MERITUS MEDICAL CENTER, INC.

Consolidated Financial Statements and
Supplementary Financial Information

June 30, 2017 and 2016

(With Independent Auditors' Report Thereon)

MERITUS MEDICAL CENTER, INC.

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

Independent Auditors' Report

Board of Directors
Meritus Medical Center, Inc.:

We have audited the accompanying consolidated financial statements of Meritus Medical Center, Inc. (Meritus), 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 U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Meritus Medical Center, Inc. as of June 30, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

KPMG

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

September 27, 2017

MERITUS MEDICAL CENTER, INC.

Consolidated Balance Sheets

June 30, 2017 and 2016

(Dollars in thousands)

Assets		**2017**	**2016**
Current assets:			
Cash and cash equivalents	$	50,144	34,943
Short-term investments		42,926	23,441
Current portion of assets whose use is limited		10,359	11,122
Accounts receivable, net		41,909	44,378
Supplies		5,267	6,900
Prepaid and other current assets		4,064	6,194
Total current assets		154,669	126,978
Assets whose use is limited		187,479	180,651
Property, plant and equipment, net		237,909	242,685
Pledges receivable, net		362	561
Equity investments in affiliates		35,676	29,851
Other assets		4,932	5,318
Total assets	$	621,027	586,044
Liabilities and Net Assets			
Current liabilities:			
Accounts payable and accrued expenses	$	23,386	12,315
Accrued salaries, wages and withholdings		9,844	9,316
Accrued compensation benefit		10,496	10,192
Advances from third-party payors		9,194	14,238
Accrued interest payable		6,144	6,241
Current portion of long-term debt		6,607	6,281
Total current liabilities		65,671	58,583
Long-term debt, net of current portion		264,673	271,281
Accrued retirement benefits		6,206	4,973
Other long-term liabilities		8,518	7,527
Total liabilities		345,068	342,364
Net assets:			
Unrestricted		270,155	235,799
Total unrestricted net assets		270,155	235,799
Temporarily restricted		4,775	6,852
Permanently restricted		1,029	1,029
Total net assets		275,959	243,680
Total liabilities and net assets	$	621,027	586,044

See accompanying notes to consolidated financial statements.

MERITUS MEDICAL CENTER, INC.

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2017 and 2016

(Dollars in thousands)

		2017	2016
Unrestricted revenue, gains and other support:			
Net patient service revenue	$	388,080	373,864
Less provision for bad debts		(16,940)	(16,192)
Net patient service revenue less provision for bad debts		371,140	357,672
Other revenue		8,271	10,626
Equity earnings in affiliates		5,628	1,024
Net assets released from restriction used for operations		1,067	496
Total revenues		386,106	369,818
Expenses:			
Salaries and wages		136,125	125,392
Employee benefits		34,720	32,184
Professional fees		14,124	12,354
Supplies and other		151,073	152,962
Interest		11,951	12,295
Depreciation and amortization		21,085	20,448
Total expenses		369,078	355,635
Operating income		17,028	14,183
Nonoperating gains (losses), net:			
Investment returns, net		15,531	(647)
Loss on extinguishment of debt		—	(33,115)
Other, net		(318)	(494)
Income tax expense		(16)	(1,223)
Excess (deficit) of revenue over expenses	$	32,225	(21,296)

(Continued)

MERITUS MEDICAL CENTER, INC.

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2017 and 2016

(Dollars in thousands)

		2017	2016
Unrestricted net assets:			
Excess (deficit) of revenues over expenses	$	32,225	(21,296)
Other		(424)	—
Transfer to temporarily restricted net assets		—	(238)
Net assets released from restriction for property, plant, and equipment		2,555	—
Increase (decrease) in unrestricted net assets		34,356	(21,534)
Temporarily restricted net assets:			
Contributions		1,473	878
Other		72	1,342
Transfer from unrestricted net assets		—	238
Net assets released from restriction for property, plant, and equipment		(2,555)	—
Net assets released from restriction for operations		(1,067)	(496)
(Decrease) increase in temporarily restricted net assets		(2,077)	1,962
Increase (decrease) in net assets		32,279	(19,572)
Net assets:			
Beginning of year		243,680	263,252
End of year	$	275,959	243,680

See accompanying notes to consolidated financial statements.

MERITUS MEDICAL CENTER, INC.

Consolidated Statements of Cash Flows

Years ended June 30, 2017 and 2016

(Dollars in thousands)

	2017	2016
Cash flows from operating activities:		
Increase (decrease) in net assets	$ 32,279	(19,572)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation and amortization	21,085	20,448
Provision for bad debts	16,940	16,192
Net realized and unrealized (gains) losses on investments	(11,754)	4,712
Loss (gain) on disposal of assets	38	(111)
Equity earnings in affiliates	(5,628)	(1,024)
Loss on extinguishment of debt	—	33,115
Restricted contributions and other	(1,121)	(2,220)
Changes in assets and liabilities:		
Accounts receivable	(14,471)	(11,058)
Supplies, prepaid, and other current assets	3,763	1,610
Other assets	585	(357)
Accounts payable, accrued expenses and long-term liabilities	5,656	(3,133)
Accrued salaries, wages and withholdings	528	302
Accrued compensation benefit	304	257
Advances from third-party payors	(5,044)	5,753
Interest payable	(97)	(950)
Accrued retirement benefits	1,233	(74)
Net cash provided by operating activities	44,296	43,890
Cash flows from investing activities:		
Purchase of property, plant and equipment	(10,080)	(16,780)
Proceeds from the disposal of assets	139	335
Purchases of alternative investments	(6,000)	—
Sales of alternative investment	20,218	—
(Purchases)/sales of restricted cash, short-term investments, and assets whose use is limited, net	(28,014)	(6,473)
Equity contributions to affiliates, net	(197)	(523)
Net cash used in investing activities	(23,934)	(23,441)
Cash flows from financing activities:		
Payments on long-term debt and capital leases	(6,282)	(281,843)
Proceeds from bond issuance	—	272,421
Payments of debt issuance costs	—	(2,339)
Restricted contributions and other	1,121	2,220
Net cash used in financing activities	(5,161)	(9,541)
Net increase in cash and cash equivalents	15,201	10,908
Cash and cash equivalents:		
Beginning of year	34,943	24,035
End of year	$ 50,144	34,943
Supplemental disclosure of cash flow information:		
Cash paid for interest, net of amounts capitalized	$ 11,951	12,295
Capital additions accrued but not yet paid	6,406	—

See accompanying notes to consolidated financial statements.

(1) Description of Organization

Organization

Meritus Medical Center, Inc. (Hospital or the Company) is the parent corporation of the Meritus Healthcare Foundation, Inc. (Foundation), the Meritus Insurance Company, Ltd. (MIC), Meritus ACO, LLC (MACO) and Meritus Holdings, LLC (Holdings), which owns Meritus Enterprises (MEI). These entities are collectively referred to as “Meritus”.

The Hospital is a not-for-profit acute care hospital located in Hagerstown, Maryland and serves the residents of western Maryland, southern Pennsylvania, and the panhandle of West Virginia. The Hospital currently offers acute general hospital inpatient services including adult medical/surgical care, obstetrics and newborn care, including a family birthing center, cardiac catheterizations, comprehensive inpatient rehabilitation, radiology and diagnostic services, inpatient and outpatient mental health services, a regional Level III Trauma Center, an intensive care unit, an intermediate care unit, and a pediatric unit. The Hospital also manages gifts, donations or bequests given for the benefit of Meritus and owns real estate properties for rental to medical provider entities and development opportunities.

The Foundation is a not-for-profit corporation whose purpose is to raise philanthropic support for the capital and endowment campaigns of the Hospital. The Foundation also raises money for the Hospital’s medical programs, healthcare objectives, scientific research, educational programs, and related community activities. Resources for the Foundation’s activities are primarily provided by donors.

MIC is a Cayman Island captive insurance company, wholly owned by the Hospital that provides primary limits of insurance to Meritus for professional liability, employed physicians professional liability, comprehensive general liability, deductible, and stop loss coverage for health insurance.

As of June 30, 2017, MEI a for-profit corporation, held ownership interests in the following joint venture:

- Diagnostic Imaging Services, LLC (DIS), an outpatient imaging services provider

As of June 30, 2017, Holdings a nonprofit corporation, held ownership interests in the following joint ventures:

- General Surgery Real Estate, LLC (GSRE), a real estate holding company
- GI Real Estate Company, LLC (GI REC), a real estate holding company
- Western Maryland Medical Supply, LLC (WMMS), a durable medical equipment company, dissolved June 30, 2016

MEI also owned and operated The Learning Center (TLC), a child care center located in Washington County, Maryland (the Learning Center), which ceased operations in August 2016 and Equipped for Life, a durable medical equipment company (EFL).

MACO is an Accountable Care Organization (ACO), wholly owned by the Hospital. MACO is a Medicare ACO with a start date of January 1, 2017.

(2) Summary of Significant Accounting Policies

(a) Principles of Consolidation

The Company's consolidated financial statements include the subsidiaries in which the Company has 50% or more voting interests or when the Company is deemed to have control. Significant intercompany accounts and transactions have been eliminated in consolidation. The accompanying consolidated financial statements include the accounts of the Hospital, Holdings, MEI, the Foundation, MACO, and MIC. MEI owned a 100% interest in Robinwood Surgery Center, LLC, at June 30, 2017 and 2016. All material inter-company balances and transactions have been eliminated in consolidation.

(b) Use of Estimates

The preparation of consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the 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.

(c) Cash and Cash Equivalents

Cash and cash equivalents consist of short-term, highly liquid investments that are readily convertible to cash and have original maturities of three months or less. Cash and cash equivalents are carried at cost which approximates fair value.

(d) Patient Accounts Receivable/Allowance for Doubtful Accounts

Patient accounts receivable result from the healthcare services provided by Meritus. Meritus provides an allowance for doubtful accounts for estimated losses resulting from the unwillingness or inability of patients or third-party payors to make payments for services. The allowance is determined by analyzing specific accounts and historical data and trends. Patient accounts receivable are charged off against the allowance for doubtful accounts when management determines that recovery is unlikely and Meritus ceases collection efforts. Losses have been consistent with management's expectations.

(e) Assets Whose Use is Limited

Assets whose use is limited include assets set aside by the Board of Directors for specific purposes, for supplemental retirement benefit investments, to fulfill donor purposes, assets held by trustees under bond indenture agreement, and funds designated for insurance purposes. Amounts required to meet current liabilities are shown as current assets in the consolidated balance sheets.

(Continued)

(f) Investments and Investment Income

Investments in equity securities (i.e., investments that have readily determinable fair values and are not accounted for by the equity method) and all investments in debt securities are reported at fair value on the consolidated balance sheets. Institutional funds are recorded at their readily determinable fair values (RDFV). All securities with the exception of alternative investments are reported at fair value. Alternative investments are recorded under the equity method of accounting.

A significant portion of the Meritus' investments are held in an investment portfolio maintained for the benefit of Meritus and its affiliates and subsidiaries. Investments are classified as trading securities except for certain investments, which are limited or restricted as to use, and are classified as investments available for sale.

Investment income and realized gains are recorded as nonoperating revenue. Unrealized gains and losses on trading securities are recorded as nonoperating revenue. Unrealized gains and losses on available for sale investments are included in other changes in net assets. Investment income and realized gains and losses on assets restricted by donors for specific purposes or endowment are included in temporarily restricted net assets.

Investment income, which includes interest and dividends, on proceeds of borrowings that are held by a trustee are reported as other revenue. Other investment income, which includes interest, dividends and realized and unrealized gains and losses on assets limited as to use by Board of Directors and funds designated for insurance purposes are recorded as nonoperating gains (losses), net, unless the income or loss is restricted by donor or law.

Meritus' investments are managed by investment managers. Investment securities, in general, are exposed to various risks, such as interest rate, credit and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect the amounts reported in the consolidated financial statements.

(g) Supplies

Supplies for the Hospital are carried at cost on a weighted average basis.

(Dollars in thousands)

(h) Property, Plant and Equipment

Property, plant and equipment acquisitions are recorded at cost. Those assets acquired by gift are carried at amounts established as fair value at the time of acquisition. Depreciation is provided over the estimated useful life of each class of depreciable assets and is computed using the straight-line method. Equipment under capital lease is amortized by the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. No interest was capitalized during the years ended June 30, 2017 and 2016. Leasehold improvements are amortized over the lesser of the useful life or the lease life. Durable medical equipment held for resale is included in supplies. The remainder of durable medical equipment is rented to patients and is included in property, plant and equipment. Assets are retired or disposed of at book value and related gains or losses are recorded for assets sold. Useful lives range as follows:

Land improvements	5–25 years
Buildings	10–40 years
Equipment	3–20 years
Leasehold improvements	The lessor of the useful life or lease term

Gifts of long-lived assets such as land, buildings, or equipment are reported as other changes in unrestricted net assets unless explicit donor stipulations specify how the donated assets must be used. When applicable, gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long-lived assets must be maintained, expirations of donor restrictions, occur when the donated or acquired long-lived assets are placed into service.

Meritus continually evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets is appropriate, or whether the remaining balance may not be recoverable. When factors indicate that long-lived assets should be evaluated for possible impairment, Meritus uses an estimate of the related undiscounted operating income over the remaining life of the long lived asset in measuring whether the long-lived asset is recoverable.

The impairment loss on these assets is measured as the excess of the carrying amount of the asset over its fair value. Fair value is based upon market prices, where available, or discounted cash flows. Management believes that no revision to the remaining useful lives is required and there were no impairment of long-lived assets during the years ended June 30, 2017 and 2016.

(i) Deferred Financing Costs

Financing costs incurred in issuing debt have been capitalized and are being amortized over the life of the debt using the effective interest method.

(j) Compensated Absences

Meritus records a liability for amounts due to employees for future absences which are attributable to services performed in the current and prior periods. This liability is included in accrued salaries, wages and withholdings on the consolidated balance sheets.

(k) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by Meritus have been limited by donors to a specific time period or purpose. When donor restrictions expire, that is, when a time restriction ends or a purpose restriction is accomplished, temporarily restricted net assets are reclassified into unrestricted net assets and reported as net assets released from restrictions.

Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions if for operating purposes and as other changes in unrestricted net assets if for capital purposes in the consolidated statements of operations and changes in net assets. Permanently restricted net assets have been restricted by donors to be maintained by Meritus in perpetuity.

(l) Excess of Revenue over Expenses

The consolidated statements of operations include a performance indicator, the excess of revenue over expenses. Changes in unrestricted net assets that are excluded from the excess of revenues over expenses, consistent with industry practice, include net assets released from restrictions for property, plant and equipment, the change in retirement benefit obligation and change in noncontrolling interest.

(m) Net Patient Service Revenue

For services provided at the Hospital campus, all payors are required to pay the Maryland Health Services Cost Review Commission (HSCRC) approved rates. The major third-party payors, as recognized by the HSCRC, are allowed discounts of up to 6% on approved rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered.

The Hospital’s charges are subject to review and approval by the HSCRC. The total rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on an arrangement between the Centers for Medicare and Medicaid Service and the HSCRC. Management believes that this program will remain in effect at least through June 30, 2018. The Hospital has an agreement with the HSCRC under a rate regulation concept called Global Budget Revenue (GBR) which was renewed as of July 1, 2016 and this agreement is expected to be renewed for July 1, 2017. GBR is a revenue constraint methodology which provides for inflation, bad debt, payor differential and adjustments for population growth, but excludes case mix and volume changes. For the years ended June 30, 2017 and 2016, the regulated revenue cap was $325,957 and $322,063, respectively. For the year ending June 30, 2018, the expected regulated revenue cap is $334,670. The HSCRC also may impose various other revenue adjustments that could be significant in the future.

(Continued)

(Dollars in thousands)

Services not located on the Hospital campus and certain other services are not regulated by the HSCRC. Medicare and Medicaid pay the revenues associated with these services based upon established fee schedules. Commercial payors pay at negotiated rates for these services.

Net patient service revenue is reported as estimated net realizable amounts from patients, third-party payors, and others for services rendered and include estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Laws and regulations governing the HSCRC, Medicare and Medicaid programs are 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. Meritus believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action.

Patient service revenue as a percentage for the years ended June 30, 2017 and 2016, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources based on primary insurance designation, is as follows:

Net patient service revenue	Third-party payors	Self-pay	Total all payors
2017:			
Patient service revenue, net of contractual allowances and discounts	97 %	3 %	100 %
2016:			
Patient service revenue, net of contractual allowances and discounts	96 %	4 %	100 %

Deductibles and copayments under third-party payment programs within the third-party payor amount above are the patients' responsibility and Meritus considers these amounts in its determination of the provision for bad debts based on collection experience.

(n) Charity Care

Meritus provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Meritus does not pursue collection on amounts deemed to qualify as charity. Meritus also estimates that the direct and indirect cost of services and supplies furnished to patients eligible for charity care using a ratio of cost to gross charges based on internal data is $11,206 and $13,874 for the years ended June 30, 2017 and 2016, respectively.

(Continued)

Meritus’ patient acceptance policy is based upon its mission statement and its charitable purposes. This policy results in Meritus’ assumption of higher-than-normal credit risk from its patients. To the extent that Meritus realizes additional losses resulting from such higher credit risks and clients are not identified or do not meet Meritus’ defined charity care policy, such additional losses are included in the provision for bad debt.

Meritus also sponsors certain other charitable programs, which provide substantial benefit to the broader community. Such programs include services to needy and elderly populations that require special support, as well as health and education for the general community welfare. In addition, all other uncollectable amounts resulting from the patients’ inability to pay are recorded as a reduction to net patient service, consistent with Meritus’ policy.

(o) Other Revenue

Other revenue is comprised of rental income, gains and losses on disposal of assets, incentive payments related to the implementation and meaningful use of certified electronic health records and other miscellaneous items.

The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments for eligible hospitals and professionals that implement and achieve meaningful use of certified electronic health record (EHR) technology. For Medicare and Medicaid EHR incentive payments Meritus utilizes a grant accounting model to recognize these revenues. Under this accounting policy, EHR incentive payments were recognized as revenues when attestation that the EHR meaningful use criteria for the required period of time was demonstrated. Accordingly, Meritus recognized $56 and $1,043 of EHR revenues for the years ended June 30, 2017 and 2016. These amounts are included in other revenue in the consolidated statements of operations and changes in net assets. Meritus’ attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, Medicare EHR incentive payments received are subject to retrospective adjustment upon final settlement of the applicable cost report from which payments were calculated.

(p) Income Taxes

The Internal Revenue Service has ruled that the Hospital, and the Foundation qualify under Section 501(c)(3) of the Internal Revenue Code and are, therefore, not subject to tax under present income tax regulations.

Holdings and MACO are considered a disregarded entity for tax purposes and are reported through the Hospital.

MEI accounts for income taxes through the current recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between tax bases and financial reporting bases of other assets and liabilities.

At present, no income, profit or capital gain taxes are levied in the Cayman Islands and accordingly, no provision for taxation has been made for MIC. In the event that such taxes are levied, MIC has been

(Continued)

(Dollars in thousands)

granted an exemption until September 9, 2023 for any such taxes that might be introduced. MIC intends to conduct its affairs so as not to be liable for taxes in any other jurisdiction.

Meritus follows the accounting guidance for uncertainties in income tax positions, which requires that a tax position be recognized or derecognized based on a “more likely than not” threshold. This applies to positions taken or expected to be taken in a tax return. Meritus does not believe its consolidated financial statements include any material uncertain tax positions. As of June 30, 2017, the Meritus tax years ended June 30, 2013 through June 30, 2017 for federal tax jurisdiction remain open to examination.

(q) Concentration of Credit Risk

Meritus invests its excess cash, investments, and assets in financial institutions which are federally insured under the Federal Deposit Insurance Act (FDIA). Deposits in certain accounts exceed federally insured deposit limits. Meritus has experienced no losses on its deposits.

Meritus grants credit without collateral to the patients it serves who primarily live in the tri-state area. The majority of these patients have either insurance through Blue Cross, another insurance company or a health maintenance organization, or qualify for the Maryland Medical Assistance or the Centers for Medicare and Medicaid Services (CMS) programs.

At June 30, Meritus’ patient accounts receivable were made up of the following:

	2017	2016
Medical assistance HMO / Medicaid	19 %	21 %
Medicare	31	31
Commercial insurance, HMO and other	23	22
Blue cross/blue shield	12	12
Self-pay	15	14
	100 %	100 %

(r) Deferred Compensation Plan

The Hospital is party to a 457(b) deferred compensation plan and a 457(f) deferred compensation plan, both are intended to provide retirement benefits to certain eligible employees. Assets are deposited with the plan managers, pursuant to this agreement, such that the value of the assets determined by the fair value approximately equals the related accrued deferred compensation liability. The funds are placed into a range of investment strategies from conservative to aggressive. The liability associated with this plan is included in accrued retirement benefits on the consolidated balance sheets.

(s) Management’s Assessment and Plans

The Company adopted Accounting Standards Update (ASU) 2014-5, *Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern*, (ASU 2014-15) during 2015. ASU 2014-15 requires management to evaluate an entity’s ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued, when applicable). Management determined that there were no conditions or events that raise substantial doubt about the Company's ability to continue as a going concern and the Company will continue to meet its obligations through September 27, 2018.

(t) New Accounting Pronouncements

In 2016, Meritus adopted Accounting Standards Update (ASU) 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. The presentation of debt issuance costs on the balance sheet has been changed from an asset to a direct reduction of debt, similar to the presentation of debt discounts. As a result of this change, $2,183 and $2,261 of deferred financing costs were classified as a direct reduction of debt at June 30, 2017 and 2016. The related consolidated statements of operations and changes in net assets for the periods were not affected by the adoption of ASU 2015-03.

The Financial Accounting Standards Board (FASB) issued Accounting Standards update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU establishes principles for reporting useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the entity's contracts with customers. Particularly, that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for fiscal year 2019. The Company expects to record a decrease in net patient service revenue related to self-pay patients and a corresponding decrease in bad debt expense upon the adoption of the standard.

The FASB issued ASU No. 2016-02, *Leases* (ASU 2016-02), which will require lessees to recognize most leases on-balance sheet, increasing their reported assets and liabilities – sometimes very significantly. This update was developed to provide financial statement users with more information about an entity's leasing activities, and will require changes in processes and internal controls. The adoption of ASU 2016-02 is effective fiscal year 2020, and will require application of the new guidance at the beginning of the earliest comparable period presented. Early adoption is permitted. The Company is currently assessing the impact of the adoption of ASU No. 2016-02 which is expected to have a material impact on its financial position and results of operations.

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

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

(Dollars in thousands)

The adoption of ASU 2016-14 is effective in fiscal year 2019, and is applied retrospectively in the year of adoption. The Company does not anticipate that the adoption of this ASU will have a material impact on its financial position and results of operations.

(3) Investments and Investment Income

Investments at June 30 consisted of the following:

		2017	2016
Short-term investments:			
US government notes	$	1,690	1,193
Fixed income bonds – corporate		546	—
Mutual funds		40,690	22,248
	$	42,926	23,441
Assets whose use is limited:			
Cash and cash equivalents	$	10,448	15,173
Cash surrender value of life insurance		—	2,823
Fixed income bonds:			
Corporate debt securities		3,122	6,354
Mortgage backed securities		638	2,987
Agency bonds		—	4,547
Asset backed securities		1,049	2,321
US government notes		8,194	22,494
Equities:			
Stock and equity fund s		33	20,461
Mutual funds		64,205	94,395
Institutional funds:			
Domestic equities		15,846	—
International equities		54,989	—
Fixed income		33,314	—
Alternative investments		6,000	20,218
	$	197,838	191,773

The amount of the board designated funds whose use is limited is $161,425 and $139,115 as of June 30, 2017 and 2016, respectively.

(Dollars in thousands)

Investment returns, net of investments included in the consolidated statements of operations and changes in net assets are comprised of the following for the years ended June 30:

		2017	2016
Investment returns, net:			
Interest and dividends, net of investment fees of $557 and $518 in 2017 and 2016, respectively	$	3,777	4,065
Net realized gains on investments		18,766	789
Change in unrealized gains and losses on investments		(7,012)	(5,501)
	$	15,531	(647)

At June 30, 2017 and 2016, the Hospital had invested $6,000 and $20,218, or 2.5% and 9.4%, respectively, of the portfolio in alternative investments, which are invested in a hedge fund. The redemption terms of the fund is semi-annual. The redemption notification required is 95 days.

(4) Fair Value Measurements

Meritus measures fair value as the price that would be received to sell an asset or paid to transfer a liability (the exit price) in an orderly transaction between market participants at the measurement date. The accounting guidance outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. The fair value hierarchy is broken down into three levels based on the source of inputs as follows:

Level I – Quoted prices are available in active markets for identical assets or liabilities as of the report date. A quoted price for an identical asset or liability in an active market provides the most reliable fair value measurement because it is directly observable to the market.

Level II – Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the report date. The nature of these securities include investments for which quoted prices are available but traded less frequently and investments that are fair valued using other securities, the parameters of which can be directly observed.

Level III – Securities that have little to no pricing observability as of the report date. These securities are measured using management’s best estimate of fair value, where the inputs into the determination of fair value are not observable and require significant management judgment or estimation.

Financial instruments consist of cash equivalents, patient accounts receivable, investments, excluding those accounted for by the equity method, accounts payable and accrued expenses and long-term debt. The carrying amounts reported in the consolidated balance sheets for cash equivalents, patient accounts receivable, and accounts payable and accrued expenses approximate fair value. Management’s estimates of other financial instruments are described elsewhere in the notes to the consolidated financial statements.

Meritus does not have any Level 3 financial instruments as of June 30, 2017 and 2016.

(Continued)

(Dollars in thousands)

Investments are valued using a market approach as follows:

Cash and cash equivalents – Cash and cash equivalents are classified as Level 1 inputs and represent short-term, highly liquid investments that are readily convertible to cash and have original maturities of three months or less.

Stock and equity funds – Common stock and equity funds are Level 1 inputs and consist of stock of U.S. companies and are valued based upon unadjusted quoted prices in the market.

Mutual Funds – Valued at the closing price reported in the active market in which the mutual fund is traded.

Fixed income bonds – Valued at the closing price reported in the active market in which the bond is traded.

Institutional funds – Institutional funds are commingled domestic and international equity and fixed income funds whose fair value is considered to be readily determinable. The company elected to use the fair value option for these investments in 2017. These funds are valued based on the net asset value.

The following table presents Meritus' assets measured at fair value on a recurring basis using the market approach, as of June 30:

	Level 1	Level 2	Level 3	Total
2017:				
Cash and cash equivalents	$ 10,448	—	—	10,448
Stock and equity funds	33	—	—	33
Mutual funds	104,895	—	—	104,895
Fixed income bonds:				
Corporate debt securities	—	3,668	—	3,668
Mortgage backed securities	—	638	—	638
Asset backed securities	—	1,049	—	1,049
U.S. government notes	—	9,884	—	9,884
Institutional funds:				
Domestic equities	—	15,846	—	15,846
International equities	—	54,989	—	54,989
Fixed income	—	33,314	—	33,314
Total assets	$ 115,376	119,388	—	234,764

(Dollars in thousands)

		Level 1	Level 2	Level 3	Total
2016:					
Cash and cash equivalents	$	15,173	—	—	15,173
Stock and equity funds		20,461	—	—	20,461
Mutual funds		116,643	—	—	116,643
Fixed income bonds:					
Corporate debt securities		—	6,354	—	6,354
Mortgage backed securities		—	2,987	—	2,987
Agency bonds		—	4,547	—	4,547
Asset backed securities		—	2,321	—	2,321
U.S. government notes		—	23,687	—	23,687
Total assets	$	152,277	39,896	—	192,173

There were transfers between Level 1 and 2 during the years ended June 30, 2017 and 2016. The transfers largely resulted from a portfolio realignment, which resulted in more investments in institutional grade domestic and international equity funds, and fixed income funds. There were no transfers between Level 3 and Levels 1 and 2 during the years ended June 30, 2017 and 2016.

(5) Accounts Receivable

Accounts receivable are reduced by an allowance for doubtful accounts. Meritus' allowance for doubtful accounts totaled $15,336 and $12,702 at June 30, 2017 and 2016, respectively. In evaluating the collectability of accounts receivable, Meritus analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, Meritus analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients, Meritus records a significant provision for bad debts on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. Meritus has not experienced significant changes in write-off trends and has not changed its charity care policy for the year ended June 30, 2017.

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

		2017	2016
Beginning balance as of July 1	$	12,702	8,789
Provision for uncollectible accounts		16,940	16,192
Less write offs		(14,306)	(12,279)
Ending balance as of June 30	$	15,336	12,702

(Continued)

(Dollars in thousands)

Pledges receivable at June 30 consist of the following:

		2017	2016
Capital campaign	$	428	686
Other		788	1,995
Total unconditional promises to give	$	1,216	2,681
Receivable in less than one year	$	402	1,617
Receivable in one to five years		774	1,012
Receivable in more than five years		40	52
Total unconditional promises to give		1,216	2,681
Less discounts to net present value		(90)	(130)
Less allowance for uncollectible promises		(570)	(518)
Net unconditional promises to give	$	556	2,033
Pledges receivable, current portion included in accounts receivable, net	$	194	1,472
Pledges receivable, net of current portion		362	561
	$	556	2,033

Discount rates utilized were derived utilizing the unsecured borrowing rate and ranged from 3.98% to 5.52%.

(6) Property, Plant and Equipment

Property, plant and equipment at June 30 is comprised of the following:

		2017	2016
Land	$	25,860	25,831
Buildings, and improvements		205,143	204,924
Leasehold Improvements		4,071	3,999
Equipment		178,238	204,709
		413,312	439,463
Less accumulated depreciation and amortization		(187,339)	(201,710)
		225,973	237,753
Construction in progress		11,936	4,932
Property, plant and equipment, net	$	237,909	242,685

(Continued)

(Dollars in thousands)

Equipment under capital leases		2017	2016
Equipment	$	9,000	9,000
Less accumulated amortization		(3,520)	(1,720)
	$	5,480	7,280

Total depreciation and amortization expense for property, plant and equipment for the years ended June 30, 2017 and 2016 was $21,085 and $20,448, respectively.

The Company is in the process of implementing an electronic medical record system (the Project) and has entered into multiple agreements related to the implementation of the Project. Such commitments range from $20 to $30 million and the Company expects to incur additional costs in fiscal year 2018 related to the Project.

(7) Equity Investments in Affiliates

The following investments, recorded under the equity method of accounting, are included in the consolidated balance sheets.

The Hospital holds a 25% equity interest in Maryland Care, Inc. (Maryland Care) is a managed care organization (MCO) that was established to serve Maryland's Medicaid population as a result of the State's requirement for Medicaid patients to be a member of an MCO.

The Hospital held a 50% equity interest in Tri-State Health Partners as of June 30, 2016. Tri-State Health Partners was consolidated into the Hospital as of June 30, 2017. Tri-State Health Partners was a physician hospital organization (PHO) established to organize, assemble and facilitate the provision of cost effective healthcare services.

Holdings has a 50% interest in GRI Real Estate and General Surgery Real Estate, both are real estate holding companies. Holdings also held a 33.33% interest in Western Maryland Supply, LLC, which provides durable medical equipment for rental or purchase, company dissolved June 30, 2016. MEI has a 50% interest in Diagnostic Imaging, which provides radiology imaging services.

(Dollars in thousands)

Summary financial information as of June 30, 2017 and 2016 and for the years then ended appears below for the significant equity investments:

		Maryland Care, Inc.		Tri-State Health Partners	
		2017	2016	2017	2016
Assets	$	303,086	220,516	—	(1,206)
Liabilities		199,913	134,844	—	225
Equity	$	103,173	85,672	—	(1,431)
Revenue	$	1,062,609	899,594	—	(1,984)
Expenses		1,045,108	906,587	—	895
Net income (loss)	$	17,501	(6,993)	—	(2,879)

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		MEI Diagnostic Imaging Services, LLC		Holdings General Surgery Real Estate, LLC	
		2017	2016	2017	2016
Assets	$	9,956	10,415	520	536
Liabilities		2,265	2,722	368	405
Equity	$	7,691	7,693	152	131
Revenue	$	21,304	21,520	86	87
Expenses		18,906	19,006	65	68
Net income	$	2,398	2,514	21	19

		Holdings GI Real Estate		Holdings – Western Maryland Medical Supply, LLC	
		2017	2016	2017	2016
Assets	$	481	496	—	17
Liabilities		45	112	—	222
Equity	$	436	384	—	(205)
Revenue	$	120	120	4	863
Expenses		60	63	(7)	1,218
Net income (loss)	$	60	57	11	(355)

(Continued)

(Dollars in thousands)

(8) Long-Term Debt and Leases

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

		2017	2016
MHHEFA Revenue Bonds:			
Series 2015 3.50%–5.00% serial bonds, including issue premiums of $15,122	$	267,930	272,421
City of Hagerstown note		61	83
Mortgages and equipment loans with banks, with interest rates ranging from 2.24% to 7.75%		465	546
Capital lease obligations, with interest rates ranging from 1.76% to 2.30%		5,007	6,773
		273,463	279,823
Less current portion of long-term debt		(6,607)	(6,281)
Less debt issuance costs and discounts		(2,183)	(2,261)
	$	264,673	271,281

On July 9, 2015, Meritus issued Series 2015 Bonds to (i) refund all of the Maryland Health and Higher Educational Facilities Authority's Revenue Bonds, Washington County Hospital Issue, Series 2008 (Series 2008 Bonds), and (ii) finance and refinance the cost of construction, renovation and equipping of certain additional facilities for Meritus (the 2015 Project). The Series 2015 Bonds were issued in the principal amount of $257,300 plus a premium of $15,100. The Series 2015 Bonds proceeds, together with the outstanding Series 2008 Bonds escrow fund balance totaled $22,000, and Meritus' internal cash of $7,400 were used to pay the cost of issuance, refund Series 2008 Bonds and receive $20,000 of proceeds for capital expenditures. The Series 2015 Bonds are due in annual principal installments through 2045, and bear interest at 3.5% to 5% due semiannually in January and July. A loss of approximately $33,115 was recognized at the time of the bond issue.

The long-term debt related to the Series 2015 Bonds is reflected in the consolidated financial statements including the unamortized bond premium. The original issue bond premiums are being amortized over the life of the debt and are netted against interest expense in the consolidated statements of operations and changes in net assets.

All bonds are collateralized by a first lien and claims on all receipts of Meritus, except restricted donations and contributions. In connection with the Series 2015 Bonds, the bond holders have a security interest in existing facilities of Meritus. All bonds require the Hospital to maintain certain financial ratios and stipulated insurance coverage as defined.

Meritus leases equipment under noncancelable lease arrangements. In addition, Meritus leases office space in several locations under operating leases. Some of the leases provide for renewal options. Rent expense under all operating leases was $5,888 and $6,160 for the years ended June 30, 2017 and 2016, respectively.

(Dollars in thousands)

Future minimum lease payments for operating leases and capital leases (with initial or remaining lease terms in excess of one year) as of June 30, 2017 are as follows:

		Operating leases	Capital leases
Year ending June 30:			
2018	$	1,964	1,906
2019		1,410	1,906
2020		908	1,364
2021		679	—
2022		517	—
Thereafter		674	—
Total minimum lease payments	$	6,152	5,176
Less amount representing interest			(169)
Present value of minimum lease payments			$ 5,007

Scheduled principal repayments on long-term debt including payments on capital lease obligations are as follows for the next five years as of June 30:

2018	$	6,607
2019		6,863
2020		6,579
2021		5,481
2022		5,670
Thereafter		242,263
	$	273,463

The Hospital maintains a line of credit with a financial institution which is automatically renewed annually in the amount of $1,000, bearing interest on the drawn portion at the bank’s prime interest rate. No amounts were outstanding as of June 30, 2017 and 2016.

MEI maintains a line of credit with a financial institution which is automatically renewed annually in the amount of $500, bearing interest on the drawn portion at the bank’s prime interest rate plus 2%. No amounts were outstanding as of June 30, 2017 and 2016.

Meritus uses current market prices in determining the fair value of its Revenue Bonds. The carrying value of other long-term debt approximates fair value. The fair value of total long-term debt, excluding capital lease obligations, was approximately $280,986 and $298,254 at June 30, 2017 and 2016, respectively.

(Dollars in thousands)

(9) Income Taxes

Holdings and its subsidiaries file a consolidated federal return and separate state returns. The income tax (expense) benefit for the years ended June 30, consists of:

		2017	2016
Current:			
Federal	$	114	(283)
State		25	(71)
		139	(354)
Deferred:			
Federal		(132)	(749)
State		(23)	(120)
		(155)	(869)
	$	(16)	(1,223)

On July 1, 2011, MEI completed a structural realignment to include the formation of Holdings. The realignment included the conversion of taxable subsidiaries of MEI resulting in a net federal and state conversion tax of approximately $4,000. The above conversion tax was repeated for both book and tax for the years ended June 30, 2017 and 2016.

On July 1, 2015, MEI completed a second structural realignment to convert the taxable subsidiaries of MEI to Holdings, resulting in a net federal and state conversion tax of approximately $700. The above conversion tax was including in both book and tax for the year ended June 30, 2017.

(Continued)

(Dollars in thousands)

The significant components of the deferred tax assets and deferred tax liabilities, which are included in prepaid and other current assets and other assets at June 30, are as follows:

		2017	2016
Deferred tax asset:			
Accrued vacation	$	177	275
Deferred compensation		1,454	1,386
Allowance for bad debts		60	52
Unrealized gain		2	6
NOL carryover		1,858	1,838
Other		39	212
		3,590	3,769
Deferred tax liabilities:			
Fixed assets and intangible assets		(744)	(1,091)
Captive insurance premiums		(13)	(5)
		(757)	(1,096)
	$	2,833	2,673

In assessing the reliability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon positive operation trends through 2017, and projections for future taxable income, management believes that it is more likely than not that the Company will realize the benefits of the deductible differences at June 30, 2017 and 2016. Accordingly, the Company has determined that there is no valuation allowance as of June 30, 2017 and 2016. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

As of June 30, 2017 and 2016, the Company has no unrecognized tax benefits. Therefore, the Company does not expect any impact on the effective tax rate related to recognition of unrecognized tax benefits. In addition, there are no anticipated reversals of uncertain tax positions in the next twelve months. The Company’s policy is to recognize interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of June 30, 2017 and 2016, the Company has no accrued interest or penalties related to uncertain tax positions.

(10) Post Retirement Benefit Plans

Defined Contribution Plans

Meritus has a 401(k) Savings Plan. The plan is available to all Meritus employees. Meritus matches employee contributions for an amount up to 6% of each employee’s base salary, subject to limitations.

(Continued)

Amounts charged to expense for the years ended June 30, 2017 and 2016 were $4,889 and $4,649, respectively.

The Hospital has frozen a 403(b) plan. Effective July 1, 2011, the plan was frozen to future contributions.

The Hospital and MEI each maintain an employee funded supplemental nonqualified retirement plan for certain employees. The plan requires the benefits be paid upon termination, retirement or death. The related liability is $6,206 and $4,973 at June 30, 2017 and 2016, respectively. Management has designated investments for the intended purpose of funding the liability when payable.

(11) Insurance Coverage

Meritus has a wholly owned insurance captive, MIC, to provide primary limits of insurance of $1,000 per occurrence/$3,000 aggregate for professional and general liability. In addition, MIC purchased reinsurance from an A rated reinsurer in the amount of $25,000 to cover any potential liabilities above the $1,000/$3,000 primary limits, which were covered by MIC. The self-insured liabilities determined by an actuary for professional and general liability claims are discounted at 4%, and are included in other long-term liabilities in the consolidated balance sheets. As of June 30, 2017 and 2016, Meritus recorded a liability of $7,293 and $6,224, respectively.

Consistent with most companies with similar insurance operations, the liability for 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.

In 2017 and 2016, the Company participated in a self-insured plan for workers' compensation claims. Stop-loss coverage has been purchased through a commercial carrier for claims in excess of $450. As of June 30, 2017 and 2016, Meritus recorded a liability of $3,181 and $2,881, respectively, which are included in accrued salaries, wages and withholdings in the consolidated balance sheets.

(12) Risk and Uncertainties

The Company provides general acute healthcare services in the State of Maryland. The Company and other healthcare providers 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 State of Maryland Health Services Cost Review Commission
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes, and
- Lawsuits alleging malpractice or other claims

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

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

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

The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self-referral laws (STARK law and regulation). Federal healthcare reform initiatives continue to prompt a national review of federally funded healthcare programs. In addition, the federal government and many states continue to fund programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs. The Company has devoted resources to implement a compliance program to monitor conformance with applicable laws and regulations, but the possibility of future government review and enforcement action exists. However, any negative findings from a future proceeding, if any, could result in substantial financial penalties or awards against the Company, exclusion from future participation in the Medicare and Medicaid programs and if criminal proceedings were initiated against the Company, possible criminal penalties. At this time, the Company cannot predict the ultimate outcome of any potential inquiries, or the potential range of damages, if any.

As a result of recently enacted and pending federal healthcare reform legislation, substantial changes are anticipated in the United States healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement to healthcare providers and the legal obligations of health insurers, providers and employers. These provisions are currently slated to take effect at specified times over the next decade. This federal healthcare reform legislation did not affect the 2017 or 2016 consolidated financial statements.

Litigation

Additionally, Meritus is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without a material adverse effect on Meritus' financial position or results of operations.

(Dollars in thousands)

(13) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets at June 30 are restricted for the following purposes:

		2017	2016
Temporarily restricted for financial support of patients and hospital programs	$	4,347	5,761
Capital campaign		428	1,091
	$	4,775	6,852
Permanently restricted investments are to be held in perpetuity, the income of which is expendable to support charity care and health care education	$	1,029	1,029

(14) Functional Expenses

Meritus provides general healthcare services to residents within its geographic location. Expenses related to providing these services for the years ended June 30 are as follows:

		2017	2016
Health care services	$	269,427	271,108
Administration		99,651	84,527
	$	369,078	355,635

(15) Subsequent Events

Meritus evaluated subsequent events through September 27, 2017, the date these consolidated financial statements were available to be issued. All material matters are disclosed in the footnotes to the consolidated financial statements.

SUPPLEMENTARY INFORMATION

MERITUS MEDICAL CENTER, INC.

Consolidating Balance Sheet

June 30, 2017

(Dollars in thousands)

Assets		Meritus Medical Center	Meritus Healthcare Foundation	Meritus other	Consolidating total	Consolidating entries	Consolidated total
Current assets:							
Cash and cash equivalents	$	43,848	673	5,623	50,144	—	50,144
Short-term investments		42,926	—	—	42,926	—	42,926
Current portion of assets whose use is limited		10,359	—	—	10,359	—	10,359
Accounts receivable, net		44,835	194	5,059	50,088	(8,179)	41,909
Supplies		4,553	—	714	5,267	—	5,267
Prepaid and other current assets		13,544	(365)	5,703	18,882	(14,818)	4,064
Total current assets		160,065	502	17,099	177,666	(22,997)	154,669
Assets limited as to use		161,960	7,280	18,239	187,479	—	187,479
Property, plant and equipment, net		228,945	—	8,964	237,909	—	237,909
Pledges receivable, net		—	362	—	362	—	362
Equity investments in affiliates		34,677	—	3,974	38,651	(2,975)	35,676
Other assets		5,086	—	4,564	9,650	(4,718)	4,932
Total assets	$	590,733	8,144	52,840	651,717	(30,690)	621,027

(Continued)

Schedule 1

MERITUS MEDICAL CENTER, INC.

Consolidating Balance Sheet

June 30, 2017

(Dollars in thousands)

Liabilities and Net Assets	Meritus Medical Center	Meritus Healthcare Foundation	Meritus other	Consolidating total	Consolidating entries	Consolidated total
Current liabilities:						
Accounts payable and accrued expenses	$ 20,191	139	17,874	38,204	(14,818)	23,386
Accrued salaries, wages and withholdings	8,787	—	1,057	9,844	—	9,844
Accrued compensation benefit	8,170	14	2,312	10,496	—	10,496
Advances from third party payors	9,076	—	118	9,194	—	9,194
Accrued interest payable	6,144	—	—	6,144	—	6,144
Current maturity of long-term debt	6,565	—	42	6,607	—	6,607
Total current liabilities	58,933	153	21,403	80,489	(14,818)	65,671
Long term debt, net of current portion	264,473	—	200	264,673	—	264,673
Accrued retirement benefits	2,522	—	3,684	6,206	—	6,206
Other long term liabilities	—	—	16,697	16,697	(8,179)	8,518
Total liabilities	325,928	153	41,984	368,065	(22,997)	345,068
Stockholder's equity:						
Common stock	—	—	820	820	(820)	—
Paid-in capital	—	—	1,150	1,150	(1,150)	—
Retained earnings	—	—	15,356	15,356	(15,356)	—
Total stockholders' equity	—	—	17,326	17,326	(17,326)	—
Net assets:						
Unrestricted:						
Unrestricted	259,001	3,273	(6,470)	255,804	14,351	270,155
Total unrestricted net assets	259,001	3,273	(6,470)	255,804	14,351	270,155
Restricted net assets – temporary	4,775	4,718	—	9,493	(4,718)	4,775
Restricted net assets – permanent	1,029	—	—	1,029	—	1,029
Total net assets	264,805	7,991	(6,470)	266,326	9,633	275,959
Total liabilities and net assets	$ 590,733	8,144	52,840	651,717	(30,690)	621,027

See accompanying independent auditors' report.

Schedule 2

MERITUS MEDICAL CENTER, INC.

Consolidating Statement of Operations and Change in Net Assets

Year ended June 30, 2017

(Dollars in thousands)

Fiscal period ending June 30, 2017		Meritus Medical Center	Meritus Healthcare Foundation	Meritus other	Consolidating total	Consolidating entries	Consolidated total
Unrestricted revenue, gains and other support:							
Net patient revenue	$	334,003	—	65,758	399,761	(11,681)	388,080
Less provisions for bad debts		(14,804)	—	(2,136)	(16,940)	—	(16,940)
Net patient revenue less provisions for bad debts		319,199	—	63,622	382,821	(11,681)	371,140
Other revenue		9,009	344	2,260	11,613	(3,342)	8,271
Equity earnings in affiliates		4,375	—	1,253	5,628	—	5,628
Net assets released from restriction used for operations		769	3,439	—	4,208	(3,141)	1,067
		333,352	3,783	67,135	404,270	(18,164)	386,106
Operating expenses:							
Salaries and wages		105,644	354	30,127	136,125	—	136,125
Benefits		29,209	114	5,851	35,174	(454)	34,720
Professional fees		14,124	—	—	14,124	—	14,124
Supplies and other		128,443	280	36,872	165,595	(14,522)	151,073
Interest		11,945	—	6	11,951	—	11,951
Depreciation and amortization		19,799	1	1,285	21,085	—	21,085
		309,164	749	74,141	384,054	(14,976)	369,078
Operating income (loss)		24,188	3,034	(7,006)	20,216	(3,188)	17,028
Nonoperating gains (losses), net:							
Investment returns, net		14,208	770	553	15,531	—	15,531
Other, net		(135)	(3,371)	—	(3,506)	3,188	(318)
Income tax expense		—	—	(16)	(16)	—	(16)
Excess (deficit) of revenue over expenses	$	38,261	433	(6,469)	32,225	—	32,225

(Continued)

Schedule 2

MERITUS MEDICAL CENTER, INC.

Consolidating Statement of Operations and Change in Net Assets

Year ended June 30, 2017

(Dollars in thousands)

Fiscal period ending June 30, 2017		**Meritus Medical Center**	**Meritus Healthcare Foundation**	**Meritus other**	**Consolidating total**	**Consolidating entries**	**Consolidated total**
Unrestricted net assets:							
Excess (deficit) of revenues over expenses	$	38,261	433	(6,469)	32,225	—	32,225
Other		(254)	(224)	54	(424)	—	(424)
Net assets released from restriction for property, plant, and equipment		2,555	—	—	2,555	—	2,555
Increase (decrease) in unrestricted net assets		40,562	209	(6,415)	34,356	—	34,356
Temporarily restricted net assets:							
Contributions		3,141	1,473	—	4,614	(3,141)	1,473
Other		72	—	—	72	—	72
Net assets released from restriction for property, plant, and equipment		(2,555)	—	—	(2,555)	—	(2,555)
Net assets released to restriction for operations		(769)	—	(3,439)	(4,208)	3,141	(1,067)
(Decrease) increase in temp. restricted net assets		(111)	1,473	(3,439)	(2,077)	—	(2,077)
Increase (decrease) in net assets		40,451	1,682	(9,854)	32,279	—	32,279
Net assets:							
Beginning of year		239,930	9,747	17,272	266,949	(23,269)	243,680
End of year	$	280,381	11,429	7,418	299,228	(23,269)	275,959

See accompanying independent auditors’ report.