Consolidated Financial Statements and Supplementary Information

Anne Arundel Health System, Inc. and Subsidiaries
Years Ended June 30, 2018 and 2017
With Report of Independent Auditors

Ernst & Young LLP

EY
Building a better working world

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Financial Statements and Supplementary Information

Years Ended June 30, 2018 and 2017

Contents

Ernst & Young LLP
621 East Pratt Street
Baltimore, MD 21202
Tel: +1 410 539 7940
Fax: +1 410 783 3832
ey.com

Report of Independent Auditors

The Board of Trustees
Anne Arundel Health System, Inc.

We have audited the accompanying consolidated financial statements of Anne Arundel Health System, Inc. (a Maryland not-for-profit corporation) and subsidiaries, which comprise the consolidated balance sheets as of June 30, 2018 and 2017, 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 financial statements in conformity 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 financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Cottage Insurance Company, Ltd., a wholly owned subsidiary, which statements reflect total assets of $51,647,000 and $51,399,000 as of June 30, 2018 and 2017, respectively, and net loss after elimination of intercompany revenues of $7,137,000 and $3,677,000, respectively, for the years then ended. 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 Cottage 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 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, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Anne Arundel Health System, Inc. and subsidiaries at June 30, 2018 and 2017, and the consolidated results of their operations, changes in their net assets, and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary consolidating information 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. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Ernst & Young LLP

October 18, 2018

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Balance Sheets

	June 30	
	2018	**2017**
Assets		
Current assets:		
Cash and cash equivalents	**$ 101,403,000**	$ 71,504,000
Short-term investments	**11,771,000**	4,935,000
Current portion of assets whose use is limited	**14,521,000**	16,192,000
Patient receivables, less allowance for uncollectible accounts	**78,889,000**	71,800,000
Current portion of pledges receivable, net	**1,017,000**	1,918,000
Inventories	**7,976,000**	8,391,000
Prepaid expenses and other current assets	**11,391,000**	12,814,000
Total current assets	**226,968,000**	187,554,000
Property and equipment	**884,437,000**	854,850,000
Less accumulated depreciation and amortization	**(456,606,000)**	(423,378,000)
Net property and equipment	**427,831,000**	431,472,000
Other assets:		
Investments	**292,636,000**	281,832,000
Investments in joint ventures	**9,740,000**	8,526,000
Pledges receivable, net of current portion and net of allowance for uncollectible pledges	**3,098,000**	2,996,000
Assets whose use is limited	**36,375,000**	50,107,000
Restricted collateral for interest rate swap contract	**44,893,000**	51,206,000
Investment in subsidiaries and other assets	**43,856,000**	38,624,000
Total assets	**$1,085,397,000**	$1,052,317,000

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Balance Sheets (continued)

	June 30	
	2018	**2017**
Liabilities and net assets		
Current liabilities:		
Accounts payable	**$ 21,915,000**	$ 20,253,000
Accrued salaries, wages, and benefits	**36,100,000**	28,559,000
Other accrued expenses	**21,478,000**	13,789,000
Current portion of long-term debt	**8,848,000**	9,593,000
Advances from third-party payors	**21,005,000**	18,780,000
Total current liabilities	**109,346,000**	90,974,000
Long-term debt, less current portion	**372,283,000**	388,922,000
Interest rate swap contracts	**59,303,000**	73,258,000
Accrued pension liability	**3,314,000**	10,688,000
Other long-term liabilities	**45,829,000**	42,305,000
Total liabilities	**590,075,000**	606,147,000
Net assets:		
Unrestricted	**469,018,000**	420,857,000
Temporarily restricted	**15,846,000**	14,622,000
Permanently restricted	**10,458,000**	10,691,000
Total net assets	**495,322,000**	446,170,000
Total liabilities and net assets	**$1,085,397,000**	$1,052,317,000

See accompanying notes.

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets

	Year Ended June 30	
	2018	**2017**
Operating revenue:		
Net patient service revenue	**$ 725,266,000**	$ 682,450,000
Provision for bad debts	**(17,886,000)**	(17,590,000)
Net patient service revenue less provision for bad debts	**707,380,000**	664,860,000
Other operating revenue	**28,093,000**	30,967,000
Total operating revenue	**735,473,000**	695,827,000
Operating expenses:		
Salaries and wages	**328,636,000**	315,988,000
Employee benefits	**52,781,000**	47,104,000
Supplies	**151,547,000**	150,909,000
Purchased services	**129,086,000**	126,533,000
Depreciation and amortization	**36,373,000**	35,760,000
Interest	**13,205,000**	13,722,000
Total operating expenses	**711,628,000**	690,016,000
Operating income	**23,845,000**	5,811,000
Other income:		
Investment income, net	**11,214,000**	9,521,000
Loss on advance refunding of debt	**(6,056,000)**	–
Loss from joint ventures and other, net	**(1,960,000)**	(6,073,000)
Change in unrealized gains on trading securities, net	**8,170,000**	29,904,000
Realized and unrealized gains on interest rate swap contracts, net	**8,858,000**	20,327,000
Total other income, net	**20,226,000**	53,679,000
Revenues and gains in excess of expenses	**$ 44,071,000**	$ 59,490,000

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets (continued)

	Year Ended June 30	
	2018	**2017**
Unrestricted net assets		
Revenues and gains in excess of expenses	**$ 44,071,000**	$ 59,490,000
Pension liability adjustment	**1,944,000**	8,677,000
Net assets released from restrictions used for purchase of property and equipment	**592,000**	478,000
Transfers and other, net	**1,554,000**	694,000
Increase in unrestricted net assets	**48,161,000**	69,339,000
Temporarily restricted net assets increase		
Contributions and pledges	**6,782,000**	7,434,000
Change in net unrealized gains and losses on investments	**(180,000)**	1,609,000
Temporarily restricted investment income	**89,000**	88,000
Net assets released from restrictions	**(5,550,000)**	(9,999,000)
Transfers and other, net	**83,000**	2,462,000
Increase in temporarily restricted net assets	**1,224,000**	1,594,000
Permanently restricted net assets increase		
Contributions for endowment funds	**52,000**	30,000
Transfers of interest income and other, net	**(285,000)**	(389,000)
Decrease in permanently restricted net assets	**(233,000)**	(359,000)
Increase in net assets	**49,152,000**	70,574,000
Net assets at beginning of year	**446,170,000**	375,596,000
Net assets at end of year	**$ 495,322,000**	$ 446,170,000

See accompanying notes.

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

	Year Ended June 30	
	2018	**2017**
Operating activities		
Increase in net assets	**$ 49,152,000**	$ 70,574,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Change in net unrealized (gains) on investments	**(7,990,000)**	(31,513,000)
Realized and unrealized (gains) on interest rate swap contracts, net	**(8,858,000)**	(20,327,000)
Pension liability adjustment	**(1,944,000)**	(8,677,000)
Equity in earnings of joint ventures and other	**1,143,000**	3,904,000
Loss on advance refunding of debt	**6,056,000**	–
Distributions received from joint ventures	**123,000**	1,984,000
Restricted contributions and pledges, net	**(6,834,000)**	(7,464,000)
Depreciation and amortization	**36,373,000**	35,760,000
Restricted investment income	**(89,000)**	(88,000)
Increase in investments – trading	**(9,650,000)**	(4,634,000)
Decrease (increase) in assets whose use is limited, net – trading	**13,335,000**	(1,507,000)
Net change in operating assets and liabilities	**(1,750,000)**	(29,517,000)
Net cash from operating activities	**69,067,000**	8,495,000
Investing activities		
Purchases of property and equipment	**(32,732,000)**	(22,898,000)
Decrease in assets whose use is limited – other-than-trading	**2,068,000**	21,000
Change in collateralization and payments on interest rate swaps	**1,216,000**	15,426,000
Cash used for investments in joint ventures	**(2,480,000)**	(5,697,000)
Net cash used in investing activities	**(31,928,000)**	(13,148,000)
Financing and fundraising activities		
Net proceeds from issuance of Series 2017 Revenue Bonds	**60,245,000**	–
Repayments of long-term debt	**(1,930,000)**	(10,488,000)
Advance refunding of Series 2010 Revenue Bonds	**(72,279,000)**	–
Payments for deferred financing costs	**(998,000)**	–
Restricted contributions received and other	**7,633,000**	8,883,000
Restricted income received	**89,000**	88,000
Net cash used in financing and fundraising activities	**(7,240,000)**	(1,517,000)
Net increase (decrease) in cash and cash equivalents	**29,899,000**	(6,170,000)
Cash and cash equivalents at beginning of year	**71,504,000**	77,674,000
Cash and cash equivalents at end of year	**$ 101,403,000**	$ 71,504,000

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (continued)

	Year Ended June 30	
	2018	**2017**
Changes in operating assets and liabilities		
(Increase) decrease in operating assets:		
Patient receivables, net	**$ (7,089,000)**	$ (1,161,000)
Inventories	**415,000**	544,000
Prepaid expenses and other	**1,423,000**	(7,895,000)
Other assets	**(5,232,000)**	(19,969,000)
	(10,483,000)	(28,481,000)
Increase in net assets		
Increase (decrease) in operating liabilities:		
Accounts payable	**1,662,000**	1,242,000
Accrued salaries, wages, and benefits	**7,541,000**	1,274,000
Other accrued expenses	**7,689,000**	(10,866,000)
Advances from third-party payors	**2,225,000**	(3,221,000)
Other long-term liabilities	**(10,384,000)**	10,535,000
	8,733,000	(1,036,000)
Net change in operating assets and liabilities	**$ (1,750,000)**	$ (29,517,000)
Supplemental disclosures of cash flow information		
Cash paid for interest	**$ 13,496,000**	$ 12,818,000

See accompanying notes.

1. Organization and Basis of Presentation

Anne Arundel Health System, Inc. (the Parent or the System) is a Maryland not-for-profit corporation. The Parent has the following wholly owned subsidiaries: Anne Arundel Medical Center, Inc. (the Hospital) and its subsidiaries; Anne Arundel Health Care Services, Inc. (HCS); Cottage Insurance Company, Ltd. (Cottage); Anne Arundel General Treatment Services, Inc. (GTS); Anne Arundel Health System Research Institute, Inc. (RI); Anne Arundel Medical Center Foundation, Inc. (the Foundation); Anne Arundel Health Care Enterprises, Inc. (HCE); Physician Enterprise, LLC (PE) and its subsidiaries; Anne Arundel Physician Group, LLC; AAMG Physical Therapy, LLC; Community Clinics, LLC; Anne Arundel FastCare, LLC; Orthopedic Physicians of Annapolis; Anne Arundel Medical Center Collaborative Care Network, LLC; Anne Arundel Real Estate Holding Company, Inc. (the Real Estate Company) and its subsidiaries; Pavilion Park, Inc. (PPI); Annapolis Exchange Lot IV, LLC; Annapolis Exchange Lot V, LLC; and Blue Building, LLC. The accompanying consolidated financial statements include the accounts of the Parent and its wholly owned subsidiaries (collectively, the Group). All significant intercompany accounts and transactions have been eliminated in consolidation. The Real Estate Company and PPI own a 42.84% interest in Kent Island Medical Arts, LLC (KIMA), a limited liability company that owns and operates a medical office building. PPI is the managing member of KIMA and has substantive participation rights in KIMA. The financial statements of KIMA are consolidated in the accompanying consolidated financial statements. The non-controlling interest in KIMA was 57.16% as of June 30, 2018 and 2017. This interest was $871,000 and $923,000 at June 30, 2018 and 2017, respectively, and is included within unrestricted net assets on the accompanying consolidated balance sheets.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents include cash held in checking and savings accounts, money market accounts, and short-term certificates of deposit with original maturities of 90 days or less. Cash balances and collateral held by a counterparty are principally uninsured and are subject to normal credit risks. At June 30, 2018 and 2017, and at various times during the year, the System maintained cash-in-bank balances in excess of the $250,000 federally insured limits.

2. Summary of Significant Accounting Policies (continued)

Derivative Instruments

On May 10, 2006, the Hospital entered into a forward variable-to-fixed interest rate swap agreement with an effective date of November 1, 2008. This contract was entered into in an effort to reduce the risk of variable interest rate debt and has a term through July 1, 2048. Under Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, the Hospital has recognized its derivative instruments as either assets or liabilities on the accompanying consolidated balance sheets at fair value. As these derivative instruments are not designated as hedges, the unrealized gain or loss on these contracts has been recognized on the accompanying consolidated statements of operations and changes in net assets as realized and unrealized gains (losses) on interest rate swap contracts, net. The fair market values of the derivative instruments include a credit valuation adjustment (CVA) as required by ASC 820, *Fair Value Measurement*. When applying the CVA, the valuation of the variable-to-fixed interest rate swap contract was decreased by $43,000 and $327,000 as of June 30, 2018 and 2017, respectively.

On March 23, 2016, in an effort to reduce the amount of restricted cash pledged as collateral with the original counterparty, the Hospital entered into a Novation Agreement with a second counterparty. Immediately prior to the Novation Agreement, the System modified the existing swap to bifurcate the existing swap into a five-year swap with the remainder into a 2021 through 2048 swap. The terms of the bifurcated swap remain identical to the original swap. The Novation Agreement resulted in the return of $29,164,000 as of June 30, 2016.

A summary of the Hospital's derivative instruments and related activity at June 30, 2018 and 2017, and for the years then ended, is as follows:

Description of Derivative Instrument	**2018** **Fair Value Liability**
Variable-to-fixed interest rate swap contract (maturity date March 2021)	**$ (10,251,000)**
Variable-to-fixed interest rate swap contract (maturity date July 2048)	**(49,052,000)**
	$ (59,303,000)

2. Summary of Significant Accounting Policies (continued)

Description of Derivative Instrument	2017 Fair Value Liability
Variable-to-fixed interest rate swap contract (maturity date March 2021)	$ (17,225,000)
Variable-to-fixed interest rate swap contract (maturity date July 2048)	(56,033,000)
	$ (73,258,000)

The change in unrealized losses recognized in revenues and gains in excess of expenses for the years ended June 30, 2018 and 2017, were $(13,955,000) and $(26,327,000), respectively.

At June 30, 2018 and 2017, the net termination value (i.e., mark-to-market value) of the derivative instruments totaled $60,518,000 and $74,557,000, respectively. The Hospital may be exposed to credit loss in the event of non-performance by the other party to the interest rate swap agreements, the risk of which is reflected in the fair value of the instruments under ASC 820. However, the Hospital does not anticipate non-performance by the counterparty.

During fiscal year 2018, the Hospital paid net payments under its interest rate swap program of $5,097,000. In fiscal year 2017, the Hospital paid net payments under its interest rate swap program of $6,000,000. These amounts are included within realized and unrealized gains on interest rate swap contracts, net on the accompanying consolidated statements of operations and changes in net assets and within investing activities on the accompanying consolidated statements of cash flows.

Under the derivative contract for the 2021 through 2048 swap, the Hospital must transfer collateral for the benefit of the counterparty, to the extent that the termination values exceed certain limits. The Hospital's collateral requirement for the benefit of the counterparty was approximately $44,893,000 and $51,206,000 at June 30, 2018 and 2017, respectively. The ongoing mark-to-market values and resulting collateral requirements of the Hospital's interest rate swap contract are subject to variability based on market factors (primarily changes in interest rates). Collateral requirements under this interest rate swap contract are excluded from unrestricted cash and investments for purposes of determining the System's compliance with its liquidity covenants

2. Summary of Significant Accounting Policies (continued)

under its Maryland Health and Higher Educational Facilities Authority (MHHEFA or the Authority) revenue bond agreements and its derivative agreements. Collateral amounts are included in non-current assets on the accompanying consolidated balance sheets. Approximately $199,000 of collateral was due to the financial institution as of June 30, 2018. Approximately $3,295,000 of collateral was to be returned to the Hospital as of June 30, 2017.

The amount due to the financial institution is included in other accrued expenses on the accompanying consolidated balance sheet as of June 30, 2018, and is reflected within investing activities on the accompanying consolidated statement of cash flows. The amount due to be returned to the Hospital is included in prepaid expenses and other current assets on the accompanying consolidated balance sheet as of June 30, 2017, and is reflected within investing activities on the accompanying consolidated statement of cash flows.

Assets Whose Use is Limited and Investments

Assets whose use is limited are principally composed of certain funds established to be held and invested by a trustee. These funds are related to the issuance of the Hospital's revenue bonds, investments held at Cottage, and certain permanently restricted endowment assets.

The fair values of publicly traded securities and mutual funds are based on quoted market prices of individual securities or investments or estimated amounts using quoted market prices of similar investments. Hedge fund investments, some of which are structured so that the System holds limited partnership interests, are stated at fair value as estimated in an unquoted market. Valuations of these investments, and therefore the System's holdings, may be determined by the investment manager or general partner and for fund-of-funds investments are primarily based on financial data supplied by the underlying investee funds. Values may be based on historical cost, appraisals, or other estimates that require varying degrees of judgment. Investment income or loss from all unrestricted investments is included on the accompanying consolidated statements of operations and changes in net assets as part of other income (loss).

Investment income or loss on investments of temporarily and permanently restricted assets is added to or deducted from the appropriate restricted fund balance if the income is restricted. The cost of securities sold is based on the specific-identification method.

2. Summary of Significant Accounting Policies (continued)

All investment balances are principally uninsured and subject to normal credit risk. Investments are classified as either current or non-current based on the maturity dates and the availability for current operations. Investments included in non-current assets consist of board-designated investment funds of $292,636,000 and $281,832,000 as of June 30, 2018 and 2017, respectively. Based on the System's investment policy, such amounts could be liquidated, at the discretion of the board, to satisfy short-term requirements.

Substantially all investments, other than borrowed funds required to be expended for capital projects, are classified as trading securities, with unrealized gains and losses included in revenues and gains in excess of expenses.

Borrowed funds required to be expended for capital projects are classified as other-than-trading and are included in assets whose use is limited.

Patient Receivables and Allowances

The Group's policy is to write off all patient accounts that have been identified as uncollectible. An allowance for doubtful accounts is recorded for accounts not yet written off that are anticipated to be uncollectible in future periods. When determining the allowance, the Group's policy considers the probability of recoverability of accounts based on past experience, taking into account the current collection trends. Credit risks are assessed based on historical write-offs, net of recoveries, as well as an analysis of aged accounts receivable balances with allowances generally increasing as the receivable ages. The analysis of receivables is performed monthly, and the allowances are adjusted accordingly.

Insurance coverage and credit information are obtained from patients, when available. No collateral is obtained for accounts receivable.

Accounts receivable from third-party payors have been adjusted to reflect the difference between the charges and the estimated reimbursable amounts.

Inventories

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

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment are stated at cost. Included in computers and software are capitalized labor costs of $11,240,000 and $11,026,000 as of June 30, 2018 and 2017, respectively. Depreciation and amortization, including amortization of assets recorded under capital leases, are recorded on the straight-line method over the estimated useful lives of the assets.

The following is a summary of property and equipment, stated at cost:

	Estimated Useful Lives	June 30 2018	June 30 2017
Land		**$ 14,901,000**	$ 14,901,000
Land improvements	20 years	**22,091,000**	22,026,000
Buildings and improvements	20–40 years	**487,454,000**	482,470,000
Fixed equipment	5–20 years	**10,650,000**	11,064,000
Leasehold improvements	5–10 years	**53,675,000**	52,703,000
Movable equipment	7–10 years	**198,872,000**	181,049,000
Computers and software	3–5 years	**86,311,000**	83,813,000
Construction-in-progress	–	**10,483,000**	6,824,000
		$ 884,437,000	$ 854,850,000

Construction-in-progress consists of direct costs associated with hospital department renovations, certain leasehold improvements, and smaller capital projects. As these projects are completed, the related assets are transferred out of construction-in-progress and into the appropriate asset category and are depreciated over the applicable useful lives.

Investments in Joint Ventures

The System accounts for its investments in joint ventures using the equity method of accounting. During 2011, the Real Estate Company and another party formed West County, LLC, a joint venture that owns and operates a medical office building that opened in December 2012. The Real Estate Company has a 50% interest in this joint venture, with each owner's investment being $6,947,000 and $6,658,000 as of June 30, 2018 and 2017, respectively.

2. Summary of Significant Accounting Policies (continued)

Deferred Debt Issuance Costs

Administrative, legal, financing, underwriting discount, and other miscellaneous expenses that were incurred in connection with debt financings were deferred and are being amortized over the lives of the bond issues using the straight-line method, which approximates the effective-interest method in all material respects. The amortization expense of the deferred debt issue costs was $267,000 and $328,000 for the years ended June 30, 2018 and 2017, respectively.

The System adopted Accounting Standards Update (ASU) 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*, in the prior year. This moved debt issuance costs from an asset account to a direct reduction to debt. This standard was applied retrospectively. Debt issuance costs were $3,949,000 and $4,179,000 as of June 30, 2018 and 2017, respectively.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Group has been limited by donors to a specific time period or purpose. Substantially all temporarily restricted net assets in the accompanying consolidated financial statements are restricted to fund certain Hospital capital additions and operating programs. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity. The income from these funds is expendable to support health care services.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. This includes regulatory discounts allowed to Blue Cross, Medicare, Medicaid, and other third-party payors and charity care.

During 2018 and 2017, approximately 35% and 36%, respectively, of net patient service revenue was received under the Medicare program, 29% and 29% from Blue Cross, 29% and 29% from contracts with other third parties, and 7% and 6% from other sources.

2. Summary of Significant Accounting Policies (continued)

The following table sets forth the detail of net patient service revenue:

	Year Ended June 30	
	2018	**2017**
Gross patient service revenue	**$ 923,086,000**	$ 871,740,000
Revenue deductions:		
Charity care	**4,907,000**	5,625,000
Contractual and other allowances	**192,913,000**	183,665,000
Net patient service revenue	**725,266,000**	682,450,000
Less provision for bad debts	**17,886,000**	17,590,000
Net patient service revenue, less provision for bad debts	**$ 707,380,000**	$ 664,860,000

Patient accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the Hospital analyzes its past history and identifies trends to estimate the appropriate allowance for doubtful accounts and a provision for bad debts. For receivables associated with services provided to patients who have third-party coverage, the Hospital analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary. For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and co-payment balances due for which third-party coverage exists for part of the bill), the Hospital records a provision for bad debts in the period of service on the basis of its past experience. The difference between the approved rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. The Hospital has not changed its charity care or uninsured discount policies during fiscal years 2018 or 2017.

A substantial amount of the Group's revenues is received from health maintenance organizations and other managed-care payors. Managed-care payors generally use case management activities to control hospital utilization. These payors also have the ability to select health care providers offering the most cost-effective care. Management does not believe that the Group has undue exposure to any one managed-care payor.

2. Summary of Significant Accounting Policies (continued)

The Hospital's revenues may be subject to adjustment as a result of examination by government agencies or contractors and as a result of differing interpretations of government regulations, medical diagnoses, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered.

The Group employs physicians in several hospital-based specialties (including, but not limited to, obstetrics, intensive care, and hospitalists). Net physician revenue is recognized when the services are provided and recorded at the estimated net realizable amount based on the contractual arrangements with third-party payors and the expected payments from the third-party payors and the patients. The difference between the billed charges and the estimated net realizable amounts are recorded as a reduction in physician revenue when the services are provided. The System recognized net physician revenue of $126,201,000 and $111,833,000 for the years ended June 30, 2018 and 2017, respectively. At June 30, 2018 and 2017, $9,904,000 and $8,229,000, respectively, of net physician accounts receivable are included in patient receivables on the accompanying consolidated balance sheets.

Charity Care

The Group provides charity care to patients who meet certain criteria established under its charity care guidelines. Because members of the Group do not pursue the collection of amounts determined to qualify as charity care, they are not reported as revenue on the accompanying consolidated statements of operations and changes in net assets. The direct and indirect costs associated with providing this care are $3,472,000 and $4,105,000 for the years ended June 30, 2018 and 2017, respectively. These costs are calculated by applying a ratio of operating expenses over gross patient charges to the charity care provided at established rates. The state of Maryland's rate system includes components within the rates to partially compensate hospitals for uncompensated care.

Other Operating Revenue

Other operating revenue is composed of grant revenue, incentive payments related to the implementation and meaningful use of certified electronic health records (EHRs), cafeteria revenue, net assets released from restrictions for operating purposes, and other miscellaneous items.

2. Summary of Significant Accounting Policies (continued)

Donations and Bequests

Unconditional promises to give cash and other assets are reported at fair value on the date the promise is received. Conditional promises to give, and indications of intentions to give, are reported at fair value on the date the gift is received. The gifts are reported as either temporarily or permanently restricted 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 a purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets on the accompanying consolidated statements of operations and changes in net assets. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements. Contributions that are unrestricted are reflected as other operating revenue on the accompanying consolidated statements of operations and changes in net assets.

Scheduled payments for pledges receivable for the years ending June 30 are as follows:

2019	$ 1,368,000
2020–2022	982,000
2023 and thereafter	2,490,000
Less:	
Impact of discounting pledges receivable to net present value	(351,000)
Allowance for uncollectible pledges	(374,000)
Net pledges receivable	$ 4,115,000

Pledges receivable are discounted using rates between 1.2% and 2.5%.

Revenues and Gains in Excess of Expenses

The accompanying consolidated statements of operations and changes in net assets include revenues and gains in excess of expenses. Changes in unrestricted net assets that are excluded from revenues and gains in excess of expenses, consistent with industry practice, include contributions received and used for additions of long-lived assets and certain changes in pension liabilities.

2. Summary of Significant Accounting Policies (continued)

Group Purchasing Organization Initial Public Offering

The Hospital has participated and owned equity in the Premier Limited Partnership (Premier), which has served as a group purchasing organization for many years. This participation provides purchasing contract rates and rebates the System would not be able to obtain on its own. The Hospital accounts for its investment in Premier using the equity method of accounting.

During the year ended June 30, 2014, Premier restructured from a privately held company to a public company in an initial public offering (IPO) and several financial transactions have occurred with those holding equity in Premier before the IPO, including the System. As a result, the System received a cash payment of approximately $1,500,000 in exchange for 16% of its previous ownership in Premier. In addition, in exchange for the extension of the group purchasing contract, the System received partial ownership of the new public company (the Class B units).

The System received 309,580 Class B units that are earned in seven separate tranches over an 85-month period ending October 31, 2020. At June 30, 2018 and 2017, this investment was $10,067,000 and $7,920,000, respectively, and is reflected in other assets on the consolidated balance sheets. The opportunity will exist in the future for these Class B units to be converted to the Premier public company stock. Prior to vesting, the Class B units may be transferred or sold with the approval of Premier. During the years ended June 30, 2018 and 2017, the System recognized approximately $1,373,000 and $1,423,000, respectively, of income related to Tranches 3 and 4 of the Class B units, which is included as a reduction of supplies expense on the consolidated statement of operations and changes in net assets. The value of the Class B units is tied to the Group purchasing contract and is considered a vendor incentive.

Income Tax Status

The Parent, the Hospital, the Foundation, HCS, GTS, PE, and RI have received determination letters from the Internal Revenue Service (IRS) stating that they are exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The Real Estate Company has received a determination letter from the IRS stating that it is exempt from federal income taxes under Section 501(c)(2) of the Internal Revenue Code.

HCE and PPI are subject to federal and state income taxes. These income taxes are immaterial to the consolidated financial statements.

2. Summary of Significant Accounting Policies (continued)

Certain limited liability companies within the consolidated group are not subject to income taxes. Taxable income or loss is passed through to and reportable by the members individually.

Under the Cayman Islands Tax Concessions Law (Revised), the Governor-in-Cabinet issued an undertaking regarding Cottage on November 29, 2005, exempting it from all local income, profit, or capital gains taxes. The undertaking has been issued for a period of 20 years and, at the present time, no such taxes are levied in the Cayman Islands. Accordingly, no provision for taxes is made in these consolidated financial statements.

Under the requirements of ASC 740, *Income Taxes*, tax-exempt organizations could be required to record an obligation as the result of a tax position they have historically taken on various tax exposure items. The Group has determined that it does not have any uncertain tax positions through June 30, 2018.

Use of Estimates

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

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This guidance is intended to improve and converge with the international standards and the financial reporting requirements for revenue from contracts with customers. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606)*, which extends the effective date originally contemplated by ASU 2014-09. The revised standards will be effective for fiscal year 2019 and early adoption is permitted beginning in fiscal year 2018. The System has determined the adoption of this ASU will not have a material impact on the System's consolidated results of operations, financial position and cash flows.

2. Summary of Significant Accounting Policies (continued)

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 892)*. This ASU amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets. This guidance is effective for fiscal year 2020. The System is currently assessing the potential impact this ASU will have on the System's consolidated results of operations, financial position, and cash flows.

In March 2017, the FASB issued ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which changes the presentation of net periodic pension cost and net periodic postretirement benefit cost requiring that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost as defined in paragraphs 715-30-35-4 and 715-60-35-9 are required to be presented on the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. This guidance is effective for fiscal year 2019.

3. Regulatory Environment

Medicare and Medicaid

The Medicare and Medicaid reimbursement programs represent a substantial portion of the Group's revenues. The Group's operations are subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Over the past several years, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of fines and penalties, as well as repayments for patient services previously billed. Compliance with fraud and abuse standards and other government regulations can be subject to future government review and interpretation. Also, future changes in federal and state reimbursement funding mechanisms and related government budgeting constraints could have an adverse effect on the Group.

3. Regulatory Environment (continued)

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendment Act of 1983. Hospitals in Maryland were granted a waiver from the Medicare prospective payment system under Section 1814(b) of the Social Security Act. The waiver would remain in effect as long as the Maryland rate of increase in payments per admission remained below the national average rate of increase.

In January 2014, the Centers for Medicare and Medicaid Services approved a modernized waiver that includes both inpatient and outpatient revenue. The new waiver will be in place as long as Maryland hospitals achieve significant quality improvements and limit the per capita growth for all payors for Maryland residents.

Maryland Health Services Cost Review Commission

The Hospital’s rate structure for all hospital-based services is subject to review and approval by the Maryland Health Services Cost Review Commission (HSCRC or the Commission). Under the HSCRC rate-setting system, the Hospital’s inpatient and outpatient charges are the same for all patients, regardless of payor, including Medicare and Medicaid.

Beginning in fiscal year 2014, the Hospital entered into an agreement with the HSCRC to participate in the Global Budget Revenue (GBR) program. The GBR model is a revenue constraint and quality improvement system to provide hospitals with strong financial incentives to manage their resources efficiently and effectively in order to slow the rate of increase in health care costs and improve health care delivery processes and outcomes. Under the GBR, total revenue is capped at a predetermined fixed amount. The annual approved revenue is calculated using a permanent base revenue with positive or negative adjustments for inflation, assessments, performance in quality-based programs, infrastructure requirements, and population. Revenue may also be adjusted annually for market share levels and shifts of regulated services to unregulated settings.

The Commission’s rate-setting methodology compares the approved rate with the actual average rate charged. Any overcharges or undercharges are settled in future revenue determinations on an annual basis. For the current fiscal year, the Hospital was within the allowed corridors for charging.

3. Regulatory Environment (continued)

The Hospital's policy is to recognize revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital's revenues may be subject to adjustment as a result of examination by government agencies or contractors, and as a result of differing interpretation of government regulations, medical diagnoses, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until a subsequent period than which the services were rendered.

Starting in January 2019, Maryland's hospitals will operate under a new 10-year contract with the federal government entitled Maryland Total Cost of Care Model (TCOC). TCOC is designed to test whether the improvements hospitals have made under the previous modernized waiver can be expanded to all health care providers. The GBR methodology will remain in place for hospital rate setting under the TCOC model. In addition, programs aimed to measure and reduce total health care spending for attributed Medicare patients, including pre- and post-acute care by all providers, are being introduced and will be further defined in the next fiscal year.

4. Investments

Investments, including assets whose use is limited, are stated at fair value. Borrowed funds that are required to be expended on specified capital projects under MHHEFA revenue bond agreements are classified as available for sale. All other investments and assets whose use is limited are classified as trading securities.

	June 30	
	2018	**2017**
Assets whose use is limited:		
Endowment assets:		
Cash and cash equivalents	**$ 1,164,000**	$ 218,000
Equity mutual funds	**9,797,000**	9,647,000
Fixed income mutual funds	**5,935,000**	5,920,000
	16,896,000	15,785,000
Amounts held by trustee:		
Cash and cash equivalents	**11,715,000**	10,175,000
U.S. government obligations	**7,000**	15,075,000
	11,722,000	25,250,000
Amounts held by Cottage:		
Cash and cash equivalents	**2,655,000**	3,619,000
Equity mutual funds	**5,190,000**	6,064,000
Fixed income mutual funds	**14,351,000**	14,009,000
Hedge funds	**82,000**	1,572,000
	22,278,000	25,264,000
Total assets whose use is limited	**50,896,000**	66,299,000
Less current portion	**14,521,000**	16,192,000
	$ 36,375,000	$ 50,107,000

4. Investments (continued)

Amounts held by the trustee are broken down as follows:

	June 30 2018	June 30 2017
Bond indenture	**$ 11,722,000**	$ 25,250,000

Other investments:

	June 30 2018	June 30 2017
Cash and cash equivalents	**$ 11,867,000**	$ 4,924,000
Equity mutual funds	**170,294,000**	144,145,000
Fixed income mutual funds	**99,491,000**	107,229,000
Hedge funds	**22,755,000**	30,469,000
	304,407,000	286,767,000
Less short-term investments	**11,771,000**	4,935,000
Investments	**$ 292,636,000**	$ 281,832,000

The components of investment income, net are as follows:

	June 30 2018	June 30 2017
Interest and dividend income, net	**$ 6,117,000**	$ 6,647,000
Realized gains, net	**5,097,000**	2,874,000
	$ 11,214,000	$ 9,521,000

5. Fair Value Measurements

ASC 820 defines fair value and establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles. ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include:

Level 1 – Defined as observable inputs, such as quoted prices in active markets

Level 2 – Defined as inputs other than quoted prices in active markets that are either directly or indirectly observable

Level 3 – Defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The methods described above may produce a fair value calculation that may not be indicative of the net realizable value or reflective of future fair values. Furthermore, while the Group believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

ASC 820 requires that the fair value of derivative contracts include adjustments related to the credit risks of both parties associated with the derivative transactions. The fair value of the Group's derivative contracts reflected in the accompanying consolidated financial statements includes adjustments related to the credit risks of the parties to the transactions.

5. Fair Value Measurements (continued)

The following tables present the fair value hierarchy for the Group's financial assets and liabilities measured at fair value on a recurring basis at June 30.

	2018			
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Cash and cash equivalents	$ 101,403,000	$ 101,403,000	$ –	$ –
Trading securities and assets whose use is limited:				
Cash and cash equivalents	27,402,000	11,715,000	15,687,000	–
Equity securities	185,130,000	179,940,000	5,190,000	–
Fixed income securities	119,927,000	105,576,000	14,351,000	–
U.S. Government obligation securities	7,000	–	7,000	–
Hedge funds	22,837,000	–	22,837,000	–
Total	355,303,000	297,231,000	58,072,000	–
Collateral for interest rate swap:				
Cash and cash equivalents	44,893,000	44,893,000	–	–
Total assets	$ 501,599,000	$ 443,527,000	$ 58,072,000	$ –
Liabilities				
Derivative instruments	$ (59,303,000)	$ –	$ (59,303,000)	$ –
Total liabilities	$ (59,303,000)	$ –	$ (59,303,000)	$ –

5. Fair Value Measurements (continued)

	2017			
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Cash and cash equivalents	$ 71,504,000	$ 71,504,000	$ –	$ –
Trading securities and assets whose use is limited:				
Cash and cash equivalents	18,935,000	10,175,000	8,760,000	–
Equity securities	159,857,000	153,792,000	6,065,000	–
Fixed income securities	127,158,000	113,149,000	14,009,000	–
U.S. Government obligation securities	15,075,000	–	15,075,000	–
Hedge funds	32,041,000	–	32,041,000	–
Total	353,066,000	277,116,000	75,950,000	–
Collateral for interest rate swap:				
Cash and cash equivalents	51,206,000	51,206,000	–	–
Total assets	$ 475,776,000	$ 399,826,000	$ 75,950,000	$ –
Liabilities				
Derivative instruments	$ (73,258,000)	$ –	$ (73,258,000)	$ –
Total liabilities	$ (73,258,000)	$ –	$ (73,258,000)	$ –

The Group's Level 1 securities primarily consist of U.S. Treasury securities, exchange-traded mutual funds, and cash. The Group determines the estimated fair value for its Level 1 securities using quoted (unadjusted) prices for identical assets or liabilities in active markets.

5. Fair Value Measurements (continued)

The Group's Level 2 securities primarily consist of U.S. government-sponsored entities' bonds and money market funds. The Group determines the estimated fair value for these Level 2 securities using the following methods: quoted prices for similar assets/liabilities in active markets, quoted prices for identical or similar assets in non-active markets (few transactions, limited information, non-current prices, high variability over time), inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates, yield curve volatilities, default rates.), and inputs that are derived principally from or corroborated by other observable market data. Part of the System's hedge funds are also considered Level 2 investments because the System has the ability to redeem its investment with the investee at the net asset value per share (or its equivalent) at the measurement date. Redemption can be made on the last day of any calendar quarter with 65 days' advanced written notice. The remaining part of the System's hedge funds, approximately $20 million and $18 million at June 30, 2018 and 2017, respectively, are invested in international equity funds and are considered Level 2 investments due to quoted price not being readily available.

The Group's Level 2 securities also consist of derivative instruments, which are reported using valuation models commonly used for derivatives. Valuation models require a variety of inputs, including contractual terms, market-fixed prices, inputs from forward price yield curves, notional quantities, measures of volatility, and correlations of such inputs.

The Group also has pledges receivable, which are measured at fair value on a nonrecurring basis and are discounted to the net present value upon receipt using an appropriate risk-free discount rate based on the term of the receivable. Since these inputs are not observable, pledges receivable would be considered Level 3 fair value measurements upon their initial recording. Pledges receivable are recorded net of an allowance for uncollectible pledges. The following table provides a reconciliation of the beginning and ending balances of pledges receivable that used significant unobservable inputs.

	Year Ended June 30	
	2018	**2017**
Pledges receivable:		
Balance at July 1	**$ 4,914,000**	$ 6,333,000
New pledges	**2,263,000**	2,225,000
Collections of pledges	**(2,912,000)**	(3,379,000)
Write-off of pledges	**(462,000)**	(316,000)
Change in reserves	**312,000**	51,000
Balance at June 30	**$ 4,115,000**	$ 4,914,000

6. Long-Term Debt and Line of Credit

Long-term debt consists of the following:

	Interest Rate	Maturity Dates	June 30 2018	June 30 2017
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2017	2.0%–5.0%	2018–2043	**$ 60,245,000**	$ –
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2014	2.0%–5.0%	2015–2040	**118,360,000**	120,440,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2012	2.0%–5.0%	2013–2035	**62,375,000**	64,915,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2010	4.0%–5.0%	2011–2041	**–**	74,835,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2009B	Variable	2041–2044	**60,000,000**	60,000,000
2008 term loan from a bank	Variable	2028	**41,105,000**	42,892,000
Kent Island term loan from a bank	Variable	2021	**6,159,000**	6,456,000
2008 construction loan from a bank	Variable	2028	**21,596,000**	22,506,000
			369,840,000	392,044,000
Less current portion of long-term debt			**8,848,000**	9,593,000
Less deferred debt issue costs			**3,949,000**	4,179,000
Unamortized original issue premium, net			**15,240,000**	10,650,000
Long-term debt			**$ 372,283,000**	$ 388,922,000

These debt instruments are secured by the receipts of the Hospital and substantially all of the property and equipment of the consolidated Group.

6. Long-Term Debt and Line of Credit (continued)

Principal payments due under all debt instruments as of June 30, 2018, are as follows:

2019	$ 8,848,000
2020	11,083,000
2021	16,552,000
2022	11,362,000
2023	11,667,000
Thereafter	310,328,000
	$ 369,840,000

Series 2017 Revenue Bonds

In November 2017, the Hospital entered into a loan agreement with the MHHEFA for the issuance of Series 2017 Revenue Bonds (referred to as the 2017 Bonds). The proceeds of the 2017 Bonds were used to advance refund the Series 2010 Bonds previously provided by MHHEFA. The bonds being refunded were originally obtained to finance the expansion of the parking garage for the Hospital's acute care pavilion, and costs related to the issuance. The 2017 Bonds provide for annual principal payments each July 1 from 2018 through 2034. Interest is payable annually each July 1 starting in July 2018. The 2017 Bonds bear stated interest rates between 2.00% and 5.00% and were issued at a premium of $4,590,000, which is amortized over the life of the bonds using the straight-line method, which approximates the effective interest method. The effective annual interest rate for the 2017 Bonds for the year ended June 30, 2018, was 3.00%.

Series 2014 Revenue Bonds

In November 2014, the Hospital entered into a loan agreement with the MHHEFA for the issuance of Series 2014 Revenue Bonds (referred to as the 2014 Bonds). The proceeds of the 2014 Bonds were used to advance refund the Series 2009A Bonds previously provided by MHHEFA. The bonds being refunded were originally obtained to finance a portion of the costs of construction for an eight-story patient care building, two parking garages, and costs related to the issuance. The 2014 Bonds provide for annual principal payments each July 1 from 2015 through 2040. Interest is payable semiannually each July 1 and January 1, beginning in January 2015. The 2014 Bonds bear stated interest rates between 2.00% to 5.00% and were issued at a premium of $7,520,000, which is amortized over the life of the bonds using the straight-line method, which approximates the effective interest method. The effective annual interest rate for the 2014 Bonds for the years ended June 30, 2018 and 2017, was 4.35% and 4.20%, respectively.

6. Long-Term Debt and Line of Credit (continued)

Series 2012 Revenue Bonds

In October 2012, the Hospital entered into a loan agreement with MHHEFA for the issuance of $73,625,000 of Series 2012 Revenue Bonds (referred to as the 2012 Bonds). The proceeds of the 2012 Bonds were used to repay the Series 2004A Bonds and the Series 1998 Bonds previously provided by the Authority. The bonds being refinanced were originally obtained to finance a new replacement hospital (Series 1998 Bonds) and to finance major renovations to the Hospital's Cancer Center and land acquisition (Series 2004A Bonds). The 2012 Bonds provide for annual principal payments each July 1 from 2013 through 2034. Interest is payable semiannually on each July 1 and January 1, beginning July 1, 2013. The 2012 Bonds bear stated interest at rates of 2.00% to 5.00%, and were issued at a premium of $6,746,000. The effective annual interest rates for the 2012 Bonds for the years ended June 30, 2018 and 2017, were 3.73% and 3.74%, respectively.

The provisions of the 2017, 2014, and 2012 Bonds, together with the Series 2010 Bonds and Series 2009 Bonds, require the Parent and subsidiaries to comply with certain covenants on an annual basis, including a debt service coverage requirement, a debt-to-capitalization requirement, and a liquidity requirement. The Hospital, the Parent, and HCS are members of the obligated Group for all of the revenue bonds issued by MHHEFA.

Series 2010 Revenue Bonds

In February 2010, the Hospital entered into a loan agreement with MHHEFA for the issuance of $85,410,000 of Series 2010 Revenue Bonds (referred to as the 2010 Bonds). The proceeds of the 2010 Bonds were used to repay the Series 2004B Bonds and dedicated financing previously provided by the MHHEFA and are also being used to finance the expansion of the parking garage for the Hospital's acute care pavilion. The 2010 Bonds provide for annual principal payments each July 1, from 2011 through 2040. Interest is payable semiannually on each July 1 and January 1, beginning July 1, 2010. The 2010 Bonds bear stated interest at rates of 4.00% to 5.00%, and were issued at an original issue discount of $1,507,000. The effective annual interest rates for the 2010 Bonds for the years ended June 30, 2018 and 2017, were 3.35% and 4.99%, respectively.

In November 2017, the Series 2010 Bonds were refinanced through an advance refunding using the proceeds from the Series 2017 Bonds. As a result of the refinancing of the Series 2010 Bonds, a one-time charge of $6,056,000 was recorded as a loss on advance refunding of debt and is included in other non-operating income.

6. Long-Term Debt and Line of Credit (continued)

Series 2009 Revenue Bonds

In January 2009, the Hospital entered into a loan agreement with the MHHEFA for the issuance of $120,000,000 of Series 2009A Revenue Bonds (the 2009A Bonds) and in February 2009, $60,000,000 of Series 2009B Revenue Bonds (the 2009B Bonds) (collectively referred to as the 2009 Bonds). The proceeds of the 2014 Bonds were used to advance refund the Series 2009A Bonds previously provided by the MHHEFA. The proceeds of the 2009 Bonds were used to finance a portion of the costs of construction of an eight-story patient care building, two new parking garages, and certain costs relating to the issuance. The 2009B Bonds provide for annual principal payments each July 1, from 2040 through 2043. Interest is payable semiannually on each July 1 and January 1, beginning July 1, 2009. The 2009B Bonds bear interest at variable rates, as set forth in the loan agreement. The maximum interest rate is 12% for the 2009B Bonds. The effective annual interest rates for the 2009B Bonds for the years ended June 30, 2018 and 2017, were 0.75% and 0.68%, respectively. The principal and interest payments on the Series 2009B Bonds are secured by a letter of credit equal to the original principal of the bonds plus an amount equal to 40 days' interest thereon, calculated at the maximum rate. The current letter of credit expires on July 1, 2020. Under certain circumstances, the Hospital would need to fully redeem the 2009B Bonds upon expiration of the letter of credit, unless a conforming replacement letter of credit was secured prior to such expiration.

The related balances are included in assets whose use is limited and consist of the following:

	June 30	
	2018	**2017**
Debt service funds	**$ 11,715,000**	$ 12,573,000
Debt service reserve funds	**–**	12,497,000
Construction fund and capitalized interest fund	**7,000**	180,000
	$ 11,722,000	$ 25,250,000

6. Long-Term Debt and Line of Credit (continued)

Bank Line of Credit and Term Loan

The Hospital maintains a line of credit with a bank providing available credit of $30,000,000. The agreement with the bank is reviewed for renewal on February 28 of each year. Interest on any borrowings accrues at the one-month London Interbank Offered Rate (LIBOR) plus 1.5%. At June 30, 2018 and 2017, the Group has no balance on the line of credit.

On October 23, 2008, the Real Estate Company secured a term loan in the amount of $55,000,000 with a bank. The proceeds from the term loan were used to refinance line of credit proceeds and fund certain construction costs related to a medical office building. The loan bears interest at a variable rate, based on the LIBOR market index rate plus 1.25%. The term loan requires monthly payments of $235,000 with all remaining amounts due upon final maturity on November 5, 2018. The effective annual interest rates for the years ended June 30, 2018 and 2017, were 2.72% and 1.95%, respectively. This loan was subsequently refinanced on October 17, 2018. Refer to the subsequent event footnote for more information.

2008 Construction Loan

On October 23, 2008, the Real Estate Company entered into a construction loan in the amount of $30,000,000 with a bank to fund the construction of a medical office building. The loan was issued under the same loan agreement as the term loan discussed in the immediately preceding paragraph. The debt is secured by the medical office building. Interest only is due during the construction period at a rate equal to the LIBOR market index rate plus 1.25%. The loan converted to a term loan after the completion of the construction in July 2009. The term loan provides for monthly principal and interest payments and has a final maturity of November 5, 2018. The effective annual interest rates for the years ended June 30, 2018 and 2017, were 2.72% and 1.95%, respectively. This loan was subsequently refinanced on October 17, 2018. Refer to the subsequent event footnote for more information.

Kent Island Term Loan

In August 2007, KIMA entered into a construction loan agreement with a bank in the amount of $9,000,000 that would convert to a term loan after the completion of the construction. The proceeds were used to construct a medical office building. The debt was secured by the medical office building. Interest only was due during the construction period at a rate of the 30-day LIBOR plus 1.0%. The construction was completed in June 2008.

6. Long-Term Debt and Line of Credit (continued)

On May 9, 2017, KIMA refinanced the term loan with a $6,567,000 promissory note. The promissory note provides for monthly principal and interest payments and has a final maturity of December 2021. The promissory note bears interest at a variable rate, based on the 30-day LIBOR plus 1.2%. The effective annual interest rates for the years ended June 30, 2018 and 2017, were 2.76% and 1.64%, respectively.

7. Pension Plan and Thrift Plan

The Hospital has a qualified non-contributory, defined benefit pension plan (the Plan) that covers substantially all employees. The Group's policy is to fund pension costs as determined by its actuary. Adopted by the Board of Trustees on June 11, 2009, and effective September 1, 2009, the Hospital amended the Plan to freeze future benefit accruals, and participants have not earned any additional benefits under the Plan since that date. However, subsequent to September 1, 2009, participants have continued to vest in benefits they have earned through September 1, 2009. The frozen benefit balance for the participants will only accrue interest credits until the participants' benefit commencement dates. FASB ASC 715, *Compensation – Retirement Benefits*, requires the Group to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan on its consolidated balance sheet, with a corresponding adjustment to unrestricted net assets. The pension liability adjustment to unrestricted net assets represents the change in net unrecognized actuarial losses that have not yet been recognized as part of revenues and gains in excess of expenses. These amounts are subsequently recognized as a net periodic benefit cost pursuant to the Group's historical accounting policy for amortizing such amounts.

7. Pension Plan and Thrift Plan (continued)

The reconciliation of the beginning and ending balances of the projected benefit obligation and the fair value of plan assets for the years ended June 30 and the accumulated benefit obligation at June 30 is as follows:

	2018	**2017**
Accumulated benefit obligation	**$ 124,571,000**	$ 127,127,000
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	**$ 127,127,000**	$ 130,775,000
Service cost	**–**	–
Interest cost	**4,583,000**	4,340,000
Actuarial (gain) loss	**40,000**	(1,928,000)
Benefits paid	**(2,413,000)**	(1,978,000)
Settlements paid	**(4,766,000)**	(4,082,000)
Projected benefit obligation at end of year	**124,571,000**	127,127,000
Change in plan assets:		
Fair value of plan assets at beginning of year	**116,439,000**	99,307,000
Actual return on plan assets	**6,797,000**	14,413,000
Employer contribution	**5,200,000**	8,779,000
Plan reimbursement	**–**	–
Benefits paid	**(2,413,000)**	(1,978,000)
Settlements paid	**(4,766,000)**	(4,082,000)
Fair value of plan assets at end of year	**121,257,000**	116,439,000
Net liability recognized	**$ (3,314,000)**	$ (10,688,000)

7. Pension Plan and Thrift Plan (continued)

	June 30	
	2018	**2017**
Net amounts recognized on the consolidated balance sheets consist of:		
Accrued pension costs	**$ (3,314,000)**	$ (10,688,000)
Amounts recognized in unrestricted net assets that have not been recognized in net periodic benefit costs consist of:		
Net actuarial loss	**$ 69,204,000**	$ 71,148,000

The following table sets forth the weighted average assumptions used to determine the benefit obligations:

	June 30	
	2018	**2017**
Discount rate	**4.10%**	3.70%
Rate of compensation increase	**N/A**	N/A

The following table sets forth the weighted average assumptions used to determine the net periodic benefit cost:

	Year Ended June 30	
	2018	**2017**
Discount rate	**3.70%**	3.40%
Expected return on plan assets	**7.50**	7.50
Rate of compensation increase	**N/A**	N/A

7. Pension Plan and Thrift Plan (continued)

The net periodic pension benefit cost included the following components:

	June 30	
	2018	**2017**
Service cost	**$ –**	$ –
Interest cost	**4,583,000**	4,340,000
Expected return on plan assets	**(8,979,000)**	(8,419,000)
Amortization of prior service cost	**–**	–
Recognized net actuarial loss	**1,518,000**	1,534,000
Loss recognized from partial settlement of projected benefit obligation	**2,648,000**	–
Net periodic credit	**$ (230,000)**	$ (2,545,000)

The estimated net loss of the defined benefit pension plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year is $1,499,000.

The Hospital's defined benefit plan invests in a diversified mix of traditional asset classes. Investments in certain types of U.S. equity securities and fixed-income securities are made to maximize long-term results while recognizing the need for adequate liquidity to meet ongoing benefit and administrative obligations. Risk tolerance of unexpected investment and actuarial outcomes is continually evaluated by understanding the pension plan's liability characteristics. Equity investments are used primarily to increase the overall plan returns. Debt securities provide diversification benefits and liability hedging attributes that are desirable, especially in falling interest rate environments.

The Hospital's target asset allocation percentages as of June 30, 2018, were as follows: 50% investment grade bonds, 20% international equity, 20% large cap domestic stocks, 5% small cap domestic stocks, and 5% hedge funds and exchange-traded notes.

7. Pension Plan and Thrift Plan (continued)

The following tables present the fair value hierarchy of assets of the defined benefit pension plan at June 30.

	2018			
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets				
Cash and cash equivalents	$ 736,000	$ –	$ 736,000	$ –
Mutual funds:				
Equity	31,735,000	31,735,000	–	–
Corporate bonds	48,792,000	48,792,000	–	–
International equity	13,594,000	13,594,000	–	–
International bonds	12,013,000	12,013,000	–	–
Equity closed-end funds	4,686,000	4,686,000	–	–
Collective funds:				
International equity	9,701,000	–	9,701,000	–
	$ 121,257,000	$ 110,820,000	$ 10,437,000	$ –

7. Pension Plan and Thrift Plan (continued)

	2017			
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Total	Level 1	Level 2	Level 3
Assets				
Cash and cash equivalents	$ 2,102,000	$ –	$ 2,102,000	$ –
Mutual funds:				
Equity	42,532,000	42,532,000	–	–
Corporate bonds	28,035,000	28,035,000	–	–
International equity	14,515,000	14,515,000	–	–
International bonds	10,456,000	10,456,000	–	–
Equity closed-end funds	5,236,000	5,236,000	–	–
Collective funds:				
International equity	9,136,000	–	9,136,000	–
Managed partnerships:				
Hedge funds	4,427,000	–	4,427,000	–
	$ 116,439,000	$ 100,774,000	$ 15,665,000	$ –

Level 1 securities primarily consist of exchange-traded mutual funds. Level 2 securities primarily consist of money market funds and hedge funds. Methods consistent with those discussed in Note 5 are used to estimate the fair values of these securities.

The overall expected rate of return on assets assumptions was based on historical returns, with adjustments made to reflect expectations of future returns. The extent to which the future expectations were recognized considered the target rates of returns for the future, which have historically not changed.

The Hospital currently intends to make voluntary contributions to the defined benefit pension plan of $4,400,000 in fiscal year 2019.

7. Pension Plan and Thrift Plan (continued)

The following benefit payments are expected to be paid:

2019	$ 7,467,000
2020	7,846,000
2021	8,188,000
2022	7,998,000
2023	7,528,000
2024–2028	38,218,000

In addition to the non-contributory defined benefit pension plan, the Hospital also offers an employee thrift plan. Participation in the plan is voluntary. Substantially all full-time employees of the Hospital are eligible to participate. Employees may elect to contribute a minimum of 1% of compensation, and a maximum amount as determined by Sections 403(b) and 415 of the Internal Revenue Code. Any employee making contributions to the plan is entitled to a Hospital contribution that will match the employee contribution at the rate of 50% to 75%, depending on the number of years of service, up to a maximum of 5% of qualified compensation. Matching contributions under this thrift plan were $6,365,000 and $5,010,000 in fiscal years 2018 and 2017, respectively.

8. Concentrations of Credit Risk

Certain members of the Group grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors prior to consideration of an allowance for doubtful accounts was as follows:

	June 30	
	2018	**2017**
Medicare	**24%**	26%
Medicaid	**5**	5
Blue Cross	**20**	20
Commercial, HMO, PPO, and other	**34**	32
Patients	**17**	17
	100%	100%

9. Malpractice Insurance Costs and Self-Insured Professional Liability

Until August 1, 1998, the Group maintained insurance coverage for general and professional liability claims on a claims-made basis. The professional liability coverage included a per-case deductible of $250,000, up to a maximum out-of-pocket amount of $750,000 annually. Effective August 1, 1998, the Group changed its professional liability coverage to a full coverage claims-made policy with no annual deductibles. This policy included tail coverage for claims incurred prior to August 1, 1998, but reported subsequently. Effective August 1, 2002, the Group changed its professional liability coverage back to a claims-made policy with a per-case deductible of $250,000, up to a maximum out-of-pocket amount of $750,000 annually. Also, the Group did not purchase tail coverage for claims incurred prior to August 1, 2002 that were not yet reported.

Effective March 1, 2004, the Group changed its professional liability coverage to a self-insurance trust with annual exposure limits of $2,000,000 per claim and $11,000,000 in the aggregate. The Group carried an excess liability insurance policy for claims above these limits.

Effective July 1, 2005, Cottage was formed as a captive insurer to provide professional liability insurance for the Group. Cottage is a wholly owned subsidiary of the System, which was formed in the Cayman Islands. The primary layer of professional and general liability insurance coverage is self-insured through Cottage and the secondary layer is fully reinsured through several highly rated commercial carriers.

For the period from July 1, 2005 to June 30, 2009, Cottage issued claims-made policies covering Hospital professional liability (including employed physicians) and on an occurrence basis, comprehensive general liability risks of the Parent and certain affiliates. Policy limits were $2,000,000 per claim with a $9,000,000 policy aggregate. Effective July 1, 2005, Cottage assumed existing liabilities from the System's self-insured trust discussed above on a claims-made basis. Effective July 1, 2009, Cottage issued a claims-made policy providing $2,000,000 per claim for Hospital professional liability coverage and $1,000,000 per claim for comprehensive general liability coverage, subject to a consolidated annual aggregate limit of $10,000,000. Effective July 1, 2018, policy limits were increased to $5,000,000 per claim with a $25,000,000 policy aggregate.

For the period from July 1, 2005 to June 30, 2008, Cottage also issued an excess umbrella coverage policy (covering Hospital professional liability) with limits of $20,000,000 per claim with a policy aggregate. For claims reported on and subsequent to July 1, 2008, the coverage limit provided is $30,000,000 per claim with a policy aggregate. These excess limits are in excess of the primary policy, and the umbrella policies are 100% reinsured with highly rated third-party commercial reinsurers.

9. Malpractice Insurance Costs and Self-Insured Professional Liability (continued)

The provision for estimated professional liability claims, general liability claims, and workers' compensation claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. As of June 30, 2018 and 2017, the balance for outstanding claims reserves recorded at Cottage is $45,662,000 and $42,138,000 and reinsurance receivable is $29,185,000 and $26,090,000, respectively. The remaining tail liability for claims incurred but not reported is $9,513,000 and $5,982,000 as of June 30, 2018 and 2017, respectively, with $8,061,000 of the 2018 liability and $5,220,000 of the 2017 liability recorded at the Hospital. The remainder of the liability is recorded at PE. The Group has employed an independent actuary to estimate the ultimate settlement of such claims. In management's opinion, the amounts recorded provide an adequate reserve for loss contingencies. However, changes in circumstances affecting professional liability claims could cause these estimates to change by material amounts in the short term.

10. Commitments and Contingencies

Operating Leases

Various members of the Group have operating leases for storage space, equipment, and offices. During 2018 and 2017, rent expense for these leases was approximately $10,971,000 and $10,423,000, respectively. Future minimum annual rental payments under non-cancelable operating leases, which expire through 2023, are as follows:

2019	$ 9,785,000
2020	7,870,000
2021	5,784,000
2022	3,277,000
2023	2,064,000
Thereafter	3,604,000
	$ 32,384,000

10. Commitments and Contingencies (continued)

Contingencies

Members of the Group have been named as defendants in various legal proceedings arising from the performance of their normal activities. In the opinion of management, after consultation with legal counsel and after consideration of applicable insurance, the amount of the Group's ultimate liability under all current legal proceedings will not have a material adverse effect on its consolidated financial position or results of operations.

The Group's revenues may be subject to adjustment as a result of examination by government agencies or contractors, based upon differing interpretations of government regulations, medical diagnoses, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered. Section 302 of the Tax Relief and Health Care Act of 2006 authorized a permanent program involving the use of third-party recovery audit contractors (RACs) to identify Medicare overpayments and underpayments made to providers. Management has established protocols to respond to RAC requests and payment denials. Payment recoveries resulting from RAC reviews are appealable through administrative and judicial processes, and management intends to pursue the reversal of adverse determinations where appropriate. In addition to overpayments that are not reversed on appeal, management will incur additional costs to respond to requests for records and pursue the reversal of payment denials. As of June 30, 2018 and 2017, the Group has recorded an estimated reserve regarding the Medicare overpayments. In the opinion of the Group's management, the ultimate settlement of this matter will not have a material adverse effect on the consolidated financial position of the Group.

During the year ended June 30, 2018, the System recorded a $3,500,000 accrual related to an inquiry by the Department of Justice regarding a potential billing discrepancy. In connection with this inquiry, the System is continuing to discuss a resolution with the Federal Government. It is possible that other regulatory conditions may be part of the final resolution. Based on consultation with legal counsel, management believes the final resolution will not have a material adverse effect on the June 30, 2018 financial statements.

11. Functional Expenses

Members of the Group provide general health care services to residents within their service area. Expenses related to providing these services are as follows:

	Year Ended June 30	
	2018	**2017**
Health care services	**$ 561,688,000**	$ 547,497,000
General and administrative	**149,940,000**	142,519,000
	$ 711,628,000	$ 690,016,000

12. Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, patient receivables, prepaid expenses and other current assets, accounts payable, accrued salaries, wages and benefits, other accrued expenses, and advances from third-party payors approximate fair value, given the short-term nature of these financial instruments or their methods of valuation. The following methods and assumptions were used by the Group in estimating the fair value of other financial instruments.

Investments and Assets Whose Use is Limited

Fair values are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Pledges Receivable

The Group estimates that the carrying value of pledges receivable approximates fair value, given the discount rates applied.

Long-Term Debt

Fair values of the Group’s long-term fixed-rate debt are established using discounted cash flow analyses, based on the Group’s current incremental borrowing rates for similar types of borrowing arrangements. The carrying amount of the Group’s long-term variable-rate debt approximates fair value. The estimated fair value of all long-term debt at June 30, 2018 and 2017, was $383,715,000 and $409,336,000, respectively.

13. Temporarily Restricted Net Assets

At June 30, 2018 and 2017, temporarily restricted net assets are restricted for use, as follows:

	2018	2017
Hospital capital additions	**$ 5,076,000**	$ 5,615,000
Hospital operating programs	**10,770,000**	9,007,000
	$ 15,846,000	$ 14,622,000

14. Subsequent Events

On October 17, 2018, the Real Estate Company secured a single loan from the bank through a wholly owned subsidiary and the proceeds were used to pay off the 2008 Term Loan and 2008 Construction Loan previously provided by the bank. The loans being refinanced were originally obtained to finance certain medical office buildings owned by the Company. The new loan will require flat monthly principal payments (amortized over seventeen years) plus interest at one month Libor + 1.10% from 2018 through 2028 with a balloon payment due October 5, 2028 of $25,800,000.

The Group has evaluated the impact of subsequent events through October 18, 2018, representing the date at which the accompanying consolidated financial statements were issued.

Supplementary Information

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet

June 30, 2018

	Anne Arundel Health System, Inc.	Anne Arundel Medical Center, Inc. and Subsidiaries	Anne Arundel Health Care Enterprises, Inc.	Anne Arundel Real Estate Holding Company, Inc. and Subsidiaries	Cottage Insurance Company, Ltd.	AAHS Research Institute, Inc.	Physician Enterprise, LLC	Anne Arundel Medical Center Collaborative Care Network LLC	Anne Arundel Medical Center Foundation, Inc.	Consolidating and Eliminating Entries: Cottage Insurance Company, Ltd.	Consolidating and Eliminating Entries: Other Subsidiaries	Consolidated
Assets												
Current assets:												
Cash and cash equivalents	$ (6,992,000)	$ 100,035,000	$ (144,000)	$ 1,707,000	$ –	$ 34,000	$ 1,353,000	$ 1,000	$ 5,409,000	$ –	$ –	$ 101,403,000
Short-term investments	–	11,332,000	–	–	–	–	–	–	439,000	–	–	11,771,000
Current portion of assets whose use is limited	–	11,716,000	–	–	2,806,000	–	–	–	–	–	–	14,521,000
Patient receivables, less allowance for uncollectible accounts	–	68,988,000	(3,000)	–	–	–	9,904,000	–	–	–	–	78,889,000
Current portion of pledges receivable, net	–	–	–	–	–	–	–	–	1,017,000	–	–	1,017,000
Inventories	–	7,734,000	–	–	–	–	242,000	–	–	–	–	7,976,000
Prepaid expenses and other current assets	132,000	33,045,000	5,849,000	12,190,000	34,000	467,000	1,872,000	2,801,000	1,308,000	–	(46,307,000)	11,391,000
Total current assets	(6,860,000)	232,850,000	5,702,000	13,897,000	2,840,000	501,000	13,371,000	2,802,000	8,173,000	–	(46,307,000)	226,968,000
Property and equipment	8,000	723,122,000	1,775,000	135,676,000	–	77,000	21,772,000	–	2,007,000	–	–	884,437,000
Less accumulated depreciation and amortization	–	(384,904,000)	(1,830,000)	(58,884,000)	–	(73,000)	(10,823,000)	–	(92,000)	–	–	(456,606,000)
Net property and equipment	8,000	338,218,000	(55,000)	76,792,000	–	4,000	10,949,000	–	1,915,000	–	–	427,831,000
Other assets:												
Investments	–	290,878,000	–	–	–	–	–	–	1,757,000	–	–	292,636,000
Investments in joint ventures	998,000	(273,000)	2,068,000	6,947,000	–	–	–	–	–	–	–	9,740,000
Pledges receivable, net of current portion and net of allowance for uncollectible pledges	–	–	–	–	–	–	–	–	3,098,000	–	–	3,098,000
Assets whose use is limited	–	7,000	–	–	19,622,000	–	–	–	16,746,000	–	–	36,375,000
Beneficial interest in net assets of AAMC Foundation, Inc.	–	27,933,000	–	–	–	–	–	–	–	–	(27,933,000)	–
Restricted collateral for interest rate swap contract	–	44,893,000	–	–	–	–	–	–	–	–	–	44,893,000
Investment in subsidiaries and other assets	512,759,000	13,361,000	–	1,484,000	29,185,000	–	1,392,000	–	1,028,000	–	(515,352,000)	43,856,000
Total assets	$ 506,905,000	$ 947,867,000	$ 7,715,000	$ 99,120,000	$ 51,647,000	$ 505,000	$ 25,712,000	$ 2,802,000	$ 32,717,000	$ –	$(589,592,000)	$ 1,085,397,000

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet (continued)

June 30, 2018

	Anne Arundel Health System, Inc.	Anne Arundel Medical Center, Inc. and Subsidiaries	Anne Arundel Health Care Enterprises, Inc.	Anne Arundel Real Estate Holding Company, Inc. and Subsidiaries	Cottage Insurance Company, Ltd.	AAHS Research Institute, Inc.	Physician Enterprise, LLC	Anne Arundel Medical Center Collaborative Care Network LLC	Anne Arundel Medical Center Foundation, Inc.	Consolidating and Eliminating Entries: Cottage Insurance Company, Ltd.	Consolidating and Eliminating Entries: Other Subsidiaries	Consolidated
Liabilities and net assets												
Current liabilities:												
Accounts payable	$ 26,864,000	$ 18,932,000	$ 959,000	$ 484,000	$ 231,000	$ 339,000	$ 13,455,000	$ 165,000	$ 4,519,000	$ –	$ (44,033,000)	$ 21,915,000
Accrued salaries, wages, and benefits	10,469,000	18,406,000	973,000	–	–	79,000	5,330,000	800,000	43,000	–	–	36,100,000
Other accrued expenses	846,000	19,118,000	3,000	4,825,000	(175,000)	–	1,513,000	–	221,000	–	(4,873,000)	21,478,000
Current portion of long-term debt	–	6,110,000	–	2,738,000	–	–	–	–	–	–	–	8,848,000
Advances from third-party payors	–	20,574,000	–	356,000	–	–	75,000	–	–	–	–	21,005,000
Total current liabilities	38,179,000	83,140,000	1,935,000	8,403,000	56,000	418,000	20,373,000	965,000	4,783,000	–	(48,906,000)	109,346,000
Long-term debt, less current portion	–	306,249,000	–	66,033,000	–	–	–	–	–	–	–	372,283,000
Interest rate swap contract	–	59,303,000	–	–	–	–	–	–	–	–	–	59,303,000
Accrued pension liability	–	3,314,000	–	–	–	–	–	–	–	–	–	3,314,000
Other long-term liabilities	–	–	–	–	45,662,000	–	167,000	–	–	–	–	45,829,000
Total liabilities	38,179,000	452,006,000	1,935,000	74,436,000	45,718,000	418,000	20,540,000	965,000	4,783,000	–	(48,906,000)	590,075,000
Net assets:												
Unrestricted	445,494,000	468,711,000	5,780,000	24,685,000	5,929,000	87,000	5,172,000	1,837,000	1,486,000	–	(490,161,000)	469,018,000
Temporarily restricted	12,182,000	16,693,000	–	–	–	–	–	–	16,693,000	–	(29,720,000)	15,846,000
Permanently restricted	11,050,000	10,458,000	–	–	–	–	–	–	9,755,000	–	(20,805,000)	10,458,000
Total net assets	468,726,000	495,861,000	5,780,000	24,685,000	5,929,000	87,000	5,172,000	1,837,000	27,934,000	–	(540,686,000)	495,322,000
Total liabilities and net assets	$ 506,905,000	$ 947,867,000	$ 7,715,000	$ 99,120,000	$ 51,647,000	$ 505,000	$ 25,712,000	$ 2,802,000	$ 32,717,000	$ –	$(589,592,000)	$ 1,085,397,000

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Consolidating Schedule of Revenues, Expenses, Gains, and Losses

For the Year Ended June 30, 2018

	Anne Arundel Health System, Inc.	Anne Arundel Medical Center, Inc. and Subsidiaries	Anne Arundel Health Care Enterprises, Inc.	Anne Arundel Real Estate Holding Company, Inc. and Subsidiaries	Cottage Insurance Company, Ltd.	AAHS Research Institute, Inc.	Physician Enterprise, LLC	Anne Arundel Medical Center Collaborative Care Network LLC	Anne Arundel Medical Center Foundation, Inc.	Consolidating and Eliminating Entries: Cottage Insurance Company, Ltd.	Consolidating and Eliminating Entries: Other Subsidiaries	Consolidated
Operating revenue:												
Net patient service revenue	$ –	$ 599,065,000	$ –	$ –	$ –	$ –	$ 126,201,000	$ –	$ –	$ –	$ –	$ 725,266,000
Provision for bad debts	–	(15,127,000)	–	–	–	–	(2,759,000)	–	–	–	–	(17,886,000)
Net patient service revenue less provision for bad debts	–	583,938,000	–	–	–	–	123,442,000	–	–	–	–	707,380,000
Other operating revenue	1,218,000	10,967,000	16,710,000	22,104,000	4,077,000	1,330,000	27,504,000	2,838,000	3,843,000	(4,077,000)	(58,420,000)	28,093,000
Total operating revenue	1,218,000	594,905,000	16,710,000	22,104,000	4,077,000	1,330,000	150,946,000	2,838,000	3,843,000	(4,077,000)	(58,420,000)	735,473,000
Operating expenses:												
Salaries and wages	–	213,523,000	7,641,000	–	–	1,141,000	104,187,000	1,010,000	1,134,000	–	–	328,636,000
Employee benefits	–	40,481,000	1,336,000	–	–	153,000	10,607,000	26,000	178,000	–	–	52,781,000
Supplies	–	142,283,000	115,000	225,000	–	10,000	8,859,000	2,000	54,000	–	–	151,547,000
Purchased services	885,000	120,750,000	6,321,000	9,230,000	7,524,000	835,000	41,384,000	266,000	1,418,000	(4,077,000)	(55,450,000)	129,086,000
Foundation transfer to AAMC and subsidiaries	–	–	–	–	–	–	–	–	2,748,000	–	(2,748,000)	–
Depreciation and amortization	–	30,252,000	89,000	4,282,000	–	2,000	1,723,000	–	25,000	–	–	36,373,000
Interest	–	11,245,000	–	2,052,000	–	–	1,000	–	–	–	(93,000)	13,205,000
Total operating expenses	885,000	558,534,000	15,502,000	15,789,000	7,524,000	2,141,000	166,761,000	1,304,000	5,557,000	(4,077,000)	(58,291,000)	711,628,000
Operating income (loss)	333,000	36,371,000	1,208,000	6,315,000	(3,447,000)	(811,000)	(15,815,000)	1,534,000	(1,714,000)	–	(129,000)	23,845,000
Other income (loss):												
Investment income, net	–	9,131,000	–	16,000	1,918,000	–	–	–	149,000	–	–	11,214,000
Loss on advance refunding of debt	–	(6,056,000)	–	–	–	–	–	–	–	–	–	(6,056,000)
Income (loss) from joint ventures and other, net	42,626,000	(281,000)	126,000	(684,000)	–	–	–	–	1,000	–	(43,748,000)	(1,960,000)
Change in unrealized gains (losses) on trading securities, net	–	9,715,000	–	–	(1,531,000)	–	–	–	(14,000)	–	–	8,170,000
Realized and unrealized losses on interest rate swap contracts, net	–	8,858,000	–	–	–	–	–	–	–	–	–	8,858,000
Total other income (loss), net	42,626,000	21,367,000	126,000	(668,000)	387,000	–	–	–	136,000	–	(43,748,000)	20,226,000
Revenues and gains (losses) in excess (less than) of expenses	$ 42,959,000	$ 57,738,000	$ 1,334,000	$ 5,647,000	$ (3,060,000)	$ (811,000)	$ (15,815,000)	$ 1,534,000	$ (1,578,000)	$ –	$ (43,877,000)	$ 44,071,000

Anne Arundel Medical Center, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet

June 30, 2018

	Anne Arundel Medical Center, Inc.	Anne Arundel Health Care Services, Inc.	Anne Arundel General Treatment Service, Inc.	Consolidating and Eliminating Entries	Consolidated
Assets					
Current assets:					
Cash and cash equivalents	$ 48,337,000	$ 51,297,000	$ 401,000	$ –	$ 100,035,000
Short-term investments	11,332,000	–	–	–	11,332,000
Current portion of assets whose use is limited	11,716,000	–	–	–	11,716,000
Patient receivables, net	65,695,000	2,602,000	691,000	–	68,988,000
Inventories	7,734,000	–	–	–	7,734,000
Due from affiliates, net	326,000	27,766,000	236,000	(853,000)	27,475,000
Prepaid expenses and other current assets	5,416,000	154,000	–	–	5,570,000
Total current assets	150,556,000	81,819,000	1,328,000	(853,000)	232,850,000
Property and equipment	687,893,000	26,750,000	8,479,000	–	723,122,000
Less accumulated depreciation and amortization	(356,270,000)	(24,614,000)	(4,020,000)	–	(384,904,000)
Net property and equipment	331,623,000	2,136,000	4,459,000	–	338,218,000
Other assets:					
Investments	290,878,000	–	–	–	290,878,000
Investments in joint ventures	(273,000)	–	–	–	(273,000)
Assets whose use is limited	7,000	–	–	–	7,000
Beneficial interest in net assets of Anne Arundel Medical Center Foundation, Inc.	27,933,000	–	–	–	27,933,000
Notes receivable from affiliate	2,599,000	–	–	–	2,599,000
Restricted collateral for interest rate swap contract	44,893,000	–	–	–	44,893,000
Investments in subsidiaries and other assets, net	98,106,000	–	–	(87,344,000)	10,762,000
Total assets	$ 946,322,000	$ 83,955,000	$ 5,787,000	$ (88,197,000)	$ 947,867,000

Anne Arundel Medical Center, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet (continued)

June 30, 2018

	Anne Arundel Medical Center, Inc.	Anne Arundel Health Care Services, Inc.	Anne Arundel General Treatment Service, Inc.	Consolidating and Eliminating Entries	Consolidated
Liabilities and net assets					
Current liabilities:					
Accounts payable	$ 17,672,000	$ 1,249,000	$ 11,000	$ –	$ 18,932,000
Accrued salaries, wages, and benefits	17,872,000	367,000	166,000	–	18,406,000
Other accrued expenses	18,887,000	230,000	1,000	–	19,118,000
Current portion of long-term debt	6,110,000	–	–	–	6,110,000
Intercompany payables	1,325,000	–	–	(1,325,000)	–
Advances from third-party payors	20,527,000	1,000	47,000	–	20,574,000
Total current liabilities	82,393,000	1,847,000	225,000	(1,325,000)	83,140,000
Long-term debt, less current portion	306,249,000	–	–	–	306,249,000
Interest rate swap contract	59,303,000	–	–	–	59,303,000
Accrued pension liability	3,314,000	–	–	–	3,314,000
Total liabilities	451,259,000	1,847,000	225,000	(1,325,000)	452,006,000
Net assets:					
Unrestricted	467,912,000	82,108,000	5,562,000	(86,871,000)	468,711,000
Temporarily restricted	16,693,000	–	–	–	16,693,000
Permanently restricted	10,458,000	–	–	–	10,458,000
Total net assets	495,063,000	82,108,000	5,562,000	(86,871,000)	495,861,000
Total liabilities and net assets	$ 946,322,000	$ 83,955,000	$ 5,787,000	$ (88,197,000)	$ 947,867,000

1806-2719758

Anne Arundel Medical Center, Inc. and Subsidiaries

Supplementary Consolidating Schedule of Revenues, Expenses, Gains, and Losses

For the Year Ended June 30, 2018

	Anne Arundel Medical Center, Inc.	**Anne Arundel Health Care Services, Inc.**	**Anne Arundel General Treatment Service, Inc.**	**Consolidating and Eliminating Entries**	**Consolidated**
Operating revenue:					
Net patient service revenue	$ 563,096,000	$ 30,893,000	$ 5,076,000	$ –	$ 599,065,000
Provision for bad debts	(13,889,000)	(1,120,000)	(118,000)	–	(15,127,000)
Net patient service revenue less provision for bad debts	549,207,000	29,773,000	4,958,000	–	583,938,000
Other operating revenue	11,000,000	18,000	245,000	(296,000)	10,967,000
Total operating revenue	560,207,000	29,791,000	5,203,000	(296,000)	594,905,000
Operating expenses:					
Salaries and wages	204,291,000	5,789,000	3,443,000	–	213,523,000
Employee benefits	38,800,000	1,126,000	555,000	–	40,481,000
Supplies	140,830,000	1,103,000	502,000	(152,000)	142,283,000
Purchased services	106,722,000	13,546,000	789,000	(307,000)	120,750,000
Depreciation and amortization	29,081,000	930,000	240,000	–	30,252,000
Interest	11,245,000	–	–	–	11,245,000
Total operating expenses	530,969,000	22,494,000	5,529,000	(459,000)	558,534,000
Operating income	29,238,000	7,297,000	(326,000)	163,000	36,371,000
Other income (loss):					
Investment income, net	9,131,000	–	–	–	9,131,000
Loss on advanced refunding of debt	(6,056,000)	–	–	–	(6,056,000)
Income from joint venture and other, net	6,690,000	–	–	(6,971,000)	(281,000)
Change in unrealized gains on trading securities, net	9,715,000	–	–	–	9,715,000
Realized and unrealized gains on interest rate swap contracts, net	8,858,000	–	–	–	8,858,000
Total other income (loss), net	28,338,000	–	–	(6,971,000)	21,367,000
Revenues and gains (losses) in excess (less than) of expenses	$ 57,576,000	$ 7,297,000	$ (326,000)	$ (6,808,000)	$ 57,738,000

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Description of Consolidating and Eliminating Entries

1. To eliminate intercompany payables and receivables
2. To eliminate investments in subsidiaries and related net asset accounts
3. To eliminate intercompany income and expense generated from management fees, staffing contracts, captive insurance premiums, and operating leases
4. To eliminate intercompany notes
5. To eliminate income of wholly owned subsidiaries
6. To eliminate intercompany revenue and expense for interest and other miscellaneous transactions
7. To eliminate the Hospital's beneficial interest in the Foundation

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

ey.com