended June 30, 2017 and 2016, respectively. These assets are amortized over the expected useful life of the asset on a straight-line basis. Amortization expense as depreciation and amortization on the consolidated statements of operations.

Note I - Reinsurance Receivable/Recoverable and Provision for Outstanding Losses

GIC management based the provision for losses at June 30, 2017 on a report dated July 2016 prepared by GIC's independent actuaries, Complete Actuarial Solutions Co. of Bethesda, Maryland. In their report, the actuaries estimate outstanding losses at an expected confidence level, on an undiscounted basis, to be $63,597 and $56,676 net of reinsurance as of June 30, 2017 and 2016, respectively. As of June 30, 2017 and 2016, GIC's provision for outstanding losses was $62,891 and $53,549, respectively, and the reinsurance receivable for such losses was $3,374 and $5,810, after factoring in actual losses paid to June 30. The estimates provided by the actuaries are based on the historical data of the program blended together with relevant insurance industry loss development statistics.

In the opinion of the GIC management, the provision for outstanding losses relating to losses reported and losses incurred but not reported at the consolidated balance sheet dates is adequate to cover the expected ultimate liability of GIC. However, due to the nature of the insurance risks assumed, these provisions are necessarily estimates, and could vary from the amounts ultimately paid.

Consistent with most companies with similar insurance operations, GIC's provision for outstanding losses is ultimately based on management's reasonable expectations of future events. It is reasonably possible that the expectations associated with these amounts could change in the near term (i.e., within one year) and that the effect of such changes could be material to the consolidated financial statements.

GIC's estimated provision for outstanding losses exceeds GIC's retention limits by $3,374 and $5,810 for the years ended June 30, 2017 and 2016, respectively. These losses are reinsured as described in Note R, Self-Insurance Program section, and accordingly are recorded as reinsurance balances recoverable in the accompanying consolidated balance sheets.

(Dollars in thousands)

In the event that GIC's reinsurers are unable to meet their obligations under the reinsurance agreements, GIC would still be liable to pay all losses under the insurance policies it issues, but would only receive reimbursement to the extent the reinsurers could meet their above-mentioned obligations. GIC believes that all amounts included in reinsurance balances receivable and recoverable in the accompanying consolidated balance sheets will be collected in full from the reinsurers.

Note J - Long-Term Debt

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

	2017	2016
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2006; interest rate 5.69%; due July 1, 2036	$ 29,785	$ 30,570
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2007 B and C (converted); interest rate 3.87%; due July 1, 2024	23,050	25,050
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2008 (converted); interest rate 3.99%; due July 1, 2022	17,625	20,260
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2011, interest rate ranging from 3.00% to 6.25%, due July 1, 2031	37,225	37,415
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2012, interest rate ranging from 4% to 5%, due July 1, 2031	49,995	49,995
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2016A, interest rate ranging from 3.50% to 5.00% , due July 1, 2042	135,250	135,250
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2016B; variable interest rate (1.435% at June 30, 2017), due July 1, 2037	35,055	35,055
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2016C; variable interest rate (1.565% June 30, 2017), due July 1, 2042	65,050	65,450
MHHEFA Revenue Bonds, Stella Maris Issue, Series 1997; variable interest rate (0.69% and 0.14% at June 30, 2017 and 2016, respectively); due 2021	7,435	8,715
HUD mortgage loan; interest rate 2.64%; due 2046	4,739	4,848
Other	60	205
Total long-term debt	405,269	412,813
Add:		
Net unamortized discount (premium)	8,151	8,550
Less:		
Net unamortized debt issuance costs	(2,360)	(2,560)
Current portion	(8,844)	(7,431)
Long -term portion	$ 402,216	$ 411,372

(Dollars in thousands)

Principal payments on long-term debt are as follows for the years ended June 30:

2018	$	8,844
2019		8,910
2020		9,511
2021		9,962
2022		10,085
Thereafter		357,957
	$	405,269

Pursuant to an amended and restated Master Loan Agreement, as supplemented (the "Loan Agreement"), the Obligated Group members have issued debt through Maryland Health and Higher Educational Facilities Authority ("MHHEFA"). Currently the Medical Center, MHS and MHF comprise the Obligated Group for Mercy Medical Center Issues. Each Obligated Group member is jointly and severally liable for the repayments under the obligations of the Loan Agreements. As security for the performance of the obligations of the Obligated Group members under the Loan Agreements, the Obligated Group members have granted to MHHEFA a security interest in their receipts, subject to certain permitted encumbrances. In addition, the Medical Center has mortgaged to MHHEFA certain real and personal property of the Medical Center under a mortgage from the Medical Center to MHHEFA, as amended and supplemented. The Loan Agreements contains certain restrictive, financial and nonfinancial covenants. Under the terms of the Loan Agreements and other loan agreements, certain funds are required to be maintained on deposit with the trustee or MHHEFA to provide for repayment of the obligations of the Obligated Group (see Note E).

Mercy Medical Center Issue, Series 2006 Bonds

In August 2006, MHHEFA authorized the issuance, sale and delivery of $35,000 of Mercy Medical Center Series 2006 Revenue Bonds. The proceeds were loaned by MHHEFA to MMC in order to finance the construction of a new parking garage as well as the financing of certain routine capital expenditures.

Principal repayment of these bonds began on July 1, 2009 and is paid annually through July 1, 2036. Interest is paid semiannually on January 1st and July 1st. Interest accrues at a fixed rate of 5.69%. The bonds are currently callable at par (100%).

Mercy Medical Center Issue, Series 2008 (Converted)

In July 2008, MHHEFA authorized the issuance, sale and delivery of its $35,325 Revenue Bonds, Mercy Medical Center Issue, Series 2008, the proceeds of which were loaned by MHHEFA to MMC in order to refund the MMC Series 2003 Bonds. On December 16, 2009, $30,000 of the Series 2008 Bonds was converted to Bank Qualified Revenue Bonds with a fixed interest rate period of approximately twelve years. On June 15, 2020, the bonds convert to a Floating rate at which time the bonds will be remarketed. Principal repayment of the converted bonds began July 1, 2011 and is paid annually through July 1, 2022. Interest accrues at a fixed rate of 3.9932%.

The monthly interest payments on the Series 2008 Bonds were made directly to the bank. Principal repayment of the Series 2008 Bonds began on July 1, 2009, and the portion of those bonds that were not converted to Bank Qualified Bonds were fully paid on July 1, 2011.

Mercy Medical Center Issue, Series 2011 Bonds

In February 2011, MHHEFA authorized the issuance, sale and delivery of its $40,770 Revenue Bonds, Mercy Medical Center Issue, Series 2011. The proceeds were loaned by MHHEFA to MMC to refund $35,110 aggregate principal amount of the MMC Issue, Series 2007 B and C Bonds. The bonds were issued net of an original issue discount of $881, which is being amortized over the life of the bonds using the straight line method. The bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2017 and 2016 was $4,015 and $4,025, respectively, (see Note E).

Principal repayment of the MMC Issue, Series 2011 Bonds began July 1, 2012 and is scheduled to be paid annually through July 1, 2031. Interest accrues at a rate varying from 3.0% to 6.25%. The interest is payable semi-annually on January 1st and July 1st.

Mercy Medical Center Issue, Series 2012 Bonds

In April 2012, MHHEFA authorized the issuance, sale and delivery of its $49,995 Revenue Bonds, Mercy Medical Center Issue, Series 2012. The proceeds were loaned by MHHEFA to MMC to refund $49,480 aggregate principal amount of the Mercy Medical Center Issue, Series 2001 Bonds. The bonds include an original issue premium of $1,742, which is being amortized over the life of the bonds using the straight line method. The bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2017 and 2016 was $5,055 and $5,064, respectively (see Note E).

Principal repayment of the MMC Issue, Series 2012 begins July 1, 2023 and is scheduled to be paid annually through July 1, 2031. Interest accrues at a rate varying from 4.0% to 5.0%. The interest is paid semi-annually on January 1st and July 1st.

Mercy Medical Center Issue, Series 2016A

In March 2016, MHHEFA authorized the issuance, sale and delivery of its $135,250 Revenue Bonds, Mercy Medical Center Issue, Series 2016A. The proceeds were loaned by MHHEFA to MMC to advance refund $145,880 aggregate principal amount and $11,452 aggregate interest due until July 1, 2017 of the MMC Issue, Series 2007A Bonds. As of June 30, 2016, the 2007A bonds were defeased and on July 1, 2017 the Series 2007A Bonds were fully refunded. Principal repayment of the Series 2016A begins on July 1, 2032 and is scheduled to be paid annually through July 1, 2042. Interest accrues at a fixed rate ranging from 3.5% to 5.0%. The Series 2016A bonds were issued net of an original issue premium of $9,327, which is being amortized over the life of the bonds using the straight line method which approximates the effective interest method.

Mercy Medical Center Issue, Series 2016B

In May 2016, MHHEFA authorized the issuance, sale and delivery of its $35,055 Revenue Bonds, Mercy Medical Center, Series 2016B. The proceeds were loaned by MHHEFA to MMC to refund the $34,890 Series 2011B bonds then outstanding. The Series 2016B bonds were issued as non-bank qualified revenue bonds and directly purchased by a commercial bank. The direct bank purchase terminates on May 19, 2021, at which time the Series 2016B bonds will be subject to a mandatory purchase at their par value by MMC unless the bank and MMC agree to an extension. The Series 2016B bonds bear interest at a variable rate equal to 70% of one-month

LIBOR plus 0.70%. Interest is paid monthly.

Annual principal repayment of Series 2016B bonds will begin on July 1, 2032 and the final payment will be on July 1, 2037.

Mercy Medical Center Issue Series 2016C

In May 2016, MHHEFA authorized the issuance, sale and delivery of its $65,450 Revenue Bonds, Mercy Medical Center, Series 2016C. The proceeds were loaned by MHHEFA to MMC to refund the $65,290 Series 2013 and Series 2013B bonds then outstanding. The Series 2016C bonds were issued as a non-bank qualified revenue bonds and directly purchased by a commercial bank. The direct bank purchase terminates on May 19, 2023, at which time the Series 2016C bonds will be subject to a mandatory purchase at their par value by MMC unless the bank and MMC agree to an extension. The Series 2016C bonds bear interest at a variable rate equal to 70% of one-month LIBOR plus 0.83%. Interest is paid monthly. Annual principal repayment of Series 2016C bonds began on July 1, 2016 and the final payment will be on July 1, 2042.

Stella Maris Issue, Series 1997 Bonds

The Series 1997 Bonds were issued to finance the acquisition by SMI of Stella Maris Operating Corporation and CSC; to advance refund certain nursing home revenue bonds previously issued by MHHEFA, Stella Maris Issue, Series 1991; and to refinance certain outstanding indebtedness of the acquired corporations.

Principal repayment of these bonds began on July 1, 2001 and is paid annually through July 1, 2021. All Series 1997 Bonds are subject to redemption prior to maturity beginning March 1, 2001. Interest is accrued at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date. Interest on the bonds is payable monthly.

Under the provisions of the Series 1997 Bonds agreement, SMI has granted to MHHEFA a security interest in all of its real property and the assignment of its leases. In addition, payments on the Series 1997 Bonds are secured by an irrevocable letter of credit provided by M&T Bank. An annual letter of credit fee, equal to 1.29% of the letter of credit amount, is payable quarterly by SMI. The letter of credit expires July 1, 2020.

Under the terms of the bond indenture, SMI is required to maintain certain deposits with a trustee. The bond indenture agreement also requires SMI to satisfy certain measures of financial performance as long as the Series 1997 Bonds are outstanding. As of June 30, 2016 and 2015, management believes SMI was in compliance with the financial covenant requirements of the bond indenture.

HUD Mortgage Loan

The mortgage loan from the U.S. Department of Housing and Urban Development (HUD) was used by CSC to construct St. Elizabeth Hall. This original note was refinanced during the year ended June 30, 2013. The original terms of the note reflected an interest rate of 6.875% per annum with monthly installments of $43, including interest, with the final payment due November 1, 2020.

From July 1997 through December 2005, CSC received authorization from HUD to suspend its monthly principal and interest payments of $43. The unpaid interest during this deferral period was accrued. On December 21, 2012 the original outstanding debt was refinanced with a new outstanding face amount of $5,202 and the unpaid interest accrued during the deferral period was forgiven, resulting in a gain on extinguishment of debt of $2,649. The current note reflects an interest rate of 2.64% per annum with monthly installments of $20, including interest, with the final payment due January 1, 2046. The current note requires mortgage insurance of 0.45% of the average annual outstanding principal balance determined annually for the duration of the note. Concurrent with these monthly mortgage payments, St. Elizabeth Hall is required to make monthly payments of $23 derived from the savings of the new note to a debt service savings reserve fund through May 2029 for purposes stipulated by a debt service savings agreement. In addition, concurrent with these monthly payments, St. Elizabeth Hall is required to make monthly payments of $8 to a reserve fund for the replacement of property and equipment. These payments are required until the mortgage matures and are included in Board designated and donor restricted investments. All disbursements from this fund are contingent upon HUD's prior approval.

The liability of CSC under the mortgage note is limited to the underlying value of the real estate collateral plus other amounts deposited with the lender.

Line-of-Credit

The Medical Center has a $20,000 operating line of credit. At June 30, 2017 and 2016, the $20,000 operating line of credit had $0 and $7,875 outstanding, respectively. As of June 30, 2017 and 2016, the interest rate on the outstanding line of credit draw was 3.40% and 2.65%, respectively, and was based on two hundred and fifteen basis points above one-month LIBOR. The $20,000 operating line of credit agreement is scheduled to remain in effect until all obligations, including other debt held by this bank, are paid in full or terminated by the Bank.

Interest Rate Swaps

On December 1, 2004, the Medical Center entered into a fixed spread basis swap agreement in order to reduce the cost of capital with respect to the Series 2001 Bonds by removing the tax risk to bond holders and transferring the risk to the Medical Center. The fixed spread basis swap matures on December 1, 2024 and the exchanges of cash flows with the counter party began March 1, 2005. The notional amount of the swap is $50,000. Pursuant to the swap agreement, the Medical Center pays the counter party a variable rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of USD-LIBOR-BBA and 0.60%.

Simultaneously with the issuance of the Series 2006 bonds, MMC entered into an interest rate swap agreement, which was amended in November 2014, with a counter party with a notional amount of $35,000 to convert the fixed rate structure to a variable rate. Under this amended agreement, MMC will receive a fixed interest rate of 5.69% and pay to the counter party the USD-SIFMA Municipal Swap Index plus 0.80%. The interest rate swap agreement terminates on November 19, 2019. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

The value of this contract is based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value is equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2017 and 2016, the fair value of the swap was immaterial.

At June 30, 2017 and 2016, the fair value of the interest rate swap was $1,179 and $1,715, respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling ($824) and $80 is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2017 and 2016, respectively.

During October 2007, MMC entered into a fixed payer swap with a notional amount of $65,000, which was amended in July 2014. Pursuant to the amended swap agreement, MMC pays the counter party a fixed rate of 3.459% and receives a variable rate equal to 70% of USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2042. At June 30, 2017 and 2016, the fair value of the interest rate swap was ($19,155) and ($28,098), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling $7,557 and ($10,508) is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2017 and 2016, respectively.

In August 2016, MMC terminated two interest rate swaps with contrasting market values, resulting in a net $373 realized gain. MMC had entered into a forward interest rate swap agreement on June 28, 2006 with a notional amount of $35,000 in order to convert the variable swap rate to a fixed rate. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 3.976% and receives a variable rate equal to 67% of the USD-LIBOR-BBA. The interest rate swap agreement was terminated on August 11, 2016. The interest rate swap did not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2016, the fair value of the interest rate swap was ($10,257), and is included in other long-term liabilities in the accompanying consolidated balance sheets. A realized loss of ($10,135) and an unrealized loss on interest rate swap totaling ($2,459) are reflected in the accompanying statements of operations for the fiscal years ended June 30, 2017 and 2016, respectively.

Additionally, a fixed spread basis swap that was entered into in August 2007, with a notional amount of $210,000, was terminated in August 2016. Pursuant to the swap agreement, MMC paid the counter party a fixed interest rate equal to the USD-SIFMA Municipal Swap Index and received interest at a variable rate equal to the sum of 67% of the USD-LIBOR-BBA and 0.54%. The interest rate swap did not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2016, the fair value of the interest rate swap was $8,109, and is included in other long-term liabilities in the accompanying consolidated balance sheets. For the years ended June 30, 2017 and 2016, a realized gain of $10,608 and an unrealized gain on interest rate swap totaling $6,249, respectively, is reflected in the accompanying consolidated statements of operations.

Note K - Fair Value of Financial Instruments

The following methods and assumptions were used by MHS in estimating the fair value of its financial instruments:

> *Cash and cash equivalents, patient accounts receivable, other amounts receivable, accounts payable and accrued expenses, due to third-party payers and construction retainage:* The carrying amounts reported in the consolidated balance sheets approximate fair value.
>
> *Short-term investments, funds held by trustee or authority and board designated and donor restricted investments:* Fair values, which are the amounts reported in the consolidated balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.
>
> *Pooled separate accounts:* NAV units, as determined by the custodian, are used to estimate fair value since quoted prices in active markets for identical assets are not available. These prices are determined using observable market information such as quotes from less active markets and/or quoted prices of securities with similar characteristics.
>
> *Long-term debt:* Fair values of revenue bonds and other debt are based on current traded values. At June 30, 2017 and 2016, the fair value of long-term debt was approximately $418,349 and $442,072, respectively.

Current accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establish a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels of inputs that may be used to measure fair value are:

> Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities that are traded in an active exchange market, as well as U.S. Treasury securities.
>
> Level 2: Observable input other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted market prices that are traded less frequently than exchange-traded instruments. This category generally includes certain U.S. government and agency mortgage-backed debt securities, corporate-debt securities, and alternative investments.
>
> Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private debt and equity instruments and alternative investments.

The following discussion describes the valuation methodologies used for financial assets and liabilities measured at fair value. The techniques utilized in estimating the fair values are affected by the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about the business, value, or financial position of MHS based on the fair value information of financial assets and liabilities presented below.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial asset or liability, including estimates of the timing, amount of expected future cash flows, and the credit standing of the issuer. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial asset or liability. Furthermore, the disclosed fair values do not reflect any premium or discount that could result from offering for sale at one time an entire holding of a particular financial asset or liability. Potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in the amounts disclosed.

MHS uses techniques consistent with the market approach for measuring fair value of its Level 2 and Level 3 assets and liabilities. The market approach is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Fair values of equity securities and fixed maturity securities have been determined by MHS from observable market quotations, when available. Private placement securities and other equity securities where a public quotation is not available are valued by using broker quotes. Cash equivalents comprise short-term fixed maturity securities and carrying amounts approximate fair values, which have been determined from public quotations, when available. Money markets and certificates of deposit comprise short-term fixed maturity securities. The carrying amounts approximate fair values, which have been determined from public quotations, when available.

MHS holds alternative investments that are not traded on national exchanges or over-the-counter markets. MHS is provided information on a net asset value per share as a practical expedient for these investments that has been calculated by the funds of funds' managers (who are investment advisors registered with the Securities and Exchange Commission) based on information provided by the managers of underlying funds.

Fair value of the interest rate swaps represent, or are derived from, mid-market values. Mid-market prices and inputs may not be observable, and instead valuations may be derived from proprietary or other pricing models based on certain assumptions regarding past, present and future market conditions. Some inputs may be theoretical, not empirical, and require subjective assumptions and judgments. Valuations may be based on assumptions as to the volatility of the underlying security, basket or index, interest rates, exchange rates, dividend yields, correlations between these or other factors, the impact of these factors upon the value of the security (including any embedded options), as well as issuer funding rates and credit spreads (actual or approximated) or additional relevant factors.

(Dollars in thousands)

The following table presents MHS' fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2017.

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board designated and donor restricted investments:				
Cash and cash equivalents:				
Cash	$ 9,753	$ 0	$ 0	$ 9,753
Equity securities:				
Mutual funds:				
International emerging markets	27,901	0	0	27,901
Domestic mutual fund-equity income	18,667	0	0	18,667
Common stocks:				
Healthcare	5,980	0	0	5,980
Utilities	467	0	0	467
Telecommunications	395	0	0	395
Financials	10,759	0	0	10,759
Consumer staples	3,526	0	0	3,526
Consumer discretionary	7,920	0	0	7,920
Materials	803	0	0	803
Energy	1,856	0	0	1,856
Information technology	8,540	0	0	8,540
Industrials	7,008	0	0	7,008
Miscellaneous	846	0	0	846
Foreign stocks/american deposit receipt	0	3,106	0	3,106
Fixed maturity:				
U.S. government and agencies:				
U.S. treasury bonds	19,251	0	0	19,251
Government agency bonds	0	5,746	0	5,746
Corporate bonds:				
Financial	0	3,162	0	3,162
Industrial	0	6,053	0	6,053
International (other global corp bonds)	0	1,895	0	1,895
Asset backed securities	0	1,758	0	1,758
Municipal bonds	0	275	0	275
Alternatives	0	0	1,661	1,661
Total assets in the fair value hierarchy	123,672	21,995	1,661	147,328
Investments measured at NAV [(a)]				25,193
Total board designated and donor restricted investments				172,521

(a) *In accordance with Topic 820, certain investments that were measured at NAV per share (or its equivalent) have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the line items presented in the consolidated balance sheets.*

(Dollars in thousands)

June 30, 2016 and 2017

Assets	Level 1	Level 2	Level 3	Total Fair Value
Restricted cash, cash equivalents and investments:				
Cash	2,178	0	0	2,178
Mutual funds	5,942	0	0	5,942
Bond funds	22,903	0	0	22,903
Corporate bonds	0	12,846	0	12,846
Municipal bonds	0	1,771	0	1,771
Government and agencies	15,342	0	0	15,342
Fixed income-government and agencies	0	3,920	0	3,920
Asset backed securities	0	4,102	0	4,102
Total restricted cash, cash equivalents and investments	46,365	22,639	0	69,004
Cash, cash equivalents and short-term investments:				
Cash	82,700	0	0	82,700
Money market fund	0	37,594	0	37,594
Certificate of deposit	0	27,552	0	27,552
Total cash, cash equivalents and short term investments	82,700	65,146	0	147,846
Long-term investments:				
Long-term investments:				
Money market fund	32	0	0	32
Equity securities:				
Mutual funds	1,787	0	0	1,787
Fixed maturity:				
U.S. treasury notes	2,163	0	0	2,163
U.S. government and agencies:				
Government agency mortgage backed securities	0	632	0	632
Government agency pools	0	19	0	19
Corporate Bonds:				
Financial	0	743	0	743
Industrial	0	1,025	0	1,025
International (other global corp bonds)	0	323	0	323
Municipal bonds	0	274	0	274
Total long-term investments	3,982	3,016	0	6,998

(Dollars in thousands)

June 30, 2016 and 2017

Assets	Level 1	Level 2	Level 3	Total Fair Value
Funds held by trustee (current):				
Cash	456	0	0	456
Money market	0	4,978	0	4,978
Government agency notes	0	3,277	0	3,277
Total funds held by trustee (current)	456	8,255	0	8,711
Funds held by trustee (non-current):				
Cash	82	0	0	82
Certificate of deposit	0	8,977	0	8,977
U.S. government and agencies	0	1,068	0	1,068
Funds held by trustee (non-current)	82	10,045	0	10,127
Total assets in the fair value hierarchy	$ 257,257	$ 131,097	$ 1,661	390,015
Investments measured at NAV [(a)]				25,193
Total investments at fair value				$ 415,208
Liabilities:				
Interest rate swaps	0	17,976	0	17,976
Total liabilities at fair value	$ 0	$ 17,976	$ 0	$ 17,976

(Dollars in thousands)

June 30, 2016 and 2017

The following table presents MHS' fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2016.

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board designated and donor restricted investments:				
Cash and cash equivalents:				
Cash	$ 13,333	$ 0	$ 0	$ 13,333
Equity securities:				
Mutual funds:				
International emerging markets	20,059	0	0	20,059
Domestic mutual fund-equity income	5,860	0	0	5,860
Common stocks:				
Healthcare	5,860	0	0	5,860
Utilities	417	0	0	417
Telecommunications	848	0	0	848
Financials	6,788	0	0	6,788
Consumer staples	2,940	0	0	2,940
Consumer discretionary	6,534	0	0	6,534
Materials	1,093	0	0	1,093
Energy	1,272	0	0	1,272
Information technology	11,395	0	0	11,395
Industrials	6,170	0	0	6,170
Miscellaneous	272	180	0	452
Foreign stocks/american deposit receipt	0	3,211	0	3,211
Fixed maturity:				
U.S. government and agencies:				
U.S. treasury bonds	13,884	0	0	13,884
Government agency bonds	0	5,979	0	5,979
Government agency mortgage backed securities	0	422	0	422
Corporate bonds:				
Asset backed securities	0	3,394	0	3,394
Financial	0	2,325	0	2,325
Industrial	0	3,820	0	3,820
International (other global corp bonds)	0	1,292	0	1,292
Asset backed securities	0	12,115	0	12,115
Collaterized mortgage backed securities	0	7	0	7
Fixed maturity loan fund	0	1,757	0	1,757
Municipal bonds	0	1,351	0	1,351
Alternative	0	0	1,780	1,780
Total assets in the fair value hierarchy	96,725	35,853	1,780	134,358
Investments measured at NAV [(a)]				20,525
Total board designated and donor restricted investments				154,883

(Dollars in thousands)

June 30, 2016 and 2017

Assets	Level 1	Level 2	Level 3	Total Fair Value
Restricted cash, cash equivalents and investments:				
Cash	2,178	0	0	2,178
Mutual funds	6,796	0	0	6,796
Bond funds	21,858	0	0	21,858
Corporate funds	0	15,505	0	15,505
Municipal bonds	0	2,723	0	2,723
Government and agencies	4,153	0	0	4,153
Mortgage backed securities	0	1,511	0	1,511
Total restricted cash, cash equivalents and investments	34,985	19,739	0	54,724
Cash and cash equivalents and short-term investments:				
Cash	100,373	0	0	100,373
Money market fund	0	29,283	0	29,283
Certificate of deposit	0	5,258	0	5,258
Total cash, cash equivalents and short term investments	100,373	34,541	0	134,914
Long-term investments:				
Long-term investments:				
Money market fund	34	0	0	34
Equity securities:				
Mutual funds	1,497	0	0	1,497
Fixed maturity:				
U.S. treasury notes	1,931	0	0	1,931
U.S. government and agencies:				
Government agency mortgage backed securities	0	535	0	535
Government agency pools	0	31	0	31
Corporate Bonds:				
Financial	0	568	0	568
Industrial	0	840	0	840
Healthcare	0	396	0	396
International (other global corp bonds)	0	249	0	249
Municipal bonds	0	864	0	864
Total long-term investments	3,462	3,483	0	6,945

(Dollars in thousands)

Assets	Total Fair Level 1	Level 2	Level 3	Value
Funds held by trustee (current)				
Cash	5	0	0	5
Money market	0	6,828	0	6,828
Fixed maturity:				
Government agency notes	0	729	0	729
Total funds held by trustee (current)	5	7,557	0	7,562
Funds held by trustee (non-current):				
Cash	83	0	0	83
Money market	0	1,216	0	1,216
U.S. government and agencies	0	9,006	0	9,006
Funds held by trustee (non-current)	83	10,222	0	10,305
Total assets in the fair value hierarchy	$ 235,633	$ 111,395	$ 1,780	348,808
Investments measured at NAV [(a)]				20,525
Investments at fair value				$ 369,333
Liabilities:				
Interest rate swaps	0	28,531	0	28,531
Total liabilities at fair value	$ 0	$ 28,531	$ 0	$ 28,531

(Dollars in thousands)

June 30, 2016 and 2017

The following table summarizes investments for which fair value is measured using the NAV per share practical expedient as of June 30, 2017 and 2016.

	Fair Value at June 30, 2017	Fair Value at June 30, 2016	Unfunded Commitments	Other Redemption Restrictions	Redemption Notice Period
High Yield Loan Fund (1)	**$ 8,737**	$ 7,947	None	(1)	20 days
Multi-Strategy Fund (2)	**6,465**	5,956	None	None	65 days
Emerging Markets Equity Fund (3)	**8,469**	6,622	None	None	3 days
Other	**1,522**	-	1,471	-	-

(1) The fund invests substantially all of its investable assets in Dollar Senior Loan Fund, Ltd. The principal investment objective is to invest on an unlevered basis predominately in senior secured loans to below investment grade U.S. and non-U.S. obligors. The fund may also invest in other debt securities including, without limitation, second lien loans, high yield bonds and collateralized loan obligations. The fund permits monthly redemption subject to 20 days advanced written notice.

(2) The multi-strategy fund is event-driven with a focus on opportunities to exploit situations in which announced or anticipated events create opportunities to invest in securities and other financial instruments at a discount to their exit values. The fund also invests in a long/short equities portfolio of securities that can be readily valued and trade at a discount or premium to the fair value of the underlying assets. The fund permits semiannual redemption subject to 65 days advance written notice.

(3) The fund's objective is to seek long-term capital appreciation by investing primarily in common stocks of emerging market issuers. The fund's performance benchmark is the Morgan Stanley Capital International Emerging Markets Index. The fund permits monthly redemption subject to 3 days advance written notice.

(Dollars in thousands)

Included in alternative investments as of June 30, 2017 and 2016 are three classes of hedge funds of funds with fair values of $577 and $799, respectively (Fund A), $5 and $177, respectively, (Fund B) and $1,079 and $804, respectively, (Fund C). Fund A and B are in liquidation and redemptions are suspended until the fund can liquidate its underlying holding. Fund C is redeemable calendar quarterly with 65 days advance notice. There are no unfunded commitments for any of the hedge fund of funds for either 2017 or 2016.

The following table is a rollforward of the consolidated statements of financial position amounts for financial instruments classified by MHS within level 3 of the valuation hierarchy defined above:

	Investments
Fair value June 30, 2015	$ 2,123
Unrealized gains, net	(40)
Purchases	409
Redemptions	(712)
Fair value June 30, 2016	1,780
Unrealized gain, net	207
Purchases	22
Redemptions	(348)
Fair value June 30, 2017	$ 1,661

Note L - Pension and Profit Sharing Plans

MHS has a qualified 401(k) plan covering substantially all employees of the Medical Center and SMI who have completed at least one year of service and are at least twenty-one years of age. MHS makes an annual contribution on behalf of all eligible employees based on either the employee's contributions to the 401(k) plan or their annual compensation. MHS will match, on a dollar for dollar basis (based on age and years of service thresholds) the amount contributed by the employee, not to exceed 6% of the employee's salary. MHS' contributions to the 401(k) plan for all participants employed prior to April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees, vest at a rate of 25% annually and completely vested on April 1, 2001 for Medical Center employees and July 1, 2001 for SMI employees. MHS' contributions for all participants employed on or after April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees vest after four years of service, with no vesting prior to four years of service. Contributions under this plan totaled approximately $5,097 and $4,813 for the years ended June 30, 2017 and 2016, respectively.

The Medical Center has a nonqualified deferred compensation plan for certain executives and physicians. The deferred compensation plan provides for severance and supplemental retirement benefits as defined in the plan. Compensation expense related to the deferred compensation plan was $2,002 and $1,923 for the years ended June 30, 2017 and 2016, respectively. Total deferred compensation obligations of $4,823 and $4,636 are included in other long-term liabilities in the accompanying consolidated balance sheets at June 30, 2017 and 2016, respectively (see Note W).

(Dollars in thousands)

The fair values of deferred compensation plan assets fair value on a recurring basis as of June 30, 2017 by asset category are as follows (see Notes H and K):

Assets	Level 1	Level 2	Total Fair Value
Equity:			
Mutual funds:			
International large cap core	$ 289	$ 0	$ 289
Emerging markets	127	0	127
Domestic mutual fund-equity income	3,680	0	3,680
Fixed maturity:			
Bond fund	0	727	727
Total assets fair value	$ 4,096	$ 727	$ 4,823

The fair values of deferred compensation plan assets on a recurring basis as of June 30, 2016 by asset category are as follows (see Notes H and K):

Assets	Level 1	Level 2	Total Fair Value
Equity:			
Mutual funds:			
International large cap core	$ 317	$ 0	$ 317
Emerging markets	137	0	137
Domestic mutual fund-equity income	3,343	0	3,343
Fixed maturity:			
Bond fund	0	839	839
Total assets fair value	$ 3,797	$ 839	$ 4,636

There were no significant transfers between level 1 and level 2 fair value investments for the years ended June 30, 2017 and 2016.

Note M - Post-Retirement Benefit Plan

MHS has an unfunded contributory health and medical post-retirement benefit plan available to all eligible employees who meet certain age and length of service requirements. The plan provides for health and medical benefits including primary care physician and specialist visits, hospitalization and emergency care, prescription drugs, vision care, and Medicare supplemental coverage.

(Dollars in thousands)

The following table sets forth the components of the MHS obligation at June 30:

	2017	2016
Change in Benefit Obligation:		
Benefit obligation at beginning of year	$ 5,699	$ 6,469
Service cost	55	79
Interest cost	222	227
Impact of no future Medicare D reimbursements	3,826	0
Actuarial gain and assumption changes	(3,628)	(795)
Employer portion of benefits paid	(289)	(281)
Benefit obligation at end of year	5,885	5,699
Change in Plan Assets:		
Employer contribution	289	281
Plan participants' contribution	418	431
Medicare Part D reimbursement	46	92
Benefits paid	(753)	(804)
Fair value of plan assets at end of year	0	0
Unfunded status	(5,885)	(5,699)
Accrued post-retirement benefit cost	(5,885)	(5,699)
Less current portion, included in accounts payable and accrued expenses	(295)	(228)
Total accrued post-retirement benefit cost, long-term portion	$ (5,590)	$ (5,471)

Net periodic post-retirement benefit cost included the following for the years ended June 30:

	2017	2016
Service cost - benefits attributed to service during the period	$ 55	$ 79
Interest cost on accumulated post-retirement benefit obligation	222	227
Net amortization	(119)	(249)
Net post-retirement benefit cost	$ 158	$ 57

The weighted average discount rate used in determining the accumulated post-retirement benefit obligation (APBO) for the plan was 4% and 3.75% for the years ended June 30, 2017 and 2016, respectively. For measurement purposes, the health care cost trend rates used in determining the APBO for the plan were 5.6% and 5.9% in 2017 and 2016, respectively. Increasing the health care cost trend rates by 1% would increase the APBO by $552 and aggregate service and interest cost by $30 at June 30, 2017.

(Dollars in thousands)

Note N - Retirement Annuity Plan

MHS had a pension plan that was terminated on April 1, 1997 and established a retirement annuity plan under which certain participants of the terminated plan were entitled to annuity payments. Participants in the plan include (a) the retirees and beneficiaries entitled to benefits from the terminated plan on April 1, 1997 and (b) other participants with benefits worth more than $4 that elected an annuity. All benefits are vested and based on the frozen accrued benefits at April 1, 1997.

The measurement dates for fiscal years 2017 and 2016 were June 30, 2017 and June 30, 2016, respectively. The following table sets forth the funded status of the retirement annuity plan and amounts recognized in accompanying consolidated financial statements:

	2017	2016
Change in Benefit Obligation:		
Benefit obligation at beginning of year	$ 8,140	$ 7,297
Interest cost	261	360
Actuarial loss (gain)	(857)	1,494
Benefits paid	(864)	(1,011)
Benefit obligation at end of year	6,680	8,140
Change in Plan Assets:		
Fair value of plan assets at beginning of year	1,982	2,974
Actuarial return on plan assets	1	20
Benefits paid	(864)	(1,011)
Fair value of plan assets at end of year	1,119	1,983
Unfunded status/accrued benefit cost	$ (5,561)	$ (6,157)

The discount rate was 3.75% and 4.25% for 2017 and 2016, respectively. The expected rate of return on plan assets was 6.50% for 2017 and 2016. The accompanying consolidated net pension cost was $426 in 2017 and $493 in 2016.

MHS' expected rate of return is evaluated annually and is based on the current interest rate environment, rate of inflation, allocation of the plan assets among various investment options and other market conditions.

(Dollars in thousands)

The weighted-average asset allocations in the plan as of June 30, 2017 and 2016, by asset category were as follows:

	June 30,	
	2017	**2016**
Asset Category:		
Fixed income securities	76%	85%
Cash and cash equivalents	24%	15%
Total	100%	100%

The fair values of plan assets on a recurring basis as of June 30, 2017 by asset category are as follows:

Assets	**Level 1**	**Level 2**	**Level 3**	**Total Fair Value**
Cash and cash equivalents:				
Cash	$ 0	$ 5	$ 0	$ 5
Money market funds	0	260	0	260
Fixed maturity:				
Bond fund	435	0	0	435
U.S. Treasury Obligations	420	0	0	419
Total assets fair value	$ 855	$ 265	$ 0	$ 1,119

The fair values of plan assets on a recurring basis as of June 30, 2016 by asset category are as follows:

Assets	**Level 1**	**Level 2**	**Level 3**	**Total Fair Value**
Cash and cash equivalents:				
Cash	$ 0	$ 9	$ 0	$ 9
Money market funds	0	291	0	291
Fixed maturity:				
Bond fund	1,121	0	0	1,121
U.S. Treasury Obligations	562	0	0	562
Total assets fair value	$ 1,683	$ 300	$ 0	$ 1,983

There were no significant transfers between levels for the years ended June 30, 2017 and 2016.

(Dollars in thousands)

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	Benefit Payments
2018	$ 808
2019	$ 763
2020	$ 717
2021	$ 669
2022	$ 620
Next 5 years	$ 2,368

Note O - Supplemental Cash Flow Information

Cash payments for interest, net of amounts capitalized and interest rate swap payments, were $15,997 in 2017 and $17,037 in 2016. Capitalized interest related to construction activities includes interest payments to creditors on bonds, net payments/receipts to counterparties on interest rate swap arrangements, and income received on trustee-held funds.

Note P - Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following health care services at June 30:

	2017	2016
Capital improvements	$ 13,682	$ 13,836
Departmental expenses	7,747	8,272
Pastoral care	4,516	4,516
Research programs	1,280	1,370
Indigent care	1,092	1,057
Education programs	503	276
Other	784	441
	$ 29,604	$ 29,768

Permanently restricted net assets consist of the following at June 30:

	2017	2016
SMI Hospice Endowment	$ 1,055	$ 1,055
Weinberg Endowment	1,000	1,000
Dr. Goodman Endowment	123	123
	$ 2,178	$ 2,178

Note Q - Functional Expenses

MHS and its subsidiaries provide general health care services to patients within their geographic location. Expenses related to providing these services are as follows for the years ended June 30:

	2017	2016
Health care services	$ 517,626	$ 515,755
Administrative and support services	169,759	157,153
	$ 687,385	$ 672,908

Note R - Commitments and Contingent Liabilities

Litigation

MHS has outstanding litigation involving claims brought against it in the normal course of business. Litigation in the normal course of business, as well as responses to claims and investigations described below, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings and government investigations are difficult to predict. Attorneys for MHS are representing MHS in all of these matters. Management is currently unable to estimate, with reasonable certainty, the possible loss, or range of loss, if any, for such lawsuits and investigations.

MHS is subject to asserted and unasserted claims (in addition to litigation) encountered in the ordinary course of business. As a result of the current level of governmental and public concerns with health care fraud and abuse, management recognizes that additional investigative activity could occur in the future. In the opinion of management and after consultation with legal counsel, management believes it has established adequate accrued reserves related to all known matters. The outcome of any potential investigative, regulatory or prosecutorial activity that may occur in the future cannot be predicted with certainty, however, and any associated potential future losses resulting from such activity could have a material adverse effect on the future financial position, results of operations and liquidity of MHS.

Self-Insurance Programs

As discussed in Notes A and I, GIC provides general and professional liability coverage to MHS and its subsidiaries. GIC's policies provide primary and certain excess liability coverage. GIC retains the risk related to the primary policy and reinsures the whole of the excess policies. While insurance policy limits vary by year, management believes the amounts are appropriate.

(Dollars in thousands)

GIC's primary coverage limits for the periods ending June 30 are:

	2017	2016
Healthcare Professional Liability (HPL) and Managed Care Organization Liability (MCO)	$7,000 per related loss event $30,000 aggregate	$7,000 per related loss event $24,000 aggregate
Commercial General Liability (CGL)	$7,000 per occurrence $30,000 aggregate	$7,000 per occurrence $24,000 aggregate

GIC's primary coverage for HPL is $7,000 per loss event. GIC provides excess coverage for HPL and MCO in the aggregate amount of $75,000 in excess of $7,000 and $7,000 for related loss events and in excess of $30,000 and $24,000 for fiscal years 2017 and 2016, respectively. GIC provides excess coverage for CGL in the aggregate amount of $75,000 in excess of $7,000 and $7,000 per occurrence and in excess of $30,000 and $24,000 aggregate for fiscal years 2017 and 2016, respectively. All excess coverage is reinsured by commercial insurance companies.

In management's opinion, the assets of GIC are sufficient to meet its obligations as of June 30, 2017. If the financial condition of GIC were to materially deteriorate in the future, and GIC were unable to pay its claim obligations, the responsibility to pay those claims would return to MHS.

MHS and certain of its subsidiaries are self-insured against employee medical claims. Plan expenses include claims incurred and provisions for unreported claims. However, the program has an annual aggregate stop loss provision per employee.

MHS and certain of its subsidiaries are self-insured in the State of Maryland for the use and benefit of all employees of MHS. The State of Maryland requires any self-insured employer to provide a workers' compensation surety bond issued by a corporate surety company that meets the State's financial rating under A.M. Best. MHS has had a surety bond in place since 1997 currently written by Fidelity and Deposit Company of Maryland in the amount of $2,200. All past, present, existing and potential liability under this bond shall remain in effect and to the benefit of the State of Maryland.

MHS and certain of its subsidiaries are self-insured against unemployment claims and have surety bonds of $1,823 for the Medical Center and $428 for SMI. The amounts change each October 1 as dictated by the Maryland Department of Licensing and Regulation.

(Dollars in thousands)

Lease Commitments

The Medical Center and MFC have entered into separate long-term leases for commercial space. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2018	$	3,015
2019		3,008
2020		3,003
2021		3,069
2022		2,969
Thereafter		60,275
	$	75,339

MHS and certain of its subsidiaries have other office space leases. Rent expense for the years ended June 30, 2017 and 2016 was $3,631 and $2,992, respectively.

The Medical Center and MFC have entered into separate long-term operating leases for equipment. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2018	$	2,521
2019		1,850
2020		1,661
2021		745
2022		371
Thereafter		0
	$	7,148

MHS and certain of its subsidiaries have other operating leases for equipment. Equipment lease expense for the years ended June 30, 2017 and 2016 was$ 4,058 and $4,929, respectively.

Note S - Maryland Health Services Cost Review Commission

The Medical Center's charges are subject to review and approval by the State of Maryland Health Services Cost Review Commission (the Commission). Management has made the required filings with the Commission and believes the Medical Center to be in compliance with the Commission's requirements. The Commission has jurisdiction over hospital reimbursement in Maryland by agreement with the Centers for Medicare and Medicaid Services (CMS). This agreement is based on a waiver from the Medicare Prospective Payment System reimbursement principles granted under Section 1814(b) of the Social Security Act. On January 10, 2014, Maryland's All-Payer Hospital System Modernization was approved by CMS. This is a five-year demonstration where Maryland agreed to permanently shift away from its current statutory waiver, which is based on Medicare payment per inpatient admission, in exchange for the new CMS model based on Medicare per capita total hospital cost growth. This new global budget arrangement sets a fixed revenue amount for the upcoming year, which does not fluctuate due to utilization or case mix. The global budget provides incentives for hospitals to improve quality and focus on population health.

The Commission established an uncompensated care fund whereby all hospitals are required to contribute 0.75% of revenues to this fund to help provide for the cost associated with uncompensated care for certain Maryland hospitals above the State average. In December 2008, the Commission modified this mechanism to finance uncompensated care statewide. The policy implemented 100% pooling and all Maryland hospitals have the same percentage of uncompensated care in rates. High uncompensated care hospitals receive funds and low uncompensated care hospitals pay into the fund. The Medical Center had net receipts (payments) of $3,251 and $1,346 for 2017 and 2016, respectively, related to its participation in the uncompensated care fund mechanism.

The Commission's rate-setting methodology for service centers that provide both inpatient and outpatient services or only outpatient services consists of establishing an acceptable unit rate for these centers within the applicable facility. The actual average unit charge for each service center is compared to the approved rate on a monthly basis. The rate variances, plus penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis. The timing of the Commission's rate adjustments for the Medical Center could result in an increase or reduction due to the variances and penalties described above in a year subsequent to the year in which such items occur. MHS' policy is to accrue revenue based on actual charges for services to patients in the year in which the services are performed and billed.

Note T - Housing Assistance Payment Contract

The U.S. Federal Housing Administration (FHA) has contracted with CSC under Section 8 of Title II of the Housing and Community Development Act of 1974 to make housing assistance payments to CSC on behalf of certified tenants. For fiscal year 2017 and 2016, the maximum contract commitment was $1,168 and $1,156 per year, respectively. During the years ended June 30, 2017 and 2016, CSC received housing assistance payments of $680 and $625, respectively, which are included in patient service revenue in the accompanying consolidated statements of operations. The effective date of the contract is retroactive to April 1, 2014 and expires on March 31 of each year with automatic renewals on April 1. The final contract expiration date is March 31, 2033.

Note U - Certain Risks and Uncertainties

Regulation and Reimbursement

MHS provides health care services primarily through an acute care hospital in Baltimore City and a long-term care facility in Baltimore County, Maryland.

MHS 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 Commission;
- 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 MHS’ 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 MHS' revenues and MHS' 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 MHS. Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on MHS.

The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self-referral laws. Recent federal initiatives have prompted a national review of federally funded health care programs. In addition, the federal government and many states have implemented programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs. MHS has implemented a compliance program to monitor conformance with applicable laws and regulations, but the possibility of future governmental review and enforcement action exists. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

As a result of federal health care reform legislation, substantial changes are underway in the U.S. health care delivery system. Such legislation includes numerous provisions affecting the delivery of health care services, the financing of health care costs, reimbursement of health care 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 decade. The known impact of all currently applicable federal health care reform legislation has been accounted for in the consolidated financial statements for the year ended June 30, 2017.

Investments

MHS and certain of its subsidiaries have funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation.

Certain alternative investments held in the MHS portfolio are exposed to potential risks in excess of the risks associated with the other investments in the MHS portfolio. These include, but are not limited to, the following potential risks:

- Limited or no liquidity (including “side pocket” arrangements),
- Derivative financial instruments that expose the investment funds to market risk (if the market value of the contract is higher or lower than the contract price at the maturity date) and credit risk (arising from the potential inability of counterparties to perform under the terms of the contracts),
- Investment in non-marketable securities that are valued without the benefit of an active secondary market,
- Substantially less regulation, and
- No current income production.

Note V - Endowment

Current accounting standards provide guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Act of 2006 (UPMIFA) and additional disclosures about an organization's endowment funds. In 2008, the State of Maryland adopted UPMIFA.

The MHS endowments consist of three individual funds established for a variety of purposes. The endowments include both donor-restricted endowment funds and funds designated by the board of trustees to function as endowments. As required by generally accepted accounting principles, net assets associated with endowment funds, including funds designated by the board of trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The board of trustees of MHS has interpreted the Maryland State Prudent Management of Institutional Funds Act (SPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, MHS classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts donated to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the standard of prudence prescribed by SPMIFA. In accordance with SPMIFA, MHS considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

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

MHS has adopted an investment policy for endowment assets that attempts to provide a predictable stream of funding to programs supported by its endowments while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that must be held in perpetuity.

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

(Dollars in thousands)

At June 30, 2017, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ 0	$ 42	$ 2,178	$ 2,220
Total funds	$ 0	$ 42	$ 2,178	$ 2,220

At June 30, 2016, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ 0	$ 59	$ 2,178	$ 2,237
Total funds	$ 0	$ 59	$ 2,178	$ 2,237

Changes in endowment net assets for the fiscal year ended June 30, 2017, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 0	$ 59	$ 2,178	$ 2,237
Investment return:				
Investment gain	0	204	0	204
Total investment gain	0	204	0	204
Appropriation of endowment asset for expenditure	0	(221)	0	(221)
Endowment net assets, end of year	$ 0	$ 42	$ 2,178	$ 2,220

(Dollars in thousands)

Changes in endowment net assets for the fiscal year ended June 30, 2016, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 0	$ 84	$ 2,178	$ 2,262
Investment return:				
Investment loss	0	(25)	0	(25)
Total investment loss	0	(25)	0	(25)
Appropriation of endowment asset for expenditure	0	0	0	0
Endowment net assets, end of year	$ 0	$ 59	$ 2,178	$ 2,237

Note W - Other Long-Term Liabilities

Other long-term liabilities consist of the following at June 30:

	2017	2016
Deferred compensation plan	$ 4,823	$ 4,636
Retirement annuity plan	5,561	6,157
GIC claims estimated tail	2,822	2,938
Other	576	569
	$ 13,782	$ 14,300

Note X - Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2017 and through September 7, 2017, the date the consolidated financial statements were issued.

Supplementary Consolidating Information

Mercy Health Services, Inc. and Subsidiaries

Consolidating Balance Sheet Information
(Dollars in thousands)

June 30, 2017

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
ASSETS							
CURRENT ASSETS							
Cash, cash equivalents and short term investments	$ -	$ 1,744	$ 101,648	$ 10,059	$ 993	$ -	$ 114,444
Short-term investments	182	5,973	27,012	235	-	-	33,402
Current portion of funds held by trustee or authority	-	-	7,362	1,349	-	-	8,711
Resident prepayment deposits	-	-	-	608	-	-	608
Patient receivables, net	-	-	41,960	7,038	14,284	-	63,282
Other receivables, net	573	-	5,819	634	1,248	(897)	7,377
Current pledges receivable, net	-	2,907	-	-	-	-	2,907
Inventory	-	-	9,147	138	(95)	-	9,190
Other current assets	-	-	5,750	73	324	-	6,147
TOTAL CURRENT ASSETS	755	10,624	198,698	20,134	16,754	(897)	246,068
PROPERTY AND EQUIPMENT	-	-	488,697	22,955	12,658	-	524,310
INVESTMENTS AND OTHER ASSETS							
Funds held by trustee or authority, less current portion	-	-	9,070	1,057	-	-	10,127
Board designated and donor restricted investments	12,302	14,291	126,115	19,813	-	-	172,521
Restricted cash	-	2,055	66,949	-	-	-	69,004
Interest in net assets of MHF	-	-	13,361	12,902	-	(26,263)	-
Long-term investments	6,998	-	-	-	-	-	6,998
Long-term pledges receivable, net	-	5,139	-	-	-	-	5,139
Investments in and advances to affiliates	14,774	(4,977)	2,358	(929)	(5,129)	(3,000)	3,097
Reinsurance balances receivable	-	-	3,374	-	-	-	3,374
Other assets	138	-	10,945	426	2,605	-	14,114
TOTAL ASSETS	$ 34,967	$ 27,132	$ 919,567	$ 76,358	$ 26,888	$ (30,160)	$ 1,054,752

Mercy Health Services, Inc. and Subsidiaries

Consolidating Balance Sheet Information - Continued
(Dollars in thousands)

June 30, 2017

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
LIABILITIES AND NET ASSETS							
CURRENT LIABILITIES							
Current maturities of long-term debt	$ 26	$ -	$ 7,360	$ 1,458	$ -	$ -	$ 8,844
Accounts payable and accrued expenses	204	5	70,107	6,263	12,748	(1,011)	88,316
Advances from third-party payers	-	-	25,227	-	-	-	25,227
Resident prepayment deposits	-	-	-	610	-	-	610
Construction retainage	-	-	12	-	-	-	12
Line of credit	-	-	-	-	-	-	-
TOTAL CURRENT LIABILITIES	230	5	102,706	8,331	12,748	(1,011)	123,009
Long-term debt	22	-	391,478	10,716	-	-	402,216
Provision for outstanding losses	-	-	66,266	-	-	-	66,266
Post-retirement obligation	-	-	5,590	-	-	-	5,590
Interest rate swap liabilities	-	-	17,976	-	-	-	17,976
Other long-term liabilities	-	(19)	13,358	6	437	-	13,782
TOTAL LIABILITIES	252	(14)	597,374	19,053	13,185	(1,011)	628,839
NET ASSETS							
Unrestricted	34,715	884	307,970	40,926	12,523	(2,887)	394,131
Temporarily restricted	-	24,207	13,100	15,324	1,180	(24,207)	29,604
Permanently restricted	-	2,055	1,123	1,055	-	(2,055)	2,178
TOTAL NET ASSETS	34,715	27,146	322,193	57,305	13,703	(29,149)	425,913
TOTAL LIABILITIES AND NET ASSETS	$ 34,967	$ 27,132	$ 919,567	$ 76,358	$ 26,888	$ (30,160)	$ 1,054,752

See independent auditors' report.

Mercy Health Services, Inc. and Subsidiaries

Consolidating Balance Sheet Information

(Dollars in thousands)

June 30, 2016

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	As Adjusted Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	As Adjusted Consolidated
ASSETS							
CURRENT ASSETS							
Cash, cash equivalents and short term investments	$ -	$ 6,368	$ 118,536	$ 9,053	$ 509	-	$ 134,466
Short-term investments	228	-	-	220	-	-	448
Current portion of funds held by trustee or authority	-	-	6,280	1,282	-	-	7,562
Resident prepayment deposits	-	-	-	764	-	-	764
Patient receivables, net	-	-	45,506	6,492	14,705	-	66,703
Other receivables, net	573	-	6,687	(196)	838	(897)	7,005
Current pledges receivable, net	-	4,235	-	-	-	-	4,235
Inventory	-	-	8,623	142	290	-	9,055
Other current assets	-	-	4,926	51	325	-	5,302
TOTAL CURRENT ASSETS	801	10,603	190,558	17,808	16,667	(897)	235,540
PROPERTY AND EQUIPMENT	-	-	498,728	24,217	13,552	-	536,497
INVESTMENTS AND OTHER ASSETS							
Funds held by trustee or authority, less current portion	-	-	9,089	1,216	-	-	10,305
Board designated and donor restricted investments	10,970	12,522	113,328	18,063	-	-	154,883
Restricted cash	-	2,055	52,669	-	-	-	54,724
Interest in net assets of MHF	-	-	14,973	11,425	-	(26,398)	-
Long-term investments	6,945	-	-	-	-	-	6,945
Long-term pledges receivable, net	-	6,450	-	-	-	-	6,450
Investments in and advances to affiliates	14,271	(4,221)	(3,989)	(499)	(1,646)	(3,000)	916
Reinsurance balances receivable	-	-	5,810	-	-	-	5,810
Other assets	138	-	11,738	598	3,879	-	16,353
TOTAL ASSETS	$ 33,125	$ 27,409	$ 892,904	$ 72,828	$ 32,452	$ (30,295)	$ 1,028,423

Mercy Health Services, Inc. and Subsidiaries

Consolidating Balance Sheet Information - Continued

(Dollars in thousands)

June 30, 2016

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	As Adjusted Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterpise	Eliminations	As Adjusted Consolidated
LIABILITIES AND NET ASSETS							
CURRENT LIABILITIES							
Current maturities of long-term debt	$ 26	$ -	$ 6,015	$ 1,390	$ -	$ -	$ 7,431
Accounts payable and accrued expenses	215	-	68,955	6,229	14,980	(1,010)	89,369
Advances from third-party payers	-	-	27,050	-	-	-	27,050
Resident prepayment deposits	-	-	-	764	-	-	764
Construction retainage	-	-	888	-	-	-	888
Line of credit	-	-	7,875	-	-	-	7,875
TOTAL CURRENT LIABILITIES	241	-	110,783	8,383	14,980	(1,010)	133,377
Long-term debt	53	-	399,145	12,174	-	-	411,372
Provision for outstanding losses	-	-	59,359	-	-	-	59,359
Post-retirement obligation	-	-	5,471	-	-	-	5,471
Interest rate swap liabilities	-	-	28,531	-	-	-	28,531
Other long-term liabilities	-	127	13,884	9	280	-	14,300
TOTAL LIABILITIES	294	127	617,173	20,566	15,260	(1,010)	652,410
NET ASSETS							
Unrestricted	32,831	884	259,913	37,349	15,977	(2,887)	344,067
Temporarily restricted	-	24,343	14,695	13,858	1,215	(24,343)	29,768
Permanently restricted	-	2,055	1,123	1,055	-	(2,055)	2,178
TOTAL NET ASSETS	32,831	27,282	275,731	52,262	17,192	(29,285)	376,013
TOTAL LIABILITIES AND NET ASSETS	$ 33,125	$ 27,409	$ 892,904	$ 72,828	$ 32,452	$ (30,295)	$ 1,028,423

See independent auditors’ report.

Mercy Health Services, Inc. and Subsidiaries

Consolidating Statement of Operations Information
(Dollars in thousands)

June 30, 2017

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
REVENUES							
Patient service revenues							
(net of allowances and discounts)	$ -	$ -	$ 465,772	$ 52,923	$ 167,343	$ -	$ 686,038
Provisions for bad debt	-	-	(7,966)	(697)	(7,193)	-	(15,856)
Net patient service revenues	-	-	457,806	52,226	160,150	-	670,182
Other operating revenues	1,596	876	24,384	6,816	9,294	(12,378)	30,588
Net assets released from restrictions							
used for operations	-	-	2,990	1,492	229	-	4,711
TOTAL REVENUES	1,596	876	485,180	60,534	169,673	(12,378)	705,481
EXPENSES							
Salaries and benefits	1,394	1,171	212,494	40,822	131,799	(5,439)	382,241
Medical and surgical supplies	-	-	62,277	771	1,147	-	64,195
Pharmacy supplies	-	-	27,354	984	17,563	-	45,901
Other expendable supplies	-	229	22,545	3,965	1,765	-	28,504
Professional fees	-	-	9,021	3,053	7,316	(1,791)	17,599
Insurance	-	-	16,062	934	5,906	32	22,934
Other purchased services	27	167	50,779	4,222	4,089	(5,902)	53,382
Interest expense	-	-	15,561	706	1	-	16,268
Repairs	-	31	14,105	1,110	1,139	-	16,385
Depreciation and amortization	-	-	35,033	2,543	2,400	-	39,976
TOTAL EXPENSES	1,421	1,598	465,231	59,110	173,125	(13,100)	687,385
OPERATING INCOME (LOSS)	175	(722)	19,949	1,424	(3,452)	722	18,096

Mercy Health Services, Inc. and Subsidiaries

Consolidating Statement of Operations Information - Continued

(Dollars in thousands)

June 30, 2017

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
OTHER INCOME (EXPENSES)							
Investment income	639	400	7,391	1,296	-	(400)	9,326
Net unrealized gain (loss) on trading securities	494	322	6,344	1,006	-	(322)	7,844
Unrealized gain on interest rate swap	-	-	10,555	-	-	-	10,555
Gain on termination of interest rate swap	-	-	373	-	-	-	373
Extinguishment of debt	-	-	-	(45)	(4)	-	(49)
Equity in joint ventures	579	-	-	-	-	-	579
Other	-	-	2	-	-	-	2
NET OTHER INCOME (EXPENSES)	1,712	722	24,665	2,257	(4)	(722)	28,630
EXCESS (DEFICIT) OF REVENUES OVER EXPENSES	1,887	-	44,614	3,681	(3,456)	-	46,726
Changes to post retirement plan obligations	-	-	1,759	-	-	-	1,759
Transfers of net assets	-	-	-	-	-	-	-
Net assets released from restrictions for the purchase of property and equipment	-	-	1,686	(107)	-	-	1,579
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$ 1,887	$ -	$ 48,059	$ 3,574	$ (3,456)	$ -	$ 50,064

See independent auditors' report.

Mercy Health Services, Inc. and Subsidiaries

Consolidating Statement of Operations Information
(Dollars in thousands)

June 30, 2016

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	As Adjusted Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	As Adjusted Consolidated
REVENUES							
Patient service revenues (net of allowances and discounts)	$ -	$ -	$ 454,524	$ 51,104	$ 156,425	$ -	$ 662,053
Provisions for bad debt	-	-	(7,732)	(691)	(4,463)	-	(12,886)
Net patient service revenues	-	-	446,792	50,413	151,962	-	649,167
Other operating revenues	1,553	1,717	26,695	6,805	10,126	(12,456)	34,440
Net assets released from restrictions used for operations	-	-	2,007	1,436	147	-	3,590
TOTAL REVENUES	1,553	1,717	475,494	58,654	162,235	(12,456)	687,197
EXPENSES							
Salaries and benefits	1,381	1,333	211,959	38,670	132,259	(5,726)	379,876
Medical and surgical supplies	-	-	63,172	824	1,081	-	65,077
Pharmacy supplies	-	-	29,085	1,082	10,514	-	40,681
Other expendable supplies	-	120	21,036	4,210	1,645	-	27,011
Professional fees	-	-	8,725	3,104	5,940	(1,248)	16,521
Insurance	-	-	14,755	936	5,820	32	21,543
Other purchased services	11	169	51,170	3,714	3,104	(5,430)	52,738
Interest expense	-	-	16,514	732	-	-	17,246
Repairs	-	11	12,476	1,082	718	-	14,287
Depreciation and amortization	-	-	33,537	2,406	1,985	-	37,928
TOTAL EXPENSES	1,392	1,633	462,429	56,760	163,066	(12,372)	672,908
OPERATING INCOME (LOSS)	161	84	13,065	1,894	(831)	(84)	14,289

Consolidating Statement of Operations Information - Continued
(Dollars in thousands)

June 30, 2016

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	As Adjusted Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	As Adjusted Consolidated
OTHER INCOME (EXPENSES)							
Investment income	$ 99	$ 69	$ 804	$ 175	$ -	$ (69)	$ 1,078
Net unrealized gain (loss) on trading securities	(182)	(153)	(503)	(347)	-	153	(1,032)
Unrealized gain on interest rate swap	-	-	(6,638)	-	-	-	(6,638)
Loss on termination of interest rate swap	-	-	-	-	-	-	-
Extinguishment of debt	-	-	(10,914)	-	-	-	(10,914)
Equity in joint ventures	557	-	-	-	-	-	557
Other	-	-	20	-	22	-	42
NET OTHER INCOME (EXPENSES)	474	(84)	(17,231)	(172)	22	84	(16,907)
EXCESS (DEFICIT) OF REVENUES OVER EXPENSES	635	-	(4,166)	1,722	(809)	-	(2,618)
Changes to post retirement plans obligations	-	-	(431)	-	-	-	(431)
Transfers of net assets	-	-	(8,879)	-	8,879	-	-
Net assets released from restrictions for the purchase of property and equipment	-	-	2,433	(44)	-	-	2,389
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$ 635	$ -	$ (11,043)	$ 1,678	$ 8,070	$ -	$ (660)

See independent auditors' report.

DHG