



Consolidated Financial Statements,  
Supplementary Information and Report of  
Independent Certified Public Accountants

**Peninsula Regional Health System, Inc.**

June 30, 2018 and 2017

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## **Report of Independent Certified Public Accountants**

Board of Trustees  
Peninsula Regional Health System, Inc.

We have audited the accompanying consolidated financial statements of Peninsula Regional Health System, Inc. and subsidiaries (the “Health System”), which comprise the consolidated balance sheet as of June 30, 2018, and the related consolidated statements of operations and changes in net assets and cash flows for the year then ended, and the related notes to the consolidated financial statements.

### **Management’s responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor’s responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We did not audit the financial statements of a joint venture of Peninsula Health Ventures, Inc., a wholly owned subsidiary of the Health System. The joint venture is Delmarva Surgery Center, LLC. (“Delmarva”), which reflects total assets and total revenues constituting 2.6% and 1.8%, respectively, in 2018 of the related consolidated totals. 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 Delmarva, is based solely on the report of the other auditors. Additionally, we did not audit the financial statements of Peninsula Imaging, LLC (“Imaging”), in which the Health System has a 50% interest. The Health System’s investment in Imaging is \$3.8 million as of June 30, 2018 and the Health System’s equity in the excess of unrestricted revenue and other support over expenses of Imaging is \$0.9 million for the year ended June 30, 2018. 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 Imaging, is based solely on the report of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

### **Opinion**

In our opinion, based on our audit and the reports of other auditors, the 2018 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Peninsula Regional Health System, Inc. and subsidiaries as of June 30, 2018 and the results of their operations and changes in net assets, and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

### **Supplementary information**

Our audit was performed for the purpose of forming an opinion on the 2018 consolidated financial statements as a whole. The accompanying 2018 consolidating information is presented for the purpose of additional analysis, rather than to present the financial position, results of operations and changes in net assets, and cash flows of the individual entities, and is not a required part of the consolidated financial statements. Such supplementary 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 our audit of the consolidated financial statements and certain additional procedures. These additional procedures include comparing and reconciling the information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the 2018 consolidating information is fairly stated, in all material respects, in relation to the 2018 consolidated financial statements as a whole.

**Other matter**

The consolidated financial statements of Peninsula Regional Health System, Inc. and subsidiaries as of and for the year ended June 30, 2017 were audited by other auditors. Those auditors expressed an unmodified opinion on those 2017 consolidated financial statements in their report dated September 27, 2017.

A handwritten signature in black ink that reads "Grant Thornton LLP". The signature is written in a cursive, flowing style.

Philadelphia, Pennsylvania

September 21, 2018

Peninsula Regional Health System, Inc.

Consolidated Balance Sheets  
(In Thousands)

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 36,881	\$ 37,525
Short-term investments	9,154	6,899
Patient accounts receivable, less allowance for uncollectible accounts (2018 - \$8,101; 2017 - \$9,355)	40,268	39,105
Supplies	9,782	8,734
Prepays and other	7,081	6,854
Total current assets	<u>103,166</u>	<u>99,117</u>
Investments	311,657	268,034
Assets limited as to use:		
Construction fund	-	760
Donor-restricted fund	38,193	33,267
Self-insurance fund	25,195	21,901
	<u>63,388</u>	<u>55,928</u>
Property and equipment, net	225,361	228,303
Other assets	28,006	24,840
Total assets	<u>\$ 731,578</u>	<u>\$ 676,222</u>

Peninsula Regional Health System, Inc.

Consolidated Balance Sheets (continued)  
(In Thousands)

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
<b>Liabilities and net assets</b>		
Current liabilities:		
Current portion of long-term debt	\$ 2,281	\$ 2,172
Current portion of self-insured liabilities	3,025	2,495
Accounts payable	17,334	20,769
Accrued liabilities	18,623	13,730
Advances from third-party payors	10,084	9,806
Total current liabilities	<u>51,347</u>	<u>48,972</u>
Long-term debt, net	135,931	139,008
Self insured liabilities	18,029	17,071
Accrued pension	-	10,952
Other liabilities	1,584	4,393
Total liabilities	<u>206,891</u>	<u>220,396</u>
Net assets:		
Unrestricted:		
Peninsula Regional Health System, Inc.	480,754	418,548
Noncontrolling interest	1,541	1,900
Total unrestricted net assets	<u>482,295</u>	<u>420,448</u>
Temporarily restricted	34,156	27,123
Permanently restricted	8,236	8,255
Total net assets	<u>524,687</u>	<u>455,826</u>
Total liabilities and net assets	<u>\$ 731,578</u>	<u>\$ 676,222</u>

See accompanying notes.

Peninsula Regional Health System, Inc.

Consolidated Statements of Operations and Changes in Net Assets  
(In Thousands)

	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
Unrestricted revenue and other support:		
Net patient service revenue	\$ 446,145	\$ 425,802
Less: Provision for bad debts	<b>(9,165)</b>	(11,686)
Net patient service revenue less provision for bad debts	<b>436,980</b>	414,116
Other revenue	<b>5,625</b>	2,576
Total unrestricted revenue and other support	<b>442,605</b>	416,692
Expenses:		
Salaries and wages	<b>179,887</b>	175,710
Supplies and other expenses	<b>177,731</b>	192,798
Employee benefits	<b>43,553</b>	39,337
Depreciation	<b>29,120</b>	26,749
Interest	<b>5,660</b>	5,627
Total expenses	<b>435,951</b>	440,221
Income (loss) from operations	<b>6,654</b>	(23,529)
Nonoperating income:		
Investment income, net	<b>36,282</b>	16,608
Contributions and other	<b>862</b>	98
Total nonoperating income	<b>37,144</b>	16,706
Excess of (deficiency in) unrestricted revenue and other support over expenses	<b>43,798</b>	(6,823)
Non-controlling interest losses (earnings)	<b>315</b>	(82)
Excess of (deficiency in) unrestricted revenue and other support over expenses attributable to Peninsula Regional Health System, Inc.	<b>44,113</b>	(6,905)

(continued on next page)



Peninsula Regional Health System, Inc.

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

	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
Unrestricted net assets:		
Excess of (deficiency in) unrestricted revenue and other support over expenses attributable to Peninsula Regional Health System, Inc.	\$ 44,113	\$ (6,905)
Net assets released from restrictions, net	(524)	3,309
Change in unrealized gains and losses on investments	-	16,153
Changes in non-controlling interest	(359)	82
Pension adjustments	18,617	10,704
Increase in unrestricted net assets	<u>61,847</u>	<u>23,343</u>
Temporarily restricted net assets:		
Donations	2,525	2,324
Net realized gains on investments	3,618	1,506
Change in unrealized gains and losses on investments	252	1,742
Net assets released from restrictions, net	638	(3,507)
Increase in temporarily restricted net assets	<u>7,033</u>	<u>2,065</u>
Permanently restricted net assets:		
Net realized gains on investments	18	5
Change in unrealized gains and losses on investments	1	5
Net assets released from restrictions, net	(38)	-
(Decrease) increase in permanently restricted net assets	<u>(19)</u>	<u>10</u>
Increase in net assets	<u>68,861</u>	<u>25,418</u>
Net assets at beginning of year	<u>455,826</u>	<u>430,408</u>
Net assets at end of year	<u>\$ 524,687</u>	<u>\$ 455,826</u>

See accompanying notes.

Peninsula Regional Health System, Inc.

Consolidated Statements of Cash Flows

(In Thousands)

	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
<b>Operating activities</b>		
Increase in net assets	\$ 68,861	\$ 25,418
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation expense	29,120	26,749
Pension adjustments	(18,617)	(10,704)
Provision for bad debts	9,165	11,686
Amortization of original issue premium	(849)	(836)
Amortization of financing costs	54	46
Equity in earnings of joint ventures	(1,561)	(1,713)
Losses (gains) on sale of property and equipment	430	(320)
Change in unrealized gains and losses on investments	(10,162)	(17,900)
Net realized gains on investments	(26,487)	(11,744)
Proceeds from restricted contributions	(2,525)	(2,324)
Changes in operating assets and liabilities:		
Patient accounts receivable	(10,328)	(8,557)
Supplies and other assets	677	(1,269)
Distributions from unconsolidated joint ventures	3,444	2,448
Accounts payable and accrued liabilities	1,458	1,475
Accrued pension	2,488	5,350
Other liabilities	(1,321)	(767)
Advances from third-party payors	278	(1,595)
Net cash provided by operating activities	<u>44,125</u>	<u>15,443</u>
<b>Investing activities</b>		
Change in investments and cash limited as to use	(16,689)	17,374
Investment in unconsolidated joint ventures	(1,824)	(2,414)
Purchases of property and equipment	(26,609)	(30,229)
Proceeds from disposal of assets	1	340
Net cash used in investing activities	<u>(45,121)</u>	<u>(14,929)</u>
<b>Financing activities</b>		
Proceeds from restricted donations	2,525	2,324
Repayments of long-term debt	(2,173)	(2,068)
Net cash provided by financing activities	<u>352</u>	<u>256</u>
Net (decrease) increase in cash and cash equivalents	(644)	770
Cash and cash equivalents at beginning of year	37,525	36,755
Cash and cash equivalents at end of year	<u>\$ 36,881</u>	<u>\$ 37,525</u>

See accompanying notes.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements

*(Dollar Amounts in Thousands)*

June 30, 2018

### **1. Organization and Mission**

Peninsula Regional Health System, Inc. (the “Health System”) serves as the parent company to Peninsula Regional Medical Center (the “Hospital”); Peninsula Regional Medical Center Foundation, Inc. (the “Foundation”); Peninsula Health Ventures, Inc. (“Health Ventures”); Peninsula Women’s Surgery Center, LLC; and Peninsula Regional Clinically Integrated Network, LLC. The Health System is a not-for-profit Maryland membership corporation established to manage the integrated delivery of health care services to the community. The Health System is the sole corporate member of the Hospital and the Foundation. In its capacity as sole corporate member, the Health System will appoint trustees, approve major expenditures, and approve long-term borrowings.

The Hospital is a not-for-profit, nonstock corporation founded in 1897 to serve the health care needs of its region. Primary service areas include the Maryland counties of Wicomico, Somerset, and Worcester; southern Delaware; and the northern Eastern Shore of Virginia. The Hospital’s mission is to improve the health care of the community by providing exceptional quality primary, secondary, and selected tertiary health care services to patients in a competent and compassionate manner, designed to elicit a high degree of customer satisfaction. The Hospital wholly owns Delmarva Peninsula Insurance Company (“DPIC”) a Cayman Island captive insurance company that provides professional and general liability insurance.

The Foundation is a not-for-profit, nonstock corporation organized to raise contributions exclusively for the benefit of charitable, educational, medical, and scientific purposes for the Hospital.

Health Ventures is a for-profit corporation organized for the purpose of owning, developing, operating, and investing in health care enterprises on the Delmarva Peninsula. The Health System owns all of the outstanding shares of common stock of Health Ventures.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies**

#### **Principles of Consolidation**

The consolidated financial statements include the accounts of the Health System and all wholly owned subsidiaries as described in Note 1. Additionally, the Health System has consolidated a 55%-owned affiliate, Delmarva Surgery Center, LLC, and recorded a noncontrolling interest equal to the remaining ownership interest.

#### **Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant management estimates and assumptions relate to the determination of allowance for doubtful accounts and contractual allowances for patient accounts receivable, useful lives of property and equipment, actuarial estimates for the pension plan, professional, general liabilities and workers’ compensation costs and the reported fair value of certain assets and liabilities. Actual amounts could differ from those estimates.

#### **Fair Value of Financial Instruments**

Financial instruments consist of cash equivalents, accounts receivable, investments and assets limited as to use, accounts payable, accrued liabilities, advances from third-party payors and long-term debt. The carrying amounts reported in the consolidated balance sheets for cash equivalents, accounts receivable, accounts payable, accrued liabilities, and advances from third-party payors, approximate fair value. Management’s estimate of the fair value of other financial instruments is described elsewhere in the notes to the consolidated financial statements.

#### **Cash and Cash Equivalents**

Cash and cash equivalents include surplus operating funds invested in money market funds and highly-liquid corporate, U.S. government, and agency obligations, all with maturities of less than three months when purchased.

## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **Investments and Assets Limited As To Use**

Investments are carried at fair value. Fair values of all investments, including short-term investments, investments, and assets limited as to use are based on quoted market prices and/or prices obtained from a third party using other market data for the same or comparable instruments and transactions in establishing the prices. Short-term investments represent investments with contractual maturities within one year and current investments in money market funds that have been designated for investment purposes.

Assets limited as to use includes externally held assets held by trustees under a bond indenture agreement in a construction fund to be spent on capital improvements, and used for the acquisition, renovation or equipping of certain facilities of the Hospital; assets held by trustees under self-insurance programs; and assets internally held, to meet donor's intentions. Amounts required to meet current liabilities have been classified on the consolidated balance sheets as a component of short-term investments.

Investment income, including interest and dividend, realized gains and losses (the value of securities sold) is based on the specific identification method. During 2018, the Health System implemented Accounting Standards Update ("ASU") 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, which changed how the Health System accounts for equity investments and how they are presented on the consolidated financial statements. As a result, changes in unrealized gains and losses are included in investment income for the year ended June 30, 2018 and prior to the implementation for the year ended June 30, 2017 in other changes in unrestricted net assets. Investment income on investments of restricted assets are added to or deducted from the appropriate restricted net assets when restricted as to use by the donor.

#### **Contractual and Doubtful Account Allowances**

Patient accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, management analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, management 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 copayment balances due for which third-party coverage exists for part of the bill), management records a provision for bad debts in the period of service on the basis of its past experience. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all

## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. There have been no changes in the charity care or uninsured discount policies during the years ended June 30, 2018 or 2017.

Discounts ranging from 2% to 6% of charges are given to Medicare, Medicaid, and certain approved commercial health insurance and health maintenance organization programs for regulated services. Discounts in varying percentages are given for certain unregulated services.

#### **Supplies**

Supplies are carried at the lower of cost or market, using the first-in, first-out method.

#### **Property and Equipment**

Property acquired and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Software development costs that are incurred in the preliminary project stage for internal use software are expensed as incurred. During the development stage, direct consulting costs and payroll and payroll-related costs for employees that are directly associated with each project are capitalized and amortized over the estimated useful life of the software once the software is ready for its intended use. Capitalized software is amortized using the straight-line method over its estimated useful life, which is generally seven years. Replacements and upgrades and enhancements to existing systems that result in added functionality are capitalized, while maintenance and repairs are charged to expense as incurred.

Gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted donations. Absent explicit donor stipulations about how long those assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

### Other Assets

Other assets are comprised of:

	Year Ended June 30	
	2018	2017
Investments in unconsolidated joint ventures (Note 5)	\$ 10,744	\$ 10,803
Reinsurance receivable (Note 9)	5,942	5,793
Prepaid pension (Note 10)	5,177	-
Other	6,143	8,244
Total	<u>\$ 28,006</u>	<u>\$ 24,840</u>

### Estimated Self-Insurance Liabilities

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.

### Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose.

Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

### Performance Indicator

The performance indicator for the Health System is excess of (deficiency in) unrestricted revenue and other support over expenses, which excludes net assets released from restrictions for property acquisitions net of transfers to restricted net assets, change in the unrealized gains and losses on investments (for the year ended June 30, 2017) changes in non-controlling interest, and pension adjustments.

### Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted donations if they are received with donor stipulations that limit the use of

## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

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

#### **Net Patient Service Revenue**

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

For services provided at the Hospital campus, all payors are required to pay the Maryland Health Services Cost Review Commission (“HSCRC”) approved rates. Management believes that this program will remain in effect at least through June 30, 2019. The major third-party payors, as recognized by the HSCRC, are allowed discounts of up to 6% on approved rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered.

The Hospital’s charges are subject to review and approval by the HSCRC. The total rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on a waiver arrangement between the Centers for Medicare and Medicaid Service and the HSCRC. This waiver arrangement will be in place as long as Maryland hospitals achieve certain savings and improvements, as defined. The Hospital has an agreement with the HSCRC to participate in its Global Budgeted Revenue (“GBR”) program. GBR methodology encourages hospitals to focus on population health strategies by establishing a fixed annual revenue cap for each GBR hospital. The agreement is evergreen in nature and covers both regulated inpatient and outpatient revenues.

Under GBR, hospital revenue is known at the beginning of each fiscal year, and for the year ending June 30, 2019 is expected to be approximately \$456,000. Annual revenue is calculated from a base year and is adjusted annually for inflation, infrastructure requirements, population changes, performance in quality-based programs, and changes in levels of uncompensated care. Revenue may also be adjusted annually for market levels and shifts of services to unregulated services.



## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

The HSCRC's rate-setting methodology for hospital service centers that provide both inpatient and outpatient services and only outpatient services consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within a hospital. The actual average unit charge for each service center is compared to the approved rate monthly and annually. Overcharges and undercharges due to either patient volume or price variances, adjusted for penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis. The Hospital undercharged by \$863 and \$696 for the years ended June 30, 2018 and 2017, respectively, which is within the allowable corridor as specified in the GBR Agreement.

The timing of the HSCRC's rate adjustments for the Hospital could result in an increase or reduction in rates due to the variances and penalties described above in a year subsequent to the year in which such items occurred, and there is at least a possibility that the amounts may be material. The Hospital's policy is to record revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital recognizes unbilled revenue for in-house patient services.

For both the years ended June 30, 2018 and 2017, approximately 80% of net patient service revenue was subject to the HSCRC's regulations.

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

For both the years ended June 30, 2018 and 2017, approximately 52% of net patient service revenue was received under the Medicare program, 12% from CareFirst Blue Cross Blue Shield, 32% from contracts with other third parties, and 4% from other sources.

Laws and regulations governing the HSCRC, Medicare and Medicaid programs, which represent a substantial portion of the net patient service revenues, are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The Health System believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing, other than noted in Note 12. While no additional regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action.

Approximately 38% and 35% of accounts receivable were due from the Medicare program as of June 30, 2018 and 2017, respectively.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

The Health System employs physicians in several hospital-based specialties. The Health System bills for the services provided by these physicians. 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 is recorded as a reduction in physician revenue when the services are provided.

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

	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
Gross patient service revenue	\$ 563,434	\$ 534,960
Less: revenue deductions:		
Charity care	(7,898)	(9,225)
Contractual and other allowances	(109,391)	(99,933)
Patient revenue, net of deductions	446,145	425,802
Less provision for bad debts	(9,165)	(11,686)
Net patient service revenue less provision for bad debts	<u>\$ 436,980</u>	<u>\$ 414,116</u>

**Charity Care**

The Health System provided care to patients who met certain criteria under its charity care policy, without charge or at amounts less than its approved rates. Because the Health System did not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

The Health System maintains records to identify and monitor the level of charity care and community service it provides. These records include the amount of charges foregone based on established rates for services and supplies furnished under its charity care and community service policies and the number of patients receiving services under these policies. The Health System provided \$6,279 and \$7,859 for the years ended June 30, 2018 and 2017, respectively, of charity care at full cost including direct and indirect costs, based on the actual charity population using its cost to charge ratio. The state of Maryland rate system includes components within the rates to partially compensate health systems for uncompensated care.

## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

Additionally, the Health System provides a wide range of community services to the general public. These include but are not limited to the following: free health screenings for breast cancer, prostate cancer, skin cancer, diabetes, high blood pressure, high blood cholesterol, hearing loss and glaucoma; free educational programs on a variety of health care topics; health fairs and demonstrations; and networking and coordination of services for the needy, elderly, and disabled. These community services are offered at the Health System and at schools, businesses, and other locations throughout the Health System's service area.

#### **Income Taxes**

The Health System and the Foundation have been recognized as supporting organizations exempt from federal income tax under Section 501(c)(3) as described in Sections 509(a)(3) of the Internal Revenue Code (the "Code"). The Hospital has been recognized as an organization exempt from federal income tax under Section 501(c)(3) as described in Sections 509(a)(1) and Section 170(b)(1)(A)(iii) of the Code. The Health System is subject to tax on income unrelated to its exempt purpose, unless that income is otherwise excluded by the Code. Each organization has processes presently in place to ensure the maintenance of its tax-exempt status; to identify and report unrelated income; to determine its filing and tax obligations in jurisdictions for which it has nexus; and to identify and evaluate other matters that may be considered tax positions.

Peninsula Women's Surgery Center, LLC and Peninsula Regional Clinically Integrated Network, LLC, are limited liability companies with the Health System as sole member and are disregarded for income tax purposes. Health Ventures is a for-profit corporation, wholly owned by the Health System. DPIC is a Cayman Island captive insurance company, wholly owned by the Hospital. Under Cayman Islands tax regulations, no tax is imposed on DPIC for premium and investment income.

The Health System follows guidance that clarifies the accounting for uncertainty in tax positions taken or expected to be taken in a tax return, including issues relating to financial statement recognition and measurement. This guidance provides that the tax effects from an uncertain tax position can only be recognized in the financial statements if the position is "more-likely-than-not" to be sustained if the position were to be challenged by a taxing authority. The assessment of the tax position is based solely on the technical merits of the position, without regard to the likelihood that the tax position may be challenged.

The tax years ending June 30, 2018, 2017, 2016 and 2015 are still open to audit for both federal and state purposes. The Health System has determined that there are no material uncertain tax positions that require recognition or disclosure in the consolidated financial statements for the years ended June 30, 2018 and 2017.

## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

#### **Pending Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, *Revenue from Contracts with Customers*, to clarify the principles for recognizing revenue and to improve financial reporting by creating common revenue recognition guidance for U.S. GAAP and International Financial Reporting Standards. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for these goods and services. This standard is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is not permitted. An entity will apply the amendments in this update using either a full retrospective application, which applies the standard to each prior period presented, or under the modified retrospective application, in which an entity recognizes the cumulative effect of initially applying the new standard as an adjustment to the opening balance sheet of retained earnings at the date of initial application. Revenue in periods presented before that date will continue to be reported under guidance in effect before the change. Currently, the American Institute of Certified Public Accountants Healthcare Revenue Recognition Task Force is interpreting this standard and its effects on the health care industry.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This standard intends to make certain improvements to the current reporting requirements for not-for-profit entities including: (1) the presentation for two classes of net assets at the end of the period, rather than the currently required three classes, as well as the annual change in each of the two classes; (2) the removal of the requirement to present or disclose the indirect method (reconciliation) when using the direct method for the statement of cash flows; and (3) the requirement to provide various enhanced disclosures relating to various not-for-profit specific topics. The new standard is effective for annual financial statements beginning after December 15, 2017.

In March 2017, the FASB issued ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This standard intends to make changes to employers that sponsor defined benefit pension and/or other postretirement benefit plans, present the net periodic benefit cost in the income statement. Employers will present the service cost component of net periodic benefit cost in the same income statement line item(s) as other employee compensation costs arising from services rendered during the period. Only the service cost component will be eligible for capitalization in assets. Employers will present the other components of the net periodic benefit cost separately from the line item(s) that include(s) the service cost and outside of any subtotal of operating income, if one is presented. The new standard is effective for annual financial statements after December 15, 2017. Early application is permitted.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires that most leased assets be recognized on the balance sheet as assets and liabilities for the rights and obligations created by these leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018. Early application is permitted. An entity is required to apply the amendments in the standard under the modified retrospective transition approach. This approach includes a number of optional practical expedients, which are described in the final standard. Under these practical expedients, an organization will continue to account for leases that commence before the effective date in accordance with current U.S. GAAP, unless the lease is modified. However, lessees are required to recognize on the balance sheet leased assets and liabilities for operating leases at each reporting date.

The Health System has not determined the impact of these new standards at this time.

**Reclassifications**

Certain amounts in the 2017 consolidated financial statements have been reclassified to be consistent with the 2018 presentation.

**3. Investments and Assets Limited As To Use**

Fair value of investments and assets limited as to use is summarized as follows:

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
Investments:		
Cash and cash equivalents	\$ 19,636	\$ 16,879
U.S. Treasury securities	27,818	19,736
Corporate bonds	64,249	52,483
Mortgage-backed securities	29,986	25,138
Equity securities	242,510	216,625
Total	<u>\$ 384,199</u>	<u>\$ 330,861</u>
	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
Investment income, net		
Interest and dividend income	\$ 4,464	\$ 4,239
Realized gains, net	22,851	10,233
Changes in unrealized gains and losses	9,909	-
Other	(942)	2,136
Total	<u>\$ 36,282</u>	<u>\$ 16,608</u>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

**4. Property and Equipment**

A summary of property and equipment follows:

	<b>Estimated Useful Lives (in Years)</b>	<b>June 30</b>	
		<b>2018</b>	<b>2017</b>
Land	-	\$ 12,018	\$ 11,410
Land improvements	20	12,892	12,702
Buildings and improvements	15 - 40	255,536	238,578
Fixed equipment	20	36,331	33,822
Movable equipment	7 - 10	250,608	245,248
		<u>567,385</u>	<u>541,760</u>
Less accumulated depreciation		<u>(345,173)</u>	<u>(326,283)</u>
		222,212	215,477
Construction in progress		3,149	12,826
Property and equipment, net		<u>\$ 225,361</u>	<u>\$ 228,303</u>

As of June 30, 2018, the Hospital was committed to building and equipment purchases totaling approximately \$1,322.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

**5. Investment in Unconsolidated Joint Ventures**

The Health System and physicians located throughout Maryland and Delaware have joined together, along with other non-related for-profit investors, to expand surgical and certain other services within the local communities through jointly owned ventures, as follows:

	Membership percentage	Investment in unconsolidated joint ventures		Equity earnings (losses) in unconsolidated joint ventures	
		June 30, 2018	2017	Year ended June 30, 2018	2017
Health System :					
Health Visions Delmarva, LLC	50%	\$ 3	\$ 4	\$ (27)	\$ (7)
Advanced Health Collaborative I, LLC	25%	48	(28)	60	(211)
Advanced Health Collaborative II, LLC	25%	1,492	1,244	(1,484)	(1,015)
		<u>1,543</u>	<u>1,220</u>	<u>(1,451)</u>	<u>(1,233)</u>
Health Ventures:					
Peninsula Imaging, LLC	50%	3,794	3,345	949	993
AHP Delmarva, LLP	50%	945	901	270	(58)
Genesis Healthcare - Salisbury, LLC	50%	3,854	4,402	827	1,085
Peninsula Home Care, LLC	50%	558	431	931	881
PHC at Nanticoke, LLC	33%	-	(32)	32	(14)
Peninsula NRH Regional Rehab, LLC	50%	-	486	53	59
YDI, Inc.	50%	-	50	(50)	-
Corelife, Inc.	50%	50	-	-	-
		<u>9,201</u>	<u>9,583</u>	<u>3,012</u>	<u>2,946</u>
		<u>\$ 10,744</u>	<u>\$ 10,803</u>	<u>\$ 1,561</u>	<u>\$ 1,713</u>

Regardless of the proportionate ownership of capital investment in these ventures, all decisions are made by the respective venture's operating board. In each case, the operating board is composed equally of members appointed by the Health System/Health Ventures and the other investors as a group. Accordingly, these are accounted on the equity method of accounting.

Equity earnings (losses) in unconsolidated joint ventures for the Health System are included in investment income, net and Health Ventures are included in other revenue on the consolidated statements of operations and changes in net assets, due to the type of operations of the joint venture.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**6. Long-Term Debt**

Long-term debt consists of the following:

	<b>June 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Hospital:</b>		
Maryland Health and Higher Educational Facilities Authority (“MHHEFA”) Revenue Bonds Series 2015: Series 2015 5.00% serial and term bonds and effective rates ranging from 2.57% to 4.13% due in annual amounts ranging from \$2,090 to \$7,795 on July 1 of each year through 2045	<b>\$ 119,880</b>	\$ 121,970
<b>Delmarva Surgery Center, LLC:</b>		
Building and equipment collateral loans: 4.40% fixed rate due monthly through 2022	<b>1,612</b>	1,695
	<b>121,492</b>	123,665
Less current portion of Series 2015 serial bonds	<b>(2,195)</b>	(2,090)
Less current portion of building and equipment collateral loans	<b>(86)</b>	(82)
	<b>119,211</b>	121,493
Plus original issue premium - Series 2015	<b>17,963</b>	18,812
Less unamortized debt issue costs - Series 2015	<b>(1,243)</b>	(1,297)
Long-term debt, less current portion	<b>\$ 135,931</b>	\$ 139,008

**Series 2015 Revenue Bonds**

On February 5, 2015, MHHEFA authorized the issuance of \$126,665 aggregate principal amount of Revenue Bonds (Series 2015 Revenue Bonds) at a premium of \$20,770. The proceeds of the issue, after payment of financing costs, were used primarily (i) to advance refund the 2006 bonds and (ii) to finance \$25,000 of capital purchases.

The Hospital is required to make semiannual payments to the trustee sufficient to meet the annual debt service requirements. The premium and related financing costs on the Series 2015 Bonds are being amortized over the life of the bonds.



Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

As security for the debt service requirements of the Series 2015 Bonds, MHHEFA has a first lien and claim on all receipts of the Hospital. The terms of the indenture agreement restrict the Hospital's ability to create additional indebtedness and its use of the facilities, and require the Hospital to maintain stipulated insurance coverage and a rate structure in each year sufficient to meet certain rate covenant requirements. The Hospital has complied with these financial covenants for the years ended June 30, 2018 and 2017.

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

2019	\$ 2,281
2020	2,397
2021	2,515
2022	2,639
2023	2,764
2024 and thereafter	108,896
	<u>\$ 121,492</u>

The Health System uses quoted market prices in estimating the fair value of its long-term debt. The fair value of the long-term debt outstanding as of June 30, 2018 and 2017, was approximately \$132,590 and \$137,498, respectively.

### 7. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes:

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
Health care services:		
Capital purposes	\$ 18,379	\$ 17,434
Patient services	11,905	8,340
Educational purposes	3,872	1,349
	<u>\$ 34,156</u>	<u>\$ 27,123</u>

Permanently restricted net assets are restricted as follows:

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
Investments to be held in perpetuity, the income from which is expendable to support health care services	<u>\$ 8,236</u>	<u>\$ 8,255</u>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

The Foundation has ongoing fundraising campaigns, which include pledges and contributions receivable included in other assets on the consolidated balance sheets. Scheduled payments on pledges receivable are as follows:

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
Due:		
Within one year	\$ 479	\$ 480
2 to 5 years	1,179	1,075
Greater than 5 years	205	281
	<u>1,863</u>	<u>1,836</u>
Less:		
Impact of discounting of pledges receivable to net present value	(98)	(91)
Allowance for uncollectible pledges	(174)	(171)
Net pledges receivable, for capital purposes	<u>\$ 1,591</u>	<u>\$ 1,574</u>

**8. Functional Expenses**

The Health System considers health care services and management and general to be its primary functional categories for purposes of expense classification. Depreciation and interest costs are included in health care services. The operating expenses by functional classification are as follows:

	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
Health care services	\$ 383,846	\$ 385,506
Management and general	52,105	54,715
	<u>\$ 435,951</u>	<u>\$ 440,221</u>

**9. Self-Insured Liabilities**

Effective July 1, 2013, DPIC provides Primary Medical Professional Liability (“MPL”) and Primary General Liability (“GL”) coverage to the Health System and its employed physicians on a mature claims-made basis. The primary MPL policy provides limits of liability of \$2,000 per occurrence with an \$8,000 annual aggregate. The primary GL policy provides limits of liability of \$1,000 per occurrence with a \$3,000 annual aggregate. The employed physicians are covered with retro dates consistent with their date of hire. This policy is retrospectively rated.

## Peninsula Regional Health System, Inc.

### Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

Effective July 1, 2013, DPIC provides excess umbrella liability coverage on a mature claims-made basis with a retroactive date of March 1, 2005. The excess MPL coverage follows the form of the underlying MPL coverage providing a total of \$30,000 limits of liability. The umbrella liability coverage provides \$30,000 limits of liability in excess of scheduled underlying coverages. The excess umbrella liability coverage is 100% reinsured with an unrelated commercial insurance company for the first \$10,000 limit and another unrelated commercial insurance company for the second \$20,000 limit.

Effective July 1, 2013, DPIC assumed the MPL and GL coverage previously included under the Health System's self-insurance plan (the "LPT"), for incidents occurring between March 1, 1986 and June 30, 2013 for MPL and for occurrences between March 1, 2004 and June 30, 2013 for GL, that were reported to the Hospital prior to June 30, 2013. The policy provides MPL coverage limits varying from \$1,000 to \$2,000 per occurrence, with policy aggregates varying from \$3,000 to \$8,000. The policy provides GL coverage limits of \$1,000 per occurrence and \$3,000 annual aggregates.

Effective July 1, 2016, DPIC also provides employee benefit plan stop loss coverage to the Health System on a claims-made basis. DPIC covers liability in excess of \$350 per covered person with a \$100 deductible. DPIC's liability above \$250 is fully reinsured with an unrelated commercial reinsurance company.

The reserves for reported professional liability claims and claims incurred but not reported ("IBNR") are reported gross of expected insurance recoveries. The reserves for reported claims and claims IBNR are reported within the self insured liabilities in the consolidated balance sheets. In addition, the expected insurance recoveries are reported as reinsurance receivable in other assets in the consolidated balance sheets.

The loss reserves are management's best estimate based on actuarial estimates of the ultimate net cost of settling losses on incurred claims. The estimates are reviewed and adjusted, as necessary, as experience develops or new information becomes known. Management believes that the loss reserves are adequate; however, the ultimate settlement of losses may vary significantly from the amounts recorded in the accompanying consolidated financial statements.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

Accrued claims activity related to MPL, GL and employee benefit plan for the year ended June 30, is as follows:

	<u>2018</u>	<u>2017</u>
Accrued claims and IBNR - beginning of the year	\$ 15,826	\$ 16,646
Less: Reinsurance receivable	<u>(5,793)</u>	<u>(5,100)</u>
Accrued claims and IBNR, net - beginning of the year	10,033	11,546
Incurred related to:		
Current year	2,950	5,350
Prior year	<u>(631)</u>	<u>(2,768)</u>
Total incurred	2,319	2,582
Paid related to:		
Current year	(36)	(42)
Prior year	<u>(984)</u>	<u>(4,053)</u>
Total paid	<u>(1,020)</u>	<u>(4,095)</u>
Accrued claims and IBNR, net - end of the year	11,332	10,033
Add: Reinsurance receivable	<u>5,942</u>	<u>5,793</u>
Accrued claims and IBNR - end of the year	<u>\$ 17,274</u>	<u>\$ 15,826</u>

The Hospital is also self insured for workers' compensation up to an annual limit of \$500 per occurrence. The Hospital carries an excess liability insurance policy for workers' compensation claims above this limit. As of June 30, 2018 and 2017, \$3,736 and \$3,695, respectively, have been reserved for workers' compensation loss contingencies.

## 10. Fair Value Measurements

U.S. GAAP establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below.

- Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Health System has the ability to access.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

Level 2 Inputs to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in inactive markets
- Inputs other than quoted prices that are observable for the asset or liability
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

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 net realizable value or reflective of future fair values. Furthermore, while the Health System 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.

The following table presents the Health System's assets measured at fair value, aggregated by level in the fair value hierarchy within which those measurements fall:

	<b>Fair Value as of June 30, 2018</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Assets</b>				
Cash and cash equivalents	\$ 19,636	\$ -	\$ -	\$ 19,636
U.S. government securities	27,818	-	-	27,818
Corporate bonds	-	64,249	-	64,249
Government-sponsored mortgage-backed securities	-	29,986	-	29,986
Equity securities	242,510	-	-	242,510
<b>Total assets</b>	<b>\$ 289,964</b>	<b>\$ 94,235</b>	<b>\$ -</b>	<b>\$ 384,199</b>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

	Fair Value as of June 30, 2017			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Cash and cash equivalents	\$ 16,879	\$ -	\$ -	\$ 16,879
U.S. government securities	19,736	-	-	19,736
Corporate bonds	-	52,483	-	52,483
Government-sponsored mortgage-backed securities	-	25,138	-	25,138
Equity securities	216,625	-	-	216,625
Total assets	<u>\$ 253,240</u>	<u>\$ 77,621</u>	<u>\$ -</u>	<u>\$ 330,861</u>

The fair values of securities are determined by third-party service providers utilizing various methods depending on the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the London Interbank Offered Rate curve, and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2.

### 11. Pension Plans

The Health System has a cash balance-type defined benefit pension plan, The Peninsula Regional Medical Center Pension Plus Plan (the “Plan”), covering substantially all of its employees. Plan benefits are based on years of service and the employees’ compensation during the last five years of covered employment. The Health System’s funding policy is to make sufficient contributions to the Plan to comply with the minimum funding provisions of the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The Plan provides annual allocations to a participant’s hypothetical account. When a participant retires, the participant has the choice to receive a lump-sum distribution equal to the value of the hypothetical account or to receive an annuity based on the value of the hypothetical account.

The Plan provided three different allocations: (i) a service-related allocation, (ii) an age-related allocation, and (iii) a matching allocation for certain employees. Both the service-related allocation and the age-related allocation were determined by multiplying a participant’s annual compensation by a certain percentage. The matching allocation operated to provide an annual allocation in the Plan based on the participant’s contribution to the Health System’s 403(b) plan.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

The Health System has a 403(b) defined contribution savings plan that includes all full-time and part-time employees of the Health System. The Health System matches participant contributions for active participants as of December 31 who have completed at least 975 hours of service during the calendar year. The match is 25% of the first 1% of compensation for participants with 1 – 15 years of service and 50% of the first 2% for participants with more than 15 years of service. The Health System's contribution expense for the years ended June 30, 2018 and 2017 was \$1,253 and \$1,221, respectively.

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations, and the Plan's funded status:

	<b>June 30</b>	
	<b>2018</b>	<b>2017</b>
Accumulated benefit obligation	<b>\$ 119,539</b>	<b>\$ 123,227</b>
Projected benefit obligation, beginning of year	<b>\$ 136,240</b>	<b>\$ 134,431</b>
Service cost	<b>6,999</b>	6,745
Interest cost	<b>4,624</b>	4,130
Actuarial gain	<b>(7,872)</b>	(2,084)
Benefits paid	<b>(8,880)</b>	(6,982)
Projected benefit obligation, end of year	<b>131,111</b>	136,240
Fair value of plan assets, beginning of year	<b>125,288</b>	118,125
Actual gain on plan assets	<b>16,880</b>	14,145
Employer contributions	<b>3,000</b>	-
Benefits paid	<b>(8,880)</b>	(6,982)
Fair value of plan assets, end of year	<b>136,288</b>	125,288
Funded status	<b>\$ 5,177</b>	<b>\$ (10,952)</b>
Amounts recognized in the consolidated balance sheets:		
Prepaid pension (other assets)	<b>\$ 5,177</b>	<b>\$ -</b>
Accrued pension	<b>\$ -</b>	<b>\$ (10,952)</b>
Net amounts recognized in unrestricted net assets:		
Net actuarial loss	<b>\$ 16,424</b>	<b>\$ 35,041</b>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

Components of net periodic benefit cost and changes in unrestricted net asset are as follows:

	<b>Year Ended June 30</b>	
	<b>2018</b>	<b>2017</b>
Service cost	\$ 6,999	\$ 6,745
Interest cost	4,624	4,130
Expected return on plan assets	(8,361)	(8,257)
Amortization of prior service credit	-	(63)
Recognized net actuarial loss	2,226	2,795
Net periodic benefit cost	<u>5,488</u>	<u>5,350</u>
Recognized in unrestricted net assets as other changes in pension adjustments:		
Net actuarial loss	<u>18,617</u>	<u>10,704</u>
Total recognized in net periodic benefit cost and change in unrestricted net assets	<u>\$ 24,105</u>	<u>\$ 16,054</u>

The estimated net actuarial loss for the Plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year is \$1,001.

Weighted average assumptions used to determine projected benefit obligations and net periodic benefit costs were as follows:

	<b>June 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Projected benefit obligation</b>		
Discount rate	4.00%	3.50%
Rates of increase in compensation levels:		
Service:		
<11	8.00	8.00
11<21	5.00	5.00
21=<	3.00	3.00
<b>Net periodic benefit cost and changes in unrestricted net asset</b>		
Discount rate	3.50%	3.15%
Expected long-term return on plan assets	7.00	7.00
Rate of increase in compensation levels:		
Service:		
<11	8.00	8.00
11<21	4.00	5.00
21=<	3.00	3.00



Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

The defined benefit pension plan asset allocation as of the measurement date and the target asset allocation, presented as a percentage of total plan assets, were as follows:

	<b>2018</b>	<b>June 30, 2017</b>	<b>Target Allocation</b>
Debt securities	<b>29%</b>	27%	25% - 40%
Equity securities	<b>68</b>	70	45% - 75%
Cash and cash equivalents	<b>3</b>	3	1% - 10%
<b>Total</b>	<b>100%</b>	<b>100%</b>	

The Health System's defined benefit plan invests in a diversified mix of traditional asset classes. Investments in 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. This is performed through forecasting and assessing ranges of investment outcomes over short-term and long-term horizons, and by assessing the Health System's financial condition and its future potential obligations from both the pension and general operational requirements. Complementary investment styles, such as growth and value equity investing techniques, are utilized by the Health System's investment advisors to further improve portfolio and operational risk characteristics. Equity investments, both actively and passively managed, are used primarily to increase overall plan returns. Fixed income investments provide diversification benefits and liability hedging attributes that are desirable, especially in falling interest rate environments.

Asset allocations and investment performance are formally reviewed at regularly scheduled meetings of the Health System's Financial Resources Committee.

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

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

The fair values of the Plan assets as of June 30, by asset category (see Note 10 for a description of the asset categories), are as follows:

	2018			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Investments at fair value:				
Cash and cash equivalents	\$ 3,525	\$ -	\$ -	\$ 3,525
U.S. Treasuries	9,179	-	-	9,179
Government-sponsored mortgage-backed securities	-	8,810	-	8,810
Corporate debt securities	-	22,282	299	22,581
Publicly traded equity securities	92,193	-	-	92,193
<b>Total Plan investments</b>	<b>\$ 104,897</b>	<b>\$ 31,092</b>	<b>\$ 299</b>	<b>\$ 136,288</b>

	2017			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Investments at fair value:				
Cash and cash equivalents	\$ 3,482	\$ -	\$ -	\$ 3,482
U.S. Treasuries	8,336	-	-	8,336
Government-sponsored mortgage-backed securities	-	8,162	-	8,162
Corporate debt securities	-	17,754	-	17,754
Publicly traded equity securities	87,250	11	-	87,261
Other	293	-	-	293
<b>Total Plan investments</b>	<b>\$ 99,361</b>	<b>\$ 25,927</b>	<b>\$ -</b>	<b>\$ 125,288</b>

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

*U.S. Treasuries:* The fair value is determined by an active price for an identical security in an observable market.

*Corporate debt securities and government-sponsored mortgage-backed securities:* The fair value is estimated using quoted prices for similar assets in active markets or quoted prices for identical or similar assets in non-active markets (few transactions, limited information, noncurrent prices, and high variability over time).

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (continued)

(Dollar Amounts in Thousands)

*Money market funds:* The carrying value of these money market funds approximates fair value as the maturities are less than three months.

*Publicly traded equity securities:* The fair value is determined by market quotes for an identical security in an observable market.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Health System 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.

### **Cash Flows**

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

2019	\$	7,982
2020		8,389
2021		9,345
2022		9,504
2023		9,859
2024 - 2028		53,514

The Health System intends to make voluntary contributions of \$3,000 to the defined benefit pension plan for the year ending June 30, 2019. This funding level exceeds any regulatory requirements for 2019.

### **12. Commitments and Contingencies**

The Health System has been named as a defendant in various lawsuits arising from the performance of its normal activities. In the opinion of the Health System's management, after discussion with legal counsel, the amount, if any, of the Health System's ultimate liability under these lawsuits will not have a material adverse effect on the consolidated financial position of the Health System.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (continued)

*(Dollar Amounts in Thousands)*

The Hospital has been named as a co-defendant in a qui tam action alleging that the Hospital violated the False Claims Act along with an unaffiliated ambulance transportation company. This action had been stayed for the past two years. As noted in the stay, the United States Attorney had until November 30, 2018 to decide to formally intervene or disengage from the action. At this time, management is not able to make a conclusion on the ultimate outcome of the action or its effect on the consolidated financial position. On September 14, 2018 the OIG issued a subpoena to the Hospital for additional patient records. The Hospital will serve a response to the subpoena on or before September 28, 2018. At this time, management is not able to make a conclusion on the ultimate outcome of the action or its effect on the consolidated financial position.

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

### **Operating Leases**

The Health System leases certain of its operating facilities and equipment. These leases, which expire through 2028, generally require the Health System to pay all maintenance, property tax, and insurance costs.

At June 30, 2018, aggregate amounts of future minimum payments under operating leases were as follows:

2019	\$	2,410
2020		2,104
2021		1,918
2022		1,738
2023		1,443
2024 and thereafter		3,290

Rent expense is recognized over the terms of the leases. Rent expense was \$2,828 and \$2,695 for the years ended June 30, 2018 and 2017, respectively.

### **13. Subsequent Events**

The Health System has evaluated its June 30, 2018 consolidated financial statements for subsequent events through September 21, 2018, the date the consolidated financial statements were issued. Management is not aware of any subsequent events which require recognition or disclosure in the consolidated financial statements.

## Supplementary Information

Peninsula Regional Health System, Inc.

Consolidating Balance Sheet

(In Thousands)

June 30, 2018

	Peninsula Regional Medical Center	Peninsula Regional Medical Center Foundation, Inc.	Peninsula Health Ventures, Inc.	Peninsula Regional Clinically Integrated Network	Peninsula Surgery Center	Peninsula Regional Health System, Inc.	Eliminations	Consolidated
<b>Assets</b>								
Current assets:								
Cash and cash equivalents	\$ 30,688	\$ 1,209	\$ 4,886	\$ 2	\$ 82	\$ 14	\$ -	\$ 36,881
Short-term investments	9,154	-	-	-	-	-	-	9,154
Intercompany receivables	2,557	-	-	-	-	-	(2,557)	-
Patient accounts receivable, less allowance for uncollectible accounts	39,443	-	606	-	219	-	-	40,268
Supplies	9,452	-	330	-	-	-	-	9,782
Prepays and other	6,833	-	248	-	-	-	-	7,081
Total current assets	98,127	1,209	6,070	2	301	14	(2,557)	103,166
Investments	311,657	-	-	-	-	-	-	311,657
Investment in subsidiaries	-	-	-	-	-	529,975	(529,975)	-
Assets limited as to use:								
Donor-restricted fund	39,784	6,169	-	-	-	-	(7,760)	38,193
Self-insurance fund	25,195	-	-	-	-	-	-	25,195
	64,979	6,169	-	-	-	-	(7,760)	63,388
Property and equipment, net	220,434	-	3,488	-	1,439	-	-	225,361
Other assets	15,487	-	9,386	-	-	1,542	1,591	28,006
Total assets	\$ 710,684	\$ 7,378	\$ 18,944	\$ 2	\$ 1,740	\$ 531,531	\$ (538,701)	\$ 731,578

Peninsula Regional Health System, Inc.

Consolidating Balance Sheet (continued)

(In Thousands)

June 30, 2018

	Peninsula Regional Medical Center	Peninsula Regional Medical Center Foundation, Inc.	Peninsula Health Ventures, Inc.	Peninsula Regional Clinically Integrated Network	Peninsula Surgery Center	Peninsula Regional Health System, Inc.	Eliminations	Consolidated
<b>Liabilities and net assets</b>								
Current liabilities:								
Current portion of long-term debt	\$ 2,195	\$ -	\$ 86	\$ -	\$ -	\$ -	\$ -	\$ 2,281
Current portion of self-insured liabilities	3,025	-	-	-	-	-	-	3,025
Intercompany payables	-	34	-	104	203	2,216	(2,557)	-
Accounts payable	17,074	-	260	-	-	-	-	17,334
Accrued liabilities	18,623	-	-	-	-	-	-	18,623
Advances from third-party payors	10,084	-	-	-	-	-	-	10,084
Total current liabilities	51,001	34	346	104	203	2,216	(2,557)	51,347
Long-term debt, net	134,430	-	1,501	-	-	-	-	135,931
Self insured liabilities	18,029	-	-	-	-	-	-	18,029
Other liabilities	1,584	-	-	-	-	-	-	1,584
Total liabilities	205,044	34	1,847	104	203	2,216	(2,557)	206,891
Net assets:								
Unrestricted:								
Peninsula Regional Health System, Inc.	463,248	1,175	15,556	(102)	1,537	480,754	(481,414)	480,754
Non-controlling interest	-	-	1,541	-	-	-	-	1,541
Total unrestricted net assets	463,248	1,175	17,097	(102)	1,537	480,754	(481,414)	482,295
Temporarily restricted	34,156	6,169	-	-	-	40,325	(46,494)	34,156
Permanently restricted	8,236	-	-	-	-	8,236	(8,236)	8,236
Total net assets	505,640	7,344	17,097	(102)	1,537	529,315	(536,144)	524,687
Total liabilities and net assets	\$ 710,684	\$ 7,378	\$ 18,944	\$ 2	\$ 1,740	\$ 531,531	\$ (538,701)	\$ 731,578

Peninsula Regional Health System, Inc.

Consolidating Statement of Operations  
(In Thousands)

Year Ended June 30, 2018

	Peninsula Regional Medical Center	Peninsula Regional Medical Center Foundation, Inc.	Peninsula Health Ventures, Inc.	Peninsula Regional Clinically Integrated Network	Peninsula Surgery Center	Peninsula Regional Health System, Inc.	Eliminations	Consolidated
Unrestricted revenue and other support:								
Net patient service revenue	\$ 440,752	\$ -	\$ 4,761	\$ -	\$ 632	\$ -	\$ -	\$ 446,145
Less provision for bad debts	(9,098)	-	(17)	-	(50)	-	-	(9,165)
Net patient service revenue less provision for bad debts	431,654	-	4,744	-	582	-	-	436,980
Other revenue	2,605	-	3,020	-	-	-	-	5,625
Net assets released from restrictions	-	872	-	-	-	-	(872)	-
Total unrestricted revenue and other support	434,259	872	7,764	-	582	-	(872)	442,605
Expenses:								
Salaries and wages	179,062	-	-	755	70	-	-	179,887
Supplies and other expenses	170,635	7	5,846	327	916	-	-	177,731
Employee benefits	43,472	-	-	76	5	-	-	43,553
Depreciation	28,614	-	220	-	286	-	-	29,120
Interest	5,579	-	81	-	-	-	-	5,660
Contributions to Hospital	-	872	-	-	-	-	(872)	-
Total expenses	427,362	879	6,147	1,158	1,277	-	(872)	435,951
Income (loss) from operations	6,897	(7)	1,617	(1,158)	(695)	-	-	6,654
Nonoperating income:								
Investment income, net	37,422	16	295	-	-	(1,451)	-	36,282
Contributions and other	785	-	77	-	-	-	-	862
Total nonoperating income	38,207	16	372	-	-	(1,451)	-	37,144
Excess of (deficiency in) unrestricted revenue and other support over expenses	45,104	9	1,989	(1,158)	(695)	(1,451)	-	43,798
Non-controlling interest losses	-	-	315	-	-	-	-	315
Excess of (deficiency in) unrestricted revenue and other support over expenses attributable to Peninsula Regional Health System, Inc.	\$ 45,104	\$ 9	\$ 2,304	\$ (1,158)	\$ (695)	\$ (1,451)	\$ -	\$ 44,113