



**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

Consolidated Financial Statements and Supplementary Information

June 30, 2016 and 2015

(With Independent Auditors' Report Thereon)

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

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

Independent Auditors' Report

The Board of Trustees
Sheppard and Enoch Pratt Foundation, Inc.:

We have audited the accompanying consolidated financial statements of Sheppard and Enoch Pratt Foundation, Inc. and its subsidiaries (the Company), which comprise the consolidated balance sheets as of June 30, 2016 and 2015, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sheppard and Enoch Pratt Foundation, Inc. and its subsidiaries as of June 30, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.



Other Matters

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplementary information in Schedules 1 through 3 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

October 21, 2016

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
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Consolidated Balance Sheets

June 30, 2016 and 2015

Assets	2016	2015
Current assets:		
Cash and cash equivalents	\$ 72,181,517	63,911,826
Investments limited or restricted as to use	504,874	1,017,720
Accounts receivable, net	31,083,734	35,179,668
Prepaid expenses and other current assets	12,188,182	9,740,741
Total current assets	115,958,307	109,849,955
Investments limited or restricted as to use, less current portion	160,320,064	165,322,426
Notes receivable	2,009,394	2,141,158
Third-party payor settlements receivable	10,902,769	7,309,253
Property and equipment, net	219,485,628	222,581,110
Other assets	4,245,399	3,943,069
Total assets	\$ 512,921,561	511,146,971
Liabilities and Net Assets		
Current liabilities:		
Current maturities of long-term debt	\$ 4,831,797	10,318,139
Current portion of obligations under capital leases	637,831	578,139
Accounts payable	6,844,334	8,147,466
Accrued salaries, wages and employee benefits	27,120,911	24,965,990
Third-party payor settlements payable	33,250	212,795
Self-insurance liabilities	4,324,333	4,821,409
Other accrued expenses	4,925,910	3,808,747
Total current liabilities	48,718,366	52,852,685
Long-term liabilities:		
Long-term debt, less current portion	99,417,050	98,478,445
Obligations under capitalized leases, less current portion	4,933,000	5,570,832
Self-insurance liabilities	7,500,302	8,087,102
Accrued pension liabilities	43,989,963	26,687,763
Other long-term liabilities	3,296,672	3,381,995
Total liabilities	207,855,353	195,058,822
Net assets:		
Unrestricted	286,728,700	294,635,496
Temporarily restricted	14,253,048	17,416,653
Permanently restricted	4,084,460	4,036,000
Total net assets	305,066,208	316,088,149
Total liabilities and net assets	\$ 512,921,561	511,146,971

See accompanying notes to consolidated financial statements.

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
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Consolidated Statements of Operations

Years ended June 30, 2016 and 2015

	2016	2015
Unrestricted revenues, gains, and other support:		
Patient service revenue (net of allowances and discounts)	\$ 140,768,161	136,120,462
Residential and educational service revenue (net of allowances)	171,372,179	166,496,458
Total net service revenue	312,140,340	302,616,920
Less provision for bad debts	1,997,945	2,699,608
Net service revenue less provision for bad debts	310,142,395	299,917,312
Net assets released from restrictions used for operations	1,454,508	1,607,855
Other revenue	48,139,884	47,375,496
Total unrestricted revenues, gains, and other support	359,736,787	348,900,663
Expenses:		
Salaries and wages	211,388,886	202,492,783
Employee benefits	47,376,426	40,893,310
Expendable supplies	19,824,467	20,896,619
Purchased services	45,659,073	47,009,061
Interest	2,677,426	2,590,789
Repairs and minor alterations	8,429,297	8,627,975
Depreciation and amortization	18,756,062	18,352,046
Impairment of long-lived assets	102,781	—
Loss on disposal of assets, net	246,004	446,711
Total expenses	354,460,422	341,309,294
Operating income	5,276,365	7,591,369
Other income (expense):		
Investment income	2,494,975	3,763,488
Realized gain on investments, net	2,420,056	3,371,165
Change in unrealized gain (loss) on investments, net	(6,964,040)	(5,531,308)
Other	1,082,382	3,331,104
Total other (expense) income	(966,627)	4,934,449
Excess of revenues over expenses	4,309,738	12,525,818
Other changes in net assets:		
Net assets released from restrictions used for purchases of property and equipment	4,295,009	295,722
Pension liability adjustment	(16,483,713)	(22,980,750)
Capital grants and other	(27,830)	445,237
Decrease in unrestricted net assets	\$ (7,906,796)	(9,713,973)

See accompanying notes to consolidated financial statements.

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
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Consolidated Statements of Changes in Net Assets

Years ended June 30, 2016 and 2015

	2016	2015
Unrestricted net assets:		
Excess of revenues over expenses	\$ 4,309,738	12,525,818
Other changes in net assets:		
Net assets released from restrictions used for purchases of property and equipment	4,295,009	295,722
Pension liability adjustment	(16,483,713)	(22,980,750)
Capital grants and other	(27,830)	445,237
Decrease in unrestricted net assets	(7,906,796)	(9,713,973)
Temporarily restricted net assets:		
Gifts and grants	2,662,225	4,913,886
Investment income	95,827	145,252
Net realized gain on investments	89,408	127,412
Net unrealized loss on investments	(257,136)	(208,242)
Net assets released from restrictions for operations	(1,454,508)	(1,607,855)
Net assets released from restrictions for purchases of property and equipment	(4,295,009)	(295,722)
Net assets released from restrictions for capital grants	—	(738)
Reclassification of net assets	(4,412)	(25,000)
(Decrease) increase in temporarily restricted net assets	(3,163,605)	3,048,993
Permanently restricted net assets:		
Gifts	55,163	97,618
Investment loss	(11,115)	(29,166)
Reclassification of net assets	4,412	25,000
Increase in permanently restricted net assets	48,460	93,452
Decrease in net assets	(11,021,941)	(6,571,528)
Net assets, beginning of year	316,088,149	322,659,677
Net assets, end of year	\$ 305,066,208	316,088,149

See accompanying notes to consolidated financial statements.

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
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Consolidated Statements of Cash Flows

Years ended June 30, 2016 and 2015

	2016	2015
Cash flows from operating activities:		
Decrease in net assets	\$ (11,021,941)	(6,571,528)
Adjustments to reconcile decrease in net assets to net cash provided by operating activities:		
Depreciation and amortization	18,756,062	18,352,046
Pension liability adjustment	16,483,713	22,980,750
Provision for doubtful accounts	1,997,945	2,699,608
Gifts and grants, net	(1,262,880)	(5,356,236)
Net realized gain on investments	(2,509,464)	(3,498,577)
Net unrealized loss on investments	7,221,176	5,739,550
Restricted investment income on restricted net assets	(84,712)	(116,086)
Gain on litigation settlement	—	(4,050,000)
Capital grant and loss on disposal of assets	273,834	1,474
Impairment of long-lived assets	102,781	—
Decrease (increase) in accounts receivable, net	2,097,989	(3,119,131)
Increase in prepaid expenses and other current assets	(2,447,441)	(147,826)
Increase in third-party payor settlements receivable	(3,773,061)	(3,772,055)
Increase (decrease) in accounts payable, accrued expenses and other	1,730,312	(1,582,151)
(Decrease) increase in self-insurance liabilities	(1,083,876)	373,676
Increase (decrease) in accrued pension liability	818,487	(3,617,721)
Net cash provided by operating activities	27,298,924	18,315,793
Cash flows from investing activities:		
Purchases of property and equipment	(16,872,905)	(24,177,492)
(Increase) decrease in other assets	(49,996)	1,171,055
Proceeds from sale of property and equipment and related litigation	658,940	4,168,912
Decrease in notes receivable	131,764	131,763
Decrease (increase) in investments limited or restricted as to use, net	893,791	(4,636,289)
Net cash used in investing activities	(15,238,406)	(23,342,051)
Cash flows from financing activities:		
Proceeds from debt and other liabilities	777,750	1,189,182
Payment of long-term debt principal	(5,325,487)	(4,268,327)
Payment on capital lease obligations	(578,140)	(617,510)
Capital grants and advances	72,170	729,695
Gifts and grants, net	1,262,880	5,356,236
Net cash (used in) provided by financing activities	(3,790,827)	2,389,276
Net increase (decrease) in cash and cash equivalents	8,269,691	(2,636,982)
Cash and cash equivalents, beginning of year	63,911,826	66,548,808
Cash and cash equivalents, end of year	\$ 72,181,517	63,911,826

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

June 30, 2016 and 2015

(1) Summary of Significant Accounting Policies

(a) Organization

Sheppard and Enoch Pratt Foundation, Inc. (Foundation or the Company), a not-for-profit, nonstock Company, was organized on June 15, 1984 to engage in activities necessary to provide mental health services to the public through the planning and implementation of programs provided by its various subsidiaries. Subsidiary companies, controlled by Foundation, include Sheppard Pratt Health System, Inc. (Health System), Sheppard Pratt Physicians, P.A. (Physicians), Sheppard Pratt Investment, Inc. (Investment Company), Alliance, Inc. (Alliance), Mosaic Community Services, Inc. (Mosaic), Way Station, Inc. (Way Station), Family Services, Inc. (Family Services), and Sheppard Pratt Preferred Resources, Inc. (Resources). Turning Point of Washington County, Inc. (Turning Point), formerly controlled by Foundation, was dissolved during 2015. All of the assets of Turning Point were assumed by Way Station.

On July 1, 2016, Mosaic became the sole member of Alliance. No consideration was exchanged in this transaction. The Company will account for such transaction using the “as-if” pooling of interests method at carrying value since both entities are under common control.

Health System is a not-for-profit, nonstock company that operates two inpatient hospitals, day hospitals, residential and educational services for children and adolescents, and outpatient programs.

Physicians is a professional company of licensed medical professionals organized on July 1, 1985 exclusively to carry out the charitable, educational and scientific purposes of Foundation and its affiliates. The common stock of Physicians is held by several individuals who are employed by a member of Foundation, Health System, or Physicians and are subject to the terms of a stock agreement. Under the terms of the agreement, the stockholders are required to consult with Foundation regarding its views on any matter with respect to which the stockholder is entitled to vote, and the stockholders may not transfer shares (by sale or gift) without the permission of Foundation. The stock agreement does not allow for the stockholders to receive dividends or any other benefit for having held the stock. If the stockholders cease to be employed by Foundation, Health System, or Physicians, Physicians shall require the stockholders to sell and transfer all of the stock such stockholder owns to a person designated by Foundation. The purchase price for each share of stock of the Company is \$1 per share.

Investment Company is a not-for-profit, nonstock company that manages the investments of certain subsidiaries.

Mosaic, Way Station, Family Services, and Alliance (collectively, the Affiliates) are not-for-profit, nonstock Maryland companies that provide residential, rehabilitation, vocational, and outpatient mental health services across the state of Maryland.

Resources is a for-profit company that was formed for the purpose of providing employee assistance program services to other entities. Resources was inactive as an operating entity for the years ended June 30, 2016 and 2015.

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(b) Basis of Presentation

The consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles. All majority-owned and affiliated member entities are consolidated. All entities where Foundation exercises significant influence but for which it does not have control are accounted for under the equity method. All other entities are accounted for under the cost method. All significant intercompany accounts and transactions have been eliminated.

Net assets, revenues, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. The net assets of Foundation and changes therein are classified and reported as follows:

Unrestricted net assets – Net assets that are not subject to donor-imposed stipulations. Board-designated funds are included within this category of net assets.

Temporarily restricted net assets – Net assets whose use by Foundation has been limited by donors to a specific time or purpose.

Permanently restricted net assets – Net assets that have been restricted by donors to be maintained by the Foundation in perpetuity. Generally, the donors of these assets permit Foundation to use all or part of the income earned on related investments for general or specific purposes.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Contributions with no donor-imposed restrictions are recognized as revenues in the period received as increases in unrestricted net assets.

Unconditional promises to give cash and other assets to Foundation with donor-imposed restrictions are reported as increases in temporarily or permanently restricted net assets 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. When the donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations 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.

(c) Charity Care

Foundation provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because Foundation does not pursue collection of amounts determined to qualify for charity care, such amounts are not reported as revenue.

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(d) *Cash and Cash Equivalents*

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less that are not limited or restricted as to use.

(e) *Allowance for Doubtful Accounts*

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

(f) *Investments Limited or Restricted as to Use*

Investments limited or restricted as to use, primarily recorded at fair value, represent assets that have been designated by the board of trustees for special purposes and self-insurance trust arrangements. The principal, income and capital appreciation of the Moses Sheppard and Enoch Pratt bequests are legally unrestricted but are classified, for financial reporting purposes, as board-designated and limited as to use. Assets designated by the board of trustees for particular purposes are controlled by the board of trustees, who at their discretion may subsequently use the assets for other purposes.

Investments of board-designated, temporarily restricted and permanently restricted funds are maintained in a combined investment pool or in a related investment account. Related income, and realized and unrealized gains and losses on sales of investments are apportioned on the basis of the shares held by each of the respective funds and in accordance with donor restrictions on the use of investment earnings.

Investments are recorded at fair value. Foundation classifies its investment portfolio as trading securities with unrealized gains and losses included in other income (expense), which is included in the excess of revenues over expenses. Investment income and realized gains and losses from all other investments are reported as other income (expense), unless the income is restricted by donors, which is reported as previously described above. Unrealized gains and losses on trading securities are included as a component of other income (expense). The investment portfolio is classified as current or noncurrent assets based on management's intention as to use.

Alternative investments represent both subscriptions in private equity venture capital funds and subscriptions in funds-of-funds utilized to diversify the portfolio of Foundation. Annual audited financial statements for these funds are submitted to Foundation and reviewed by management. The funds' financial statements are presented at fair value as estimated in an unquoted market.

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Foundation's alternative investments are accounted for under the equity method of accounting. The investment balance is equal to Foundation's proportionate interest in the fund's net equity. Individual investment holdings within the investment may, in turn, include investments in both nonmarketable and market-traded securities. Valuations of these 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. Certain of these investments contain additional capital call requirements, based upon the provisions of the investment agreements.

Investment income from unrestricted cash equivalents and the self-insurance trust are reported as other operating revenue since such income is considered to be a part of Foundation's ongoing central operations of providing healthcare services.

(g) Pledges

Pledges, less an allowance for uncollectible amounts, are recorded as receivables in the year the pledge is made unless the pledge carries conditions that have not been met. Conditional pledges are recorded as contributions when the conditions of the pledge have been satisfied. Pledges receivable are recorded at net realizable value, which is calculated using a discount rate of 3% at June 30, 2016 and 2015.

(h) Property and Equipment

Property and equipment acquisitions are recorded at cost (except donated property and equipment that are recorded at their fair market value at the date of receipt). Depreciation is computed on the straight-line method and charged to operations over estimated useful lives ranging from 20 to 40 years for buildings and improvements and 3 to 10 years for furniture, equipment, information systems hardware and software and motor vehicles. Property and equipment under capital lease obligations are amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the property and equipment. Interest costs incurred on borrowed funds during the period of construction are capitalized as a component of the cost of acquiring those assets.

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

(i) Costs of Borrowing

Deferred financing costs and debt premiums are amortized using the effective-interest method and charged to operations as a component of interest expense over the term of the related debt.

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(j) *Estimated Self-Insurance Liability Claims*

The estimated self-insured professional liability claims are reflected as a liability and include actuarially determined estimates of the ultimate costs for both reported claims and claims incurred but not reported. Costs under self-insurance programs for employee health benefits and workers' compensation include estimates for both reported claims and claims incurred but not reported, based on an evaluation of pending claims and past experience. These estimates are based on actuarial analysis of historical trends, claims asserted and reported incidents. Receivables for amounts in excess of self-insurance retention limits are recorded at their net realizable value and are due from highly rated commercial insurance companies.

(k) *Pension Benefits*

Pension benefits are recorded in accordance with Accounting Standards Codification (ASC) Subtopic 715-30, *Defined Benefit Plans—Pension*, which requires the recognition of the funded status of pension plans within the accompanying consolidated balance sheets.

(l) *Patient Service Revenue*

Foundation has agreements with third-party payors that provide for payments to Foundation at amounts different from its established rates. Payment arrangements include prospectively determined rates per day, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with certain third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Differences between the estimated amounts and final settlements are reported in operations in the year of settlement.

Foundation'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 diagnosis, 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 (note 15).

(m) *Residential and Educational Service Revenue*

Foundation provides educational services to special needs children under arrangements with the Maryland State Department of Education (MSDE). On an annual basis, a prospective rate per student is set with MSDE based upon an approved operating budget. Subsequently, as services are provided, invoices are submitted to each student's local school district for payment on a monthly basis.

Foundation also operates two levels of residential services for adolescents: residential treatment centers (RTCs) and respite care. Substantially all of the RTC services are reimbursed by the State of Maryland Medicaid Program on a cost basis subject to annual ceilings. Foundation receives an interim per diem rate during the year and ultimately settles final payment based upon an audited cost report filing. Respite services were provided through a Purchase of Care Agreement with the Maryland

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Department of Human Resources. Services were provided and reimbursed on an interim per diem basis and are subject to cost settlement based upon an audit of the program's operating expenses. Foundation accrues any difference between interim payments and estimates of expected cost settlement for both RTCs and respite care. The contract with the State of Maryland governing the provision of respite care was terminated effective October 31, 2014 and the program terminated at that time.

(n) *Impairment of Long-Lived Assets*

Management regularly evaluates whether events or changes in circumstances have occurred that could indicate an impairment in the value of long-lived assets. In accordance with the provisions of ASC Subtopic 360-10, *Property, Plant, and Equipment – Overall*, if there is an indication that the carrying amount of an asset is not recoverable, Foundation estimates the projected undiscounted cash flows, excluding interest, to determine if an impairment loss should be recognized. The amount of impairment loss is determined by comparing the historical carrying value of the asset to its estimated fair value. Estimated fair value is determined through an evaluation of recent and projected financial performance using standard industry valuation techniques.

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

In estimating the future cash flows for determining whether an asset is impaired and if expected future cash flows used in measuring assets are impaired, Foundation groups its assets at the lowest level for which there are identifiable cash flows independent of other groups of assets. No impairment charges were recorded during the years ended June 30, 2016 and 2015.

(o) *Rental Income*

Foundation has agreements with various organizations and individual clinicians to rent office space and land. Foundation recognizes the rent under the leases, using the straight-line method, net of an allowance for doubtful accounts, where necessary, in other income (expense).

(p) *Excess of Revenues over Expenses*

The consolidated statements of operations include a performance indicator, the excess of revenues over expenses. Changes in unrestricted net assets that are excluded from excess of revenues over expenses, consistent with industry practice, include changes in pension liability adjustments, contributions of long-lived assets (including assets acquired using contributions that by donor restriction were to be used for the purposes of acquiring such assets) and grants for capital purposes.

(q) *Income Taxes*

Foundation and its subsidiaries, except for Resources, have been recognized as tax-exempt organizations under Section 501(a) as organizations described in Section 501(c)(3) of the Internal Revenue Code and are not subject to income taxes on related income pursuant to Section 501(a) of the Internal Revenue Code. The operations of Resources, a for-profit company, are not significant to the consolidated financial statements. Foundation has cumulative net operating losses of \$2.6 million for

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unrelated business activities, which expire at various dates through 2036. The Foundation's deferred tax assets, including the asset related to its net operating losses, are fully reserved as they are not expected to be utilized. Foundation accounts for income taxes under ASC Topic 740, *Income Taxes*.

(r) Leases

Lease arrangements, including assets under construction, are capitalized when such leases convey substantially all the risks and benefits incidental to ownership. Capital leases are amortized over either the lease term or the life of the related assets, depending upon available purchase options and lease renewal features. Amortization related to capital leases is included in the statements of operations within depreciation or amortization expense.

(s) Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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. Actual results could differ from those estimates

(t) New Accounting Pronouncements

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

The FASB issued ASU 2015-03, *Interest—Imputation of Interest*. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. ASU 2015-03 is effective for fiscal year 2017. The Company does not anticipate that the adoption of this ASU will have a material impact on its financial position or its results of operations.

The FASB issued ASU 2015-07, *Fair Value Measurement (Topic 820) Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share*. This ASU removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. ASU 2015-07 is effective

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for fiscal year 2017. The Company does not anticipate that the adoption of this ASU will have a material impact on its financial position or its results of operations.

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

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

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

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

(2) Charity Care and Community Services

Foundation maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services and supplies furnished under its charity care policy and equivalent service statistics. The estimated cost of charity care provided during the years ended June 30, 2016 and 2015 was \$5,159,013 and \$3,663,564, respectively.

Foundation provides the community with other healthcare services and programs, including teaching of psychiatric residents, providing programs and facilities for teaching other medical health professionals, providing behavioral health educational programs for the general public, and conducting research to improve treatment of behavioral health problems.

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(3) Investments Limited or Restricted as to Use

Investments limited or restricted as to use, stated at fair value, except for the real estate investment, which is recorded at cost and investments in partnerships and alternative investments, which are recorded under the equity method, include the following at June 30:

	2016	2015
Board-designated, unrestricted:		
Portion of pooled investments	\$ 139,482,818	142,422,541
Other investments	9,274,303	10,070,839
Held by trustees:		
Under self-insurance trusts	3,785,267	4,507,279
Donor-restricted:		
Temporarily restricted portion of pooled investments	1,793,708	2,977,857
Other temporarily restricted investments	2,404,381	2,325,630
Permanently restricted portion of pooled investments	3,338,808	3,280,733
Other permanently restricted investments	745,653	755,267
Total investments limited or restricted as to use	160,824,938	166,340,146
Current portion	504,874	1,017,720
Investments limited or restricted as to use, less current portion	\$ 160,320,064	165,322,426

Foundation manages a significant component of its investments limited or restricted as to use in a combined investment pool. The combined investment pool has been allocated based on donor restrictions, where applicable, as follows at June 30:

	2016	2015
Board-designated unrestricted	\$ 139,482,818	142,422,541
Temporarily restricted	1,793,708	2,977,857
Permanently restricted	3,338,808	3,280,733
Total	\$ 144,615,334	148,681,131

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The combined investment pool is comprised of the following at June 30:

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 5,036,882	12,024,492
Corporate bonds	12,506,136	12,383,977
Marketable equity securities	7,422	7,726
Mutual and common trust funds	86,007,805	87,633,664
Other (primarily alternative investments under equity method)	41,057,089	36,631,272
Total	<u>\$ 144,615,334</u>	<u>148,681,131</u>

Other board-designated investments consist of the following at June 30:

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 3,042,820	3,881,295
Mutual funds	1,823,969	1,807,721
Real estate held for future development, at cost	3,092,501	3,096,682
Other	1,315,013	1,285,141
	<u>\$ 9,274,303</u>	<u>10,070,839</u>

The funds held by trustees under self-insurance trusts are comprised of the following at June 30:

	<u>2016</u>	<u>2015</u>
Cash and cash equivalents	\$ 190,738	908,949
Fixed income investments	3,594,529	3,598,330
	<u>\$ 3,785,267</u>	<u>4,507,279</u>

A Foundation trustee serves as an investment manager for a portion of the investments limited or restricted as to use totaling approximately \$12,970,000 and \$13,200,000 as of June 30, 2016 and 2015, respectively.

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The total investment return, net of investment fees, including the return from the combined investment pool, is summarized as follows for the years ended June 30:

	2016	2015
Investment income (loss):		
Unrestricted	\$ 2,494,975	3,763,488
Temporarily restricted	95,827	145,252
Permanently restricted	(11,115)	(29,166)
	<u>2,579,687</u>	<u>3,879,574</u>
Net realized gains on sales of investments:		
Unrestricted	2,420,056	3,371,165
Temporarily restricted	89,408	127,412
	<u>2,509,464</u>	<u>3,498,577</u>
Net unrealized losses on investments:		
Unrestricted	(6,964,040)	(5,531,308)
Temporarily restricted	(257,136)	(208,242)
Total unrealized losses	<u>(7,221,176)</u>	<u>(5,739,550)</u>
Total investment (loss) income	(2,132,025)	1,638,601
Investment income on other unrestricted investments and cash and cash equivalents	849,665	854,811
Investment income on self-insurance trust assets	476	245
Total investment (loss) income	<u>\$ (1,281,884)</u>	<u>2,493,657</u>

(4) Disclosures about Fair Value of Financial Instruments

Foundation accounts for its financial assets and liabilities, in accordance with ASC Subtopic 820-10 as discussed in note 1. ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. Specifically, the guidance provides for the following:

- Defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework for measuring fair value;
- Establishes a three-level hierarchy for fair value measurement;
- Requires consideration of Foundation's nonperformance risk when valuing liabilities; and
- Expands disclosures about instruments measured at fair value.

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The three-level valuation hierarchy for fair value measurements is based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect Foundation's market assumptions. The three-level valuation hierarchy is defined as follows:

- Level 1 – Quoted prices for identical instruments in active markets;
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar investments in markets that are not active; and model-derived valuations whose significant inputs are observable; and
- Level 3 – Instruments whose significant inputs are unobservable.

The table below presents Foundation's investable assets and liabilities as of June 30, 2016, aggregated by the three-level valuation hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 8,447,195	—	—	8,447,195
Equities:				
Common stocks	5,873,655	—	—	5,873,655
Mutual funds	76,630,019	—	—	76,630,019
Other	1,826,011	4,122,867	—	5,948,878
Fixed income:				
Collateralized mortgage obligations	—	1,166,084	—	1,166,084
Corporate bonds	—	10,022,598	—	10,022,598
Government issued bonds	—	4,911,982	—	4,911,982
Other financial instruments	—	1,038	—	1,038
Total assets	<u>\$ 92,776,880</u>	<u>20,224,569</u>	<u>—</u>	<u>113,001,449</u>

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The table below presents Foundation's investable assets and liabilities as of June 30, 2015, aggregated by the three-level valuation hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 16,616,835	—	—	16,616,835
Equities:				
Common stocks	6,670	—	—	6,670
Mutual funds	90,178,755	—	—	90,178,755
Other	226,689	—	—	226,689
Fixed income:				
Collateralized mortgage obligations	—	1,699,930	—	1,699,930
Corporate bonds	—	10,481,846	—	10,481,846
Government issued bonds	—	3,800,532	—	3,800,532
Other financial instruments	—	1,056	—	1,056
Total assets	<u>\$ 107,028,949</u>	<u>15,983,364</u>	<u>—</u>	<u>123,012,313</u>

Foundation did not have significant transfers between Levels, or Level 3 measurements, thus, no additional disclosures were necessary.

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

Foundation's Level 2 securities consist of collateralized mortgage obligations, corporate bonds, government issued bonds, mutual funds, and derivative instruments, which are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active or model-derived valuations whose significant inputs are observable. 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.

Investments classified within Level 3 have significant unobservable inputs, as they trade infrequently or not at all. The classification of a financial instrument within Level 3 is based upon the significance of the unobservable inputs to the overall fair value measurement.

The carrying amount of cash and cash equivalents, accounts receivable, third-party payor settlements receivable or payable, other current assets, accounts payable and accrued expenses approximates fair value because of the short-term maturity of these instruments. The fair value of Foundation's long-term debt, except for the Series A portion of the 2012 Bonds, is estimated to approximate the carrying amount because interest rates are variable and determined frequently based on prevailing market conditions. The estimated fair value of the Series A portion of the 2012 Bonds at June 30, 2016 and 2015 was approximately \$32,191,000 and \$32,358,000, respectively. Due to the subjective nature of the terms of the Foundation's notes receivable and capital lease obligations, their fair values cannot be estimated.

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(5) Temporarily Restricted Assets

Temporarily restricted assets consist of the following at June 30:

	2016	2015
Pledges receivable, net of unamortized discount of \$10,000 at June 30, 2016 and \$9,000 at June 30, 2015	\$ 184,750	190,258
Less allowance for uncollectible pledges	6,000	6,000
Net pledges receivable	178,750	184,258
Other investments (primarily property)	10,054,959	12,113,166
Portion of pooled investments (note 3)	1,793,708	2,977,857
Restricted cash and investments	2,225,631	2,141,372
	\$ 14,253,048	17,416,653

The net realizable value of the unconditional pledges receivable at June 30, 2016 was calculated using an average discount rate of 3%. The net present value of pledges receivable and the expected collection period at June 30, 2016 are as follows:

2017	\$	82,547	
2018		53,587	
2019		48,616	
	\$	184,750	

(6) Note Receivable

In connection with the land lease described in note 7, Investment Company provided a loan and a line of credit to the Maryland Economic Development Company (MEDCO) to help finance the development of university student housing located on the campus of the Foundation. The unsecured term loan of \$3.75 million is payable in equal quarterly installments between the initial repayment date (January 2004) and June 30, 2031. MEDCO repaid approximately \$132,000 during each of the years ended June 30, 2016 and 2015, which resulted in an outstanding balance of \$2,009,394 and \$2,141,158 at June 30, 2016 and 2015, respectively. The loan bears interest at the rate of 12% per annum. Foundation has included approximately \$251,000 and \$267,000 of interest income from the loan in investment income during the years ended June 30, 2016 and 2015, respectively.

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(7) Property and Equipment

Property and equipment at June 30 are summarized as follows:

	<u>2016</u>	<u>2015</u>
Land	\$ 21,969,755	22,056,580
Land improvements	12,825,695	10,731,326
Buildings and building improvements	312,829,099	304,726,725
Furniture and equipment	63,356,942	69,534,319
Vehicles	8,261,538	7,854,860
Construction in progress	10,833,186	10,455,101
	<u>430,076,215</u>	<u>425,358,911</u>
Less accumulated depreciation	210,590,587	202,777,801
	<u>\$ 219,485,628</u>	<u>222,581,110</u>

Assets under capital lease at June 30, 2016 and 2015 of \$8,143,020 and \$10,168,055, respectively, were included in buildings and building improvements and furniture and equipment in the table above. Accumulated depreciation of assets under capital leases totaled \$3,735,585 and \$5,041,783 at June 30, 2016 and 2015, respectively.

Certain land, buildings, improvements, and equipment are pledged as collateral for the debt described in note 9.

Depreciation expense for the years ended June 30, 2016 and 2015 was \$18,721,765 and \$18,317,749, respectively.

In June 2001, the Health System entered into a 40-year ground lease with MEDCO, whereby MEDCO leases certain parcels of land from Foundation. The base year rental income, included in other revenue in the accompanying consolidated statements of operations is \$885,500 and increases by 3.00% per annum over the life of the lease. MEDCO has constructed student housing on the leased parcels of land (the MEDCO lease). Unpaid accrued rent bears interest at 12.65% per annum.

The payment of ground rent is subordinate to the payment of debt on the MEDCO loan. Based on current cash flow projections, it is anticipated that the full amount of rent accruing will not be paid. Foundation has recorded an allowance for a portion of the unpaid accrued rent, and the related interest on the unpaid rents for fiscal years 2009 through 2015. Partial ground rent payments of approximately \$2,320,000 was accrued as a receivable at June 30, 2016 and 2015. As of June 30, 2016 and 2015, Foundation has recorded total ground rent receivable in other assets in the accompanying consolidated balance sheets of \$7,729,915 and \$7,766,109, respectively, with a related reserve of \$5,411,142 and \$5,445,810, respectively.

On September 20, 2016 the State Health Planning and Development Agency approved Foundation's application to build a new hospital in Elkridge, MD. The new hospital will replace Sheppard Pratt at Ellicott City which is currently housed in a leased facility in Ellicott City, MD. The project is expected to span multiple years with a cumulative investment of approximately \$96,530,000.

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(8) Other Assets

The other assets balance is composed of the following at June 30:

	<u>2016</u>	<u>2015</u>
Workers' compensation excess insurance receivable	\$ 312,934	88,814
Deferred financing costs	744,812	744,812
Intangible assets	1,307,000	1,307,000
Cash surrender value of life insurance and other	2,526,520	2,356,080
	<u>4,891,266</u>	<u>4,496,706</u>
Accumulated amortization	<u>(645,867)</u>	<u>(553,637)</u>
	<u>\$ 4,245,399</u>	<u>3,943,069</u>

(9) Long-Term Debt

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

	<u>2016</u>	<u>2015</u>
Maryland Health and Higher Educational Facilities Authority (MHHEFA) Revenue Bonds, Series 2012	\$ 83,714,907	86,910,834
MHHEFA Series D pooled loan program	3,685,000	3,925,000
MHHEFA Revenue Bond – 2013	5,910,955	6,329,446
MHHEFA Revenue Bond – 2014	3,920,748	4,259,000
Bank notes	3,009,104	3,135,406
Mortgages on real estate	3,630,409	3,767,550
Other debt	377,724	469,348
	<u>104,248,847</u>	<u>108,796,584</u>
Less current portion	<u>4,831,797</u>	<u>10,318,139</u>
	<u>\$ 99,417,050</u>	<u>98,478,445</u>

In March 2012, Health System, Physicians, Foundation and Investment (Obligated Group) refinanced certain outstanding indebtedness including the 2003 Series A and Series B bonds and the Bank of America financing agreement. The Series 2012 bonds were issued by MHHEFA and purchased by a bank in a direct placement loan arrangement.

The Series 2012 A bonds are fixed rate bonds with an original principal amount of \$34,032,000 bearing interest at a fixed rate of 2.84%. The initial term of the credit facility is 15 years, and the final scheduled maturity is July 1, 2036. The Series 2012 B bonds are variable rate bonds with an original principal amount of \$62,182,000 bearing interest at 77% of the sum of one-month LIBOR plus 1.1% (1.2% at June 30, 2016). The initial term of the credit facility is 10 years and the final scheduled maturity is July 1, 2035. The Series 2012 A and B bonds are being repaid using a 24-year amortization.

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The Series 2012 bonds are secured by a trust indenture and Obligated Group has granted the bank and MHHEFA a security interest in its revenues. The Series 2012 Bonds require Obligated Group to satisfy certain measures of financial performance as long as the Series 2012 Bonds are outstanding.

In September 2006, Mosaic borrowed \$5,420,000 through the MHHEFA Series D pooled loan program. This loan was used to defease certain bonds issued in 1996 by the Maryland Economic Development Company and certain bonds issued in 2001 by Baltimore County, Maryland for Revisions, Inc. (an entity which subsequently merged with Mosaic) and for certain renovations and equipment purchases. The variable rate bonds are supported by a bank letter-of-credit, which expires in November 2016. The terms of the loan, while subject to long-term amortization (20 years) may be put at the option of the bond holders. At such time, the letter-of-credit bank would advance fund the put bonds on behalf of Mosaic under the terms of the letter of credit. Mosaic would be required to repay such advances under the letter of credit on November 1, 2016. At June 30, 2016 and 2015, the interest rate on this debt was approximately .24% and 0.11%, respectively.

On September 28, 2016, Mosaic closed a transaction to refinance its MHHEFA Series D pooled loan program revenue bonds along with three existing mortgages. The total amount refinanced was \$4,066,000. The refinance occurred via a tax-exempt non-bank qualified direct purchase by a commercial bank. The bonds accrue interest at a variable rate and are being amortized over ten years. In conjunction with the refinance, Mosaic entered into a 10-year interest rate swap agreement with a third party under which the Company will make monthly payments at a fixed rate of 2.1% in exchange for payments based on the London Interbank Offered Rate (LIBOR).

On May 2, 2013, MHHEFA issued \$7,200,000 bank-qualified tax-exempt revenue bonds (MHHEFA Revenue Bond – 2013) for the purpose of reimbursing Way Station for certain capital expenditures associated with the acquisition and development of two properties in Frederick, Maryland, a property in Hagerstown, Maryland, and a property in Columbia, Maryland. The bonds were purchased by a bank and Way Station is required to make payments over 15 years with a fixed interest rate of 2.645%. As part of the same transaction, the same bank loaned Way Station \$1,700,000 in a taxable term loan payable over 15 years, at a fixed interest rate of 3.305%. The tax-exempt and taxable terms loans are secured by a deed of trust covering six of the Company's properties in Frederick, Hagerstown, and Columbia, Maryland and these loans require Way Station to satisfy certain measures of financial performance as long as the loans are outstanding. The bank has also provided a \$1,000,000 line of credit, which bears interest at one-month LIBOR plus 1.5%. On April 1, 2015, this line of credit was increased to \$4,000,000 with the terms remaining the same. At June 30, 2016, there were no borrowings against the line of credit. The Company is limited in additional borrowings, which cannot occur without the bank's consent.

On March 4, 2014, MHHEFA issued a \$4,430,000 bank-qualified tax-exempt revenue bond (MHHEFA Revenue Bond – 2014) for the purpose of refinancing Family Services existing mortgage debt. The bond was purchased by a bank, and Family Services is required to make payments over 25 years at varying interest rates. As part of the same transaction, the same bank loaned Family Services \$1,683,000 in a taxable term loan that is amortized over 25 years, however, it is due in 10 years, at fixed interest rates that vary from 4.25% in year one to 5.25% in subsequent years. The tax-exempt and taxable term loans are secured by a deed in trust covering the Company's properties, and these loans require Family Services to satisfy certain measures of financial performance as long as the loans are outstanding. Family Services obtained a waiver as of and for the years ended June 30, 2016 and 2017.

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As part of the MHHEFA and bank loan transaction noted above, Family Services also secured a variable rate line of credit in the amount of \$1,000,000, which is secured by certain of its assets. At June 30, 2016, there was no outstanding balance on this line of credit.

The Affiliates have mortgages on multiple properties with a total outstanding balance of \$3,630,409 as of June 30, 2016. The interest rates and years of maturity range from 0% to 8.5%, and 2017 to 2038, respectively.

The Affiliates have other nonmortgage debt, consisting primarily of auto and renovation loans, with a total outstanding balance of \$377,724 as of June 30, 2016. The interest rates range from 0% to 5.9%.

Mosaic has a variable rate line of credit with a bank in the amount of \$500,000, which is secured by certain assets of Mosaic. As of June 30, 2016, there was no outstanding balance on this line of credit.

Repayment of long-term debt, including mandatory sinking fund redemptions, in each of the next five fiscal years is as follows:

2017	\$ 4,831,797
2018	4,588,685
2019	4,698,630
2020	4,791,823
2021	4,890,739
2022 and thereafter	<u>80,447,173</u>
	<u>\$ 104,248,847</u>

Interest payments were \$2,323,975 and \$2,305,895 in 2016 and 2015, respectively.

(10) Other Financial Instruments

During the year ended June 30, 2006, Foundation received a gift annuity from donors. Under the terms of such agreement, Foundation agreed to pay 6% annually of the contributed amount (approximately \$1 million) on a quarterly basis over the remaining lives of the donors. Accordingly, as of June 30, 2016 and 2015, the net present value of the estimated remaining payments of approximately \$442,309 and \$481,000, respectively, have been recorded as an other long-term liability.

(11) Pension Plan, Employees' Thrift Plan and Life, Accident and Health Plan

Foundation has a noncontributory defined benefit pension plan that covers eligible employees of Health System and Physicians. The benefits are based on the employees' credited service and average compensation during the five consecutive years, taken from the last 10 years of service before retirement, which produces the highest result. The funding policy is to contribute annually amounts actuarially determined to provide for benefits attributed to service to date and benefits expected to be earned in the future. Prior service cost is being amortized on a straight-line basis over the estimated term of employment of current employees.

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ASC Subtopic 715-30, *Defined Benefit Plans-Pension*, requires Foundation 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 in the accompanying consolidated balance sheets, with a corresponding adjustment to unrestricted net assets. The pension liability adjustment to unrestricted net assets represents the change in net unrecognized actuarial losses and unrecognized prior service costs that have not yet been recognized as part of excess of revenues over expenses. Those amounts will be subsequently recognized as a component of net periodic pension cost pursuant to Foundation's historical accounting policy for amortizing such amounts.

The following are deferred pension costs that have not yet been recognized in periodic pension expense but instead are included as a component of unrestricted net assets, as of June 30, 2016 and 2015. Unrecognized actuarial losses represent unexpected changes in the projected benefit obligation and plan assets over time, primarily due to changes in assumed discount rates and investment experience. Unrecognized prior service cost is the impact of changes in plan benefits applied retrospectively to employee service previously rendered. Deferred pension costs are amortized into annual pension expense over the average remaining assumed service period for active employees.

	Amounts in unrestricted net assets to be recognized during the next fiscal year	Amounts recognized in unrestricted net assets at June 30, 2016	Amounts recognized in unrestricted net assets at June 30, 2015
Net prior service cost	\$ 29,137	62,266	91,403
Net actuarial loss	5,806,030	62,539,645	46,026,795
Total	<u>\$ 5,835,167</u>	<u>62,601,911</u>	<u>46,118,198</u>

During 2013, the Plan was amended to permanently allow certain vested terminated participants to take a lump sum payment of Plan benefits not previously available as a lump sum in lieu of a deferred monthly benefit. This offer will be available to terminating participants with a vested benefit value of less than \$25,000. Also, during 2013, a one-time opportunity was offered for participants who terminated employment previously with a benefit value of less than \$25,000 to take the lump sum. As a result of these changes, Foundation made lump sum payments of approximately \$217,000 and \$324,000 in 2016 and 2015, respectively.

As of June 30, 2015, Foundation adopted the new RP-2014 Mortality Table with generational improvements using projection scale MP-2014. As a result of the adoption, the projected benefit obligation increased approximately \$16.8 million. During 2016, Foundation updated to the projection scale MP-2015.

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The Plan's change in benefit obligations, the change in plan assets, current funded status and the components of net periodic pension cost as of and for the years ended June 30 are as follows:

	<u>2016</u>	<u>2015</u>
Accumulated benefit obligation at the end of the year	\$ 214,334,727	190,390,227
Changes in benefit obligations:		
Projected benefit obligation at the beginning of the year	\$ 206,323,539	186,818,066
Service cost	5,083,540	5,013,925
Interest cost	9,493,719	8,260,527
Actuarial loss (gain)	18,343,819	12,856,563
Benefits paid	<u>(6,916,393)</u>	<u>(6,625,542)</u>
Projected benefit obligation at the end of the year	<u>232,328,224</u>	<u>206,323,539</u>
Changes in plan assets:		
Fair value of plan assets at beginning of the year	179,635,776	179,493,332
Actual return on plan assets	10,618,878	1,767,986
Contributions to the plan	5,000,000	5,000,000
Benefits paid	<u>(6,916,393)</u>	<u>(6,625,542)</u>
Fair value of plan assets at end of the year	<u>188,338,261</u>	<u>179,635,776</u>
Funded status	<u>\$ (43,989,963)</u>	<u>(26,687,763)</u>

Net periodic pension expense includes the following components for the years ended June 30:

	<u>2016</u>	<u>2015</u>
Service cost	\$ 5,083,540	5,013,925
Interest cost	9,493,719	8,260,527
Expected return on plan assets	(12,650,228)	(12,659,254)
Amortization of prior service cost	29,137	35,909
Amortization of net loss	<u>3,862,319</u>	<u>731,176</u>
Net pension expense	<u>\$ 5,818,487</u>	<u>1,382,283</u>

The following table presents the weighted average assumptions used to determine benefit obligations and net periodic benefit expense for the Plan:

	<u>2016</u>	<u>2015</u>
Discount rates (benefit obligation)	3.93%	4.65%
Discount rates (benefit expense)	4.65	4.48
Rate of compensation increase	4.00	4.00
Expected long-term return on plan assets	6.80	7.10

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(a) Determination of Expected Long-Term Rate of Return

In developing the expected long-term rate of return on assets assumption, Foundation considered the current level of expected returns on risk free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested, and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target allocation to develop the expected long-term rate of return on assets assumption for the portfolio.

(b) Investment Policy and Objectives

The investment policy and objectives are established by the trustees of Foundation. The plan objectives include achieving and maintaining fully funded status and minimizing volatility with reasonable and prudent levels of risk. The investment policy is based on a long-term perspective. An investment advisory firm engaged by Foundation trustees selects investment managers, makes investment decisions in keeping with the Pension Investment Policy Statement developed by the trustees, and reviews fund performance and funding status routinely. The percentage allocation to each asset class may vary depending upon the funded status of the Plan.

Foundation monitors the investment managers' performance and ensures adequate diversification by asset class to further mitigate the risks associated with the investment program. Management believes that its assets are invested in accordance with its overall investment policies at June 30, 2016 and 2015.

(c) Plan Assets

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

	Target allocation	2016	2015
Equity securities	44%	44%	46%
Debt securities	56	54	52
Cash and cash equivalents	—	1	1
Other (including private equity/real estate funds)	—	1	1
	<u>100%</u>	<u>100%</u>	<u>100%</u>

In accordance with ASC Subtopic 715-20, *Defined Benefit Plans-General-Disclosures*, nonpublic entities are required to report the fair value of each major category of pension plan asset within the fair value hierarchy. ASC Subtopic 820-10, *Fair Value Measurements-Overall*, provides guidance for the fair value hierarchy, which is a valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Refer to note 3 for descriptions of each of the three levels within the valuation hierarchy.

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

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 2,002,164	—	—	2,002,164
Collective trusts – equity	—	82,914,651	—	82,914,651
Collective trusts – fixed income	—	101,504,324	—	101,504,324
Private equity and real estate funds	—	—	1,917,122	1,917,122
Total assets	<u>\$ 2,002,164</u>	<u>184,418,975</u>	<u>1,917,122</u>	<u>188,338,261</u>

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

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 1,319,694	—	—	1,319,694
Collective trusts – equity	—	82,878,009	—	82,878,009
Collective trusts – fixed income	—	92,848,428	—	92,848,428
Private equity and real estate funds	—	—	2,589,645	2,589,645
Total assets	<u>\$ 1,319,694</u>	<u>175,726,437</u>	<u>2,589,645</u>	<u>179,635,776</u>

The majority of the investments held by the plan are Level 2 securities. There were no significant transfers between levels during the years ended June 30, 2016 and 2015. Foundation has the ability to liquidate the collective trusts on a daily basis.

Foundation's pension plan invests in six alternative investments, which are primarily hedge funds of funds and private equity funds. Such investments are carried at their estimated fair value. Foundation uses the practical expedient to report the net asset values of these funds as an estimate of fair value. Most of the funds have not had changes in the redemption policies during the year ended June 30, 2016, and the policies range primarily from 30 to 90 days. Determination of fair value is performed on a quarterly basis by the General Partner(s) of the funds. Because of the inherent uncertainty of valuation, the determined values may differ significantly from the values that would have been used had a ready market for these investments existed.

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ASC 715-20 also requires that nonpublic entities provide a reconciliation of the beginning and ending balances for the Level 3 plan assets. In accordance with this guidance, changes to Foundation's Level 3 plan assets are summarized as follows:

		Private equity and real estate funds
Balance as of June 30, 2014	\$	3,265,525
Additions:		
Contributions/purchases		148,492
Disbursements:		
Withdrawals/sales		(1,153,522)
Realized gain		9,567
Net unrealized gains		319,583
Net change		<u>(675,880)</u>
Balance as of June 30, 2015		<u>2,589,645</u>
Additions:		
Contributions/purchases		—
Disbursements:		
Withdrawals/sales		(841,286)
Realized gain		161,942
Net unrealized gains		6,821
Net change		<u>(672,523)</u>
Balance as of June 30, 2016	\$	<u><u>1,917,122</u></u>

(d) Contributions

The Foundation expects to contribute \$5 million to its pension plan during the fiscal year ending June 30, 2017.

(e) Estimated Future Benefit Payments

The following benefit payments, which reflect expected future employee service, as appropriate, are expected to be paid from the plan in each of the fiscal years as follows:

2017	\$	8,406,000
2018		9,220,000
2019		10,039,000
2020		10,727,000
2021		11,441,000
2022–2026		64,786,000

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The expected benefits to be paid are based on the same assumptions used to measure Foundation's benefit obligation at June 30, 2016.

Effective July 1, 2006, Foundation elected to not allow employees hired on or after July 1, 2006 to participate in either the defined benefit pension plan or the current employees' thrift plan. Instead, such employees participate in a new employees' thrift plan. The new employee's thrift plan expense was \$3,468,256 and \$2,841,118 in 2016 and 2015, respectively. The retirement benefits for employees hired on or prior to June 30, 2006 under the defined benefit plan and employees' thrift plan remain unchanged.

Foundation sponsors an employees' thrift plan for certain employees of Health System and Physicians. Foundation may provide a discretionary contribution to the employees' thrift plan. There were no discretionary contributions to the thrift plan in 2016 and 2015.

Foundation maintains a self-insured life, accident and health plan for employees of Health System and Physicians, which provides for monthly contributions in amounts sufficient to cover the costs of basic hospital, surgical and diagnostic benefits and administrative expenses. The life, accident, and health plan expense was \$12,551,258 in 2016 and \$11,461,286 in 2015.

Certain of the subsidiaries maintain various tax sheltered annuity accounts, defined contribution plans or other retirement benefit plans. These subsidiaries have the option to issue discretionary matching contributions to the plans. During the years ended June 30, 2016 and 2015, these subsidiaries contributed \$379,749 and \$444,565, respectively, to the plans.

(12) Leases

Foundation leases office space under long-term operating leases, which expire at various dates through 2035, some of which require increasing monthly payments expiring over the next several years. The following is a schedule of the future minimum lease payments under operating leases as of June 30, 2016 that have initial or remaining lease terms in excess of one year for each of the years ending June 30:

2017	\$	4,217,979
2018		3,786,511
2019		3,579,731
2020		2,486,263
2021		2,851,769
Thereafter		1,359,532
Total minimum lease payments	\$	18,281,785

Rent expense was approximately \$5,758,017 and \$6,977,000 in 2016 and 2015, respectively. Foundation also leases various equipment under short-term leases.

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Foundation leases a school building and certain software and equipment related to its electronic medical records system, which are recorded in the consolidated balance sheets as capital leases. The school building lease has an initial lease term of 10 years, and Foundation has the right to extend the lease term for two successive periods of 5 years each. An agreement was signed in June 2012 to extend the electronic medical records system lease through June 2016, which was extended through 2020 in April 2015 and resulted in an increase to the capital lease asset obligation of approximately \$2 million.

The following is a schedule of future minimum lease payments under capital leases as of June 30, 2016:

2017		\$	915,069
2018			937,556
2019			903,214
2020			843,935
2021			400,083
Thereafter			3,157,588
Total minimum lease payments			7,157,445
Less amount representing interest			1,586,614
Present value of net minimum lease payments			5,570,831
Less obligations under capital leases, current portion			637,831
Obligations under capital leases, less current portion		\$	4,933,000

(13) Self-Insurance Programs and Litigation

Foundation is from time to time subject to claims and suits arising in the ordinary course of business. In the opinion of management, the ultimate resolution of pending legal proceedings will not have a material effect on the consolidated financial statements. In this regard, Foundation maintains a self-insurance program for professional liability claims, and a related trust fund has been established for the purpose of setting aside assets based on actuarial funding recommendations. Under the trust agreement, the assets can only be used for the payment of professional and general liability claims, related expenses, and the cost of administering the trust. Certain claims-made based professional and occurrence-based general liability insurance coverages have been purchased to provide protection for claims in excess of the self-insured amounts. The assets of the trust are classified as investments limited as to use in the accompanying consolidated balance sheets in the amount of approximately \$191,000 and \$909,000 at June 30, 2016 and 2015, respectively. The related claims liabilities of approximately \$4,430,000 and \$5,735,000 as of June 30, 2016 and 2015, respectively, are recorded on an undiscounted basis and represent estimates for asserted claims and unasserted claims arising from reported incidents and unreported incidents. Management believes that the provision for loss is adequate at June 30, 2016 and 2015; however, the ultimate liability may differ significantly. Management is aware of certain asserted and unasserted legal claims, none of which, in the opinion of management, are expected to result in losses in excess of insurance limits.

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Health System and Physicians are also self-insured for unemployment claims and have established a letter of credit arrangement of approximately \$1,421,000 in 2016 and \$1,390,000 in 2015 in accordance with the requirements of the Maryland Department of Employment and Training.

Also, Foundation is self-insured for workers' compensation claims up to \$550,000 for both 2016 and 2015. Investments of approximately \$3,600,000 at June 30, 2016 and 2015 are being held in an account at a financial institution to secure the payment of claims. These investments are included in the balance of investments limited or restricted as to use. The related liabilities of approximately \$5,280,000 and \$4,780,000 as of June 30, 2016 and 2015, respectively, are recorded in the accompanying consolidated balance sheets. Foundation records outstanding losses and loss expenses for workers' compensation liability claims based on the estimates of the amount of reported losses together with a provision for losses incurred but not reported, the recommendations of an independent actuary, and management's judgment using its past experience and industry experience.

Foundation offers employees a self-insured health plan. Foundation maintains an accrual for claims that have been incurred but not reported to the plan administrator. The accrued liability for claims incurred but not reported is based on the historical claim lag period and current payment trends of health insurance claims. The accrued liability for health claims is approximately \$2,120,000 and \$2,394,000, respectively, as of June 30, 2016 and 2015.

While management believes that the provision for claims on unemployment, workers' compensation, and employee health benefits is adequate, at June 30, 2016 and 2015, the ultimate liability may be significantly different from the estimates.

(14) Net Assets

Net assets at June 30 are summarized as follows:

	2016	2015
Unrestricted:		
Undesignated	\$ 167,852,776	170,895,034
Board-designated:		
Moses Sheppard bequest	43,972,497	44,578,224
Enoch Pratt bequest	28,043,927	28,430,233
Other	46,859,500	50,732,005
Total board-designated	118,875,924	123,740,462
Total unrestricted	\$ 286,728,700	294,635,496

Temporarily restricted net assets are available for the purposes of providing indigent care, health and educational programs and the purchase of property and equipment. Permanently restricted net assets are restricted in perpetuity, the income from which is expendable to provide health and educational programs.

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(15) Rate Setting Matters and Business and Credit Concentrations

Foundation provides healthcare services through its inpatient and outpatient care facilities located throughout Maryland. Foundation grants credit to patients and generally does not require collateral or other security in extending credit; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits receivable under their health insurance programs, plans or policies (e.g., Medicare, Medicaid, Blue Cross/Blue Shield, health maintenance organizations (HMOs), and commercial insurance policies).

Net patient, residential and educational service revenue, by payor class, consisted of the following for the years ended June 30:

	2016	2015
Medicare	9%	9%
Medicaid	40	41
Commercial insurers and HMOs	13	12
Local government	21	21
Blue Cross/Blue Shield	11	11
Self-pay and other	6	6
	100%	100%

Foundation accepts all patients covered by the Medicare and Medicaid programs. These programs reimburse Foundation at amounts less than charges. The difference between the charges for healthcare services and the related reimbursement amounts for these and other third-party payors is as follows for the years ended June 30:

	2016	2015
Medicare	\$ 9,248,096	9,633,562
Medicaid	5,528,310	5,956,829
Other third-party payors	6,329,298	6,728,567
	\$ 21,105,704	22,318,958

Patient charges of the Health System (other than Medicare and Medicaid) are recorded at rates established by the State of Maryland Health Services Cost Review Commission (HSCRC), reviewed on an annual basis and adjusted prospectively giving effect to, among other things, the anticipated impact of inflation on operating expenses, variances between actual volume of patient services and the volume budgeted for such services, and variances between actual unit rates and approved unit rates during the previous rate year. Such rate adjustments are reflected in revenue of Health System in the subsequent rate year, which coincides with Health System's fiscal year.

The Foundation is reimbursed for certain services to their Medicare and Medicaid program beneficiaries based upon cost reimbursement methodologies. The Maryland Medicaid program's inpatient reimbursement methodology is a prospective payment system, which is set at 94% of HSCRC rates. Medicaid outpatient

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services continue to be reimbursed on a cost report basis. Effective July 1, 2005, the Medicare program changed its reimbursement methodology to a prospective payment system. Health System has received either the final settlement or the notice of final settlement on Medicare cost reports through June 30, 2014 and on Medicaid cost reports for all programs through June 30, 2011.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount. Management periodically reviews recorded amounts receivable from or payable to third-party payors and may adjust these balances as new information becomes available. In addition, revenue received under certain third-party agreements are subject to audit.

During 2016 and 2015, some of Foundation's prior year third-party cost reports were audited and settled, or tentatively settled, by third-party payors. Adjustments resulting from such audits and management reviews of unaudited years and open claims are reflected as adjustments to revenue in the year the adjustment becomes known. The effect of these adjustments was to increase net patient service revenue by approximately \$1,547,000 and \$1,305,000 during the years ended June 30, 2016 and 2015, respectively. Although certain other prior year cost reports submitted to third-party payors remain subject to audit and retroactive adjustment, management does not expect any material adverse settlements.

Patient accounts receivable are as follows at June 30:

	<u>2016</u>	<u>2015</u>
Patient accounts receivable, net of contractuels	\$ 19,369,700	22,061,287
Residential and educational accounts receivable, net of contractuels	18,744,078	21,774,806
Less allowance for doubtful accounts	<u>(7,030,044)</u>	<u>(8,656,425)</u>
Patient accounts receivable, net	<u>\$ 31,083,734</u>	<u>35,179,668</u>

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

	<u>2016</u>	<u>2015</u>
Beginning Balance July 1	\$ 8,656,425	8,489,971
Provisions for bad debts	1,997,945	2,699,608
Less writeoffs	<u>(3,624,326)</u>	<u>(2,533,154)</u>
Ending Balance as of June 30	<u>\$ 7,030,044</u>	<u>8,656,425</u>

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(16) Functional Expenses

Members of Foundation provide healthcare and educational services to the patients, which they serve. Expenses related to providing these services, based on management's estimates of expense allocations, are as follows:

	2016	2015
Healthcare and educational services	\$ 312,442,565	301,303,644
General and administrative	42,017,857	40,005,650
	\$ 354,460,422	341,309,294

(17) Certain Significant Risks and Uncertainties

Foundation provides psychiatric healthcare services in the State of Maryland. Foundation and other healthcare providers are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the Federal Medicare and state Medicaid programs
- Regulation of hospital rates by the State of Maryland Health Services Cost Review Commission
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes
- Lawsuits alleging malpractice or other claims

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

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

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

The healthcare industry is subject to numerous laws and regulations from federal, state, and local governments, and the government has aggressively increased enforcement of Medicare and Medicaid anti-fraud and abuse laws. Foundation's compliance with these laws and regulations is subject to periodic governmental review, which could result in enforcement actions unknown or unasserted at this time. The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self-referral laws (STARK law and regulation). Recent federal initiatives have prompted a national review of federally funded healthcare programs. In addition, the federal government and many states have implemented programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs.

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As a result of recently enacted and pending federal healthcare reform legislation, substantial changes are anticipated in the U.S. healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement to healthcare providers and the legal obligations of health insurers, providers, and employers. These provisions are currently slated to take effect at specified times over the next decade. This federal healthcare reform legislation did not affect either the 2016 or the 2015 consolidated financial statements.

(18) Endowment Net Assets

Foundation's endowments consist of both individual donor-restricted funds established for a variety of purposes and funds designated by the Board of Trustees to function as endowments. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

(a) Interpretation of Relevant Law

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

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

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(b) Net Asset Classification by Type of Endowment as of June 30, 2016

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ —	—	4,084,460	4,084,460
Board-designated endowment funds	118,875,924	—	—	118,875,924
	<u>\$ 118,875,924</u>	<u>—</u>	<u>4,084,460</u>	<u>122,960,384</u>

Changes in endowment net assets for the year ended June 30, 2016:

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets beginning of year	\$ 123,740,462	—	4,036,000	127,776,462
Investment return:				
Investment income	2,175,599	—	1,474	2,177,073
Net appreciation (realized and unrealized gains and losses)	<u>(3,730,062)</u>	<u>—</u>	<u>(12,589)</u>	<u>(3,742,651)</u>
Total investment return	(1,554,463)	—	(11,115)	(1,565,578)
Contributions	—	—	59,575	59,575
Appropriation of endowment assets for expenditure	<u>(3,310,075)</u>	<u>—</u>	<u>—</u>	<u>(3,310,075)</u>
	<u>\$ 118,875,924</u>	<u>—</u>	<u>4,084,460</u>	<u>122,960,384</u>

(c) Net Asset Classification by Type of Endowment as of June 30, 2015

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ —	—	4,036,000	4,036,000
Board-designated endowment funds	123,740,462	—	—	123,740,462
	<u>\$ 123,740,462</u>	<u>—</u>	<u>4,036,000</u>	<u>127,776,462</u>

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Changes in endowment net assets for the year ended June 30, 2015:

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets beginning of year	\$ 124,995,599	—	3,942,548	128,938,147
Investment return:				
Investment income	3,195,163	—	—	3,195,163
Net appreciation (realized and unrealized gains and losses)	<u>(1,618,300)</u>	<u>—</u>	<u>(29,166)</u>	<u>(1,647,466)</u>
Total investment return	1,576,863	—	(29,166)	1,547,697
Contributions	—	—	122,618	122,618
Appropriation of endowment assets for expenditure	<u>(2,832,000)</u>	<u>—</u>	<u>—</u>	<u>(2,832,000)</u>
	<u>\$ 123,740,462</u>	<u>—</u>	<u>4,036,000</u>	<u>127,776,462</u>

(d) Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or SPMIFA requires Foundation to retain as a fund of perpetual duration as a result of unfavorable market fluctuations. During the years ended June 30, 2016 and 2015, the fair value did not fall below the specified amounts.

(e) Investment Strategies

Foundation has adopted policies for corporate investments, including endowment assets that seek to maximize risk-adjusted returns with preservation of principal. Endowment assets include those assets of donor-restricted funds that Foundation must hold in perpetuity or for a donor-specified period(s). The endowment assets are invested in a manner that is intended to hold a mix of investment assets designed to meet the objectives of the account. Foundation expects its endowment funds, over time, to provide an average rate of return that generates earnings to achieve the endowment purpose.

To satisfy its long-term rate-of-return objectives, Foundation relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). Foundation employs a diversified asset allocation structure to achieve its long-term return objectives within prudent risk constraints.

Foundation monitors the endowment funds returns and appropriates average returns for use. In establishing this practice, Foundation considered the long-term expected return on its endowment. This is consistent with Foundation's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

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(19) Subsequent Events

Foundation has evaluated all events and transactions from the balance sheet date through October 21, 2016, the date at which the consolidated financial statements were issued, and determined there are no other items to be recognized or disclosed.

SUPPLEMENTARY INFORMATION

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Consolidating Balance Sheet Information

June 30, 2016

Assets	Sheppard and Enoch Pratt Foundation, Inc.	Sheppard Pratt Health System, Inc.	Sheppard Pratt Investment, Inc.	Sheppard Pratt Physicians, P.A.	Obligated group combining eliminations	Combined obligated group subtotal
Current assets:						
Cash and cash equivalents	\$ 397,318	53,842,638	—	2,415,273	—	56,655,229
Investments limited or restricted as to use	132,903	—	—	—	—	132,903
Accounts receivable, net	—	21,401,145	—	753,430	—	22,154,575
Due from affiliates	154	695,540	3,318,718	38,388	(3,384,257)	668,543
Prepaid expenses and other current assets	—	5,717,900	—	325,778	—	6,043,678
Total current assets	<u>530,375</u>	<u>81,657,223</u>	<u>3,318,718</u>	<u>3,532,869</u>	<u>(3,384,257)</u>	<u>85,654,928</u>
Investments limited or restricted as to use, less current portion	9,452,289	30,944,030	117,302,422	—	—	157,698,741
Interest in net assets of Foundation	—	6,941,961	—	—	(6,941,961)	—
Notes receivable	—	—	2,009,394	—	—	2,009,394
Third-party payor settlements receivable	—	10,902,769	—	—	—	10,902,769
Property and equipment, net	—	167,490,257	—	—	—	167,490,257
Other assets	—	2,289,608	434,375	—	—	2,723,983
Total assets	<u>\$ 9,982,664</u>	<u>300,225,848</u>	<u>123,064,909</u>	<u>3,532,869</u>	<u>(10,326,218)</u>	<u>426,480,072</u>
Liabilities and Net Assets						
Current liabilities:						
Current maturities of long-term debt	\$ —	3,294,728	—	—	—	3,294,728
Current portion of obligations under capital leases	—	612,531	—	—	—	612,531
Accounts payable	—	4,768,589	—	306,965	—	5,075,554
Accrued salaries, wages and employee benefits	—	16,564,959	—	2,873,479	—	19,438,438
Third-party payor settlements payable	—	—	—	—	—	—
Due to affiliates	333,880	3,021,617	3,901,202	33,178	(3,384,257)	3,905,620
Self-insurance liabilities	—	3,501,079	—	262,834	—	3,763,913
Other accrued expenses	48,449	1,377,218	287,782	1,232,054	—	2,945,503
Total current liabilities	<u>382,329</u>	<u>33,140,721</u>	<u>4,188,984</u>	<u>4,708,510</u>	<u>(3,384,257)</u>	<u>39,036,287</u>
Long-term liabilities:						
Long-term debt, less current portion	—	80,420,179	—	—	—	80,420,179
Obligations under capital leases, less current portion	—	4,916,133	—	—	—	4,916,133
Self-insurance liabilities	—	6,935,849	—	—	—	6,935,849
Accrued pension liabilities	—	37,678,407	—	6,311,556	—	43,989,963
Other long-term liabilities	442,308	—	—	—	—	442,308
Total liabilities	<u>824,637</u>	<u>163,091,289</u>	<u>4,188,984</u>	<u>11,020,066</u>	<u>(3,384,257)</u>	<u>175,740,719</u>
Net assets (deficit):						
Unrestricted	1,918,011	130,068,353	118,875,925	(7,487,197)	—	243,375,092
Temporarily restricted	3,603,153	7,066,206	—	—	(6,941,961)	3,727,398
Permanently restricted	3,636,863	—	—	—	—	3,636,863
Total net assets	<u>9,158,027</u>	<u>137,134,559</u>	<u>118,875,925</u>	<u>(7,487,197)</u>	<u>(6,941,961)</u>	<u>250,739,353</u>
Total liabilities and net assets	<u>\$ 9,982,664</u>	<u>300,225,848</u>	<u>123,064,909</u>	<u>3,532,869</u>	<u>(10,326,218)</u>	<u>426,480,072</u>

(Continued)

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

Consolidating Balance Sheet Information

June 30, 2016

Assets	Alliance, Inc.	Family Services Agency, Inc.	Mosaic Community Services, Inc.	Way Station, Inc.	Consolidating eliminations	Consolidated totals
Current assets:						
Cash and cash equivalents	\$ 1,991,788	1,459,285	2,777,491	9,297,724	—	72,181,517
Investments limited or restricted as to use	33,250	—	120,936	217,785	—	504,874
Accounts receivable, net	3,752,342	2,161,519	1,138,454	1,876,844	—	31,083,734
Due from affiliates	—	1,918	127,356	1,000	(798,817)	—
Prepaid expenses and other current assets	379,090	290,891	2,293,648	3,168,075	12,800	12,188,182
Total current assets	6,156,470	3,913,613	6,457,885	14,561,428	(786,017)	115,958,307
Investments limited or restricted as to use, less current portion	—	—	2,271,566	4,250,346	(3,900,589)	160,320,064
Interest in net assets of Foundation	—	—	—	—	—	—
Notes receivable	—	—	—	—	—	2,009,394
Third-party payor settlements receivable	—	—	—	—	—	10,902,769
Property and equipment, net	6,464,938	8,815,896	15,912,315	20,802,222	—	219,485,628
Other assets	65,893	296,872	392,655	765,996	—	4,245,399
Total assets	\$ 12,687,301	13,026,381	25,034,421	40,379,992	(4,686,606)	512,921,561
Liabilities and Net Assets						
Current liabilities:						
Current maturities of long-term debt	\$ 120,592	253,527	630,592	532,358	—	4,831,797
Current portion of obligations under capital leases	—	—	25,300	—	—	637,831
Accounts payable	384,728	264,397	895,712	223,943	—	6,844,334
Accrued salaries, wages and employee benefits	900,837	1,760,861	2,557,231	2,463,544	—	27,120,911
Third-party payor settlements payable	33,250	—	—	—	—	33,250
Due to affiliates	182,194	64,450	215,510	133,923	(4,501,697)	—
Self-insurance liabilities	181,322	—	229,308	149,790	—	4,324,333
Other accrued expenses	693,296	442,569	369,175	475,367	—	4,925,910
Total current liabilities	2,496,219	2,785,804	4,922,828	3,978,925	(4,501,697)	48,718,366
Long-term liabilities:						
Long-term debt, less current portion	1,046,003	6,057,738	5,042,058	6,851,072	—	99,417,050
Obligations under capitalized leases, less current portion	—	—	16,867	—	—	4,933,000
Self-insurance liabilities	—	—	—	564,453	—	7,500,302
Accrued pension liabilities	—	—	—	—	—	43,989,963
Other long-term liabilities	—	301,461	535,287	2,202,525	(184,909)	3,296,672
Total liabilities	3,542,222	9,145,003	10,517,040	13,596,975	(4,686,606)	207,855,353
Net assets (deficit):						
Unrestricted	5,357,236	3,881,378	13,920,298	20,194,696	—	286,728,700
Temporarily restricted	3,787,843	—	149,486	6,588,321	—	14,253,048
Permanently restricted	—	—	447,597	—	—	4,084,460
Total net assets	9,145,079	3,881,378	14,517,381	26,783,017	—	305,066,208
Total liabilities and net assets	\$ 12,687,301	13,026,381	25,034,421	40,379,992	(4,686,606)	512,921,561

See accompanying independent auditors' report.

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

Consolidating Statement of Operations Information

Year ended June 30, 2016

	Sheppard and Enoch Pratt Foundation, Inc.	Sheppard Pratt Health System, Inc.	Sheppard Pratt Investment, Inc.	Sheppard Pratt Physicians, P.A.	Obligated group combining eliminations	Combined obligated group subtotal
Unrestricted revenues, gains, and other support:						
Patient service revenue (net of allowances and discounts)	\$ —	128,253,709	—	12,514,452	—	140,768,161
Residential and educational service revenue (net of allowances)	—	83,254,114	—	—	—	83,254,114
Total net service revenue	—	211,507,823	—	12,514,452	—	224,022,275
Less provision for bad debts	—	606,929	—	321,287	—	928,216
Net service revenue less provision for bad debts	—	210,900,894	—	12,193,165	—	223,094,059
Net assets released from restrictions used for operations	—	1,170,992	—	—	—	1,170,992
Other revenue	—	14,397,225	—	14,610,342	(14,949,107)	14,058,460
Total unrestricted revenues, gains, and other support	—	226,469,111	—	26,803,507	(14,949,107)	238,323,511
Expenses:						
Salaries and wages	—	114,172,337	—	23,580,587	—	137,752,924
Employee benefits	—	29,073,160	—	4,335,965	—	33,409,125
Expendable supplies	—	12,128,232	—	—	—	12,128,232
Purchased services	9,976	35,985,273	—	6,114,537	(15,156,958)	26,952,828
Interest	—	1,891,044	—	—	—	1,891,044
Repairs and minor alterations	—	5,903,972	—	—	—	5,903,972
Depreciation and amortization	—	14,328,863	—	—	—	14,328,863
Impairment of long-lived assets	—	—	—	—	—	—
Realized loss on disposal of assets, net	—	48,491	—	—	—	48,491
Total expenses	9,976	213,531,372	—	34,031,089	(15,156,958)	232,415,479
Operating income (loss)	(9,976)	12,937,739	—	(7,227,582)	207,851	5,908,032
Other income (expense):						
Investment income	—	440,048	2,175,599	—	(207,851)	2,407,796
Realized gain on investments, net	—	431,297	1,938,652	—	—	2,369,949
Change in unrealized gain (loss) on investments, net	—	(1,244,467)	(5,593,749)	—	—	(6,838,216)
Other	—	1,157,347	(74,965)	—	—	1,082,382
Total other income (expense)	—	784,225	(1,554,463)	—	(207,851)	(978,089)
Excess (deficiency) of revenues over expenses	(9,976)	13,721,964	(1,554,463)	(7,227,582)	—	4,929,943
Other changes in net assets:						
Net assets released from restrictions used for purchases of property and equipment	—	932,474	—	—	—	932,474
Transfer from (to) affiliates	(19,719)	(2,659,205)	(3,310,075)	5,980,000	—	(8,999)
Pension liability adjustment	—	(16,483,713)	—	—	—	(16,483,713)
Capital grants and other	—	—	—	—	—	—
Increase (decrease) in unrestricted net assets	\$ (29,695)	(4,488,480)	(4,864,538)	(1,247,582)	—	(10,630,295)

(Continued)

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

Consolidating Statement of Operations Information
Year ended June 30, 2016

	<u>Alliance, Inc.</u>	<u>Family Services Agency, Inc.</u>	<u>Mosaic Community Services, Inc.</u>	<u>Way Station, Inc.</u>	<u>Consolidating eliminations</u>	<u>Consolidated totals</u>
Unrestricted revenues, gains, and other support:						
Patient service revenue (net of allowances and discounts)	\$ —	—	—	—	—	140,768,161
Residential and educational service revenue (net of allowances)	12,557,894	22,581,405	28,995,743	23,983,023	—	171,372,179
Total net service revenue	12,557,894	22,581,405	28,995,743	23,983,023	—	312,140,340
Less provision for bad debts	51,185	631,402	211,683	175,459	—	1,997,945
Net service revenue less provision for bad debts	12,506,709	21,950,003	28,784,060	23,807,564	—	310,142,395
Net assets released from restrictions used for operations	50,000	—	20,085	163,431	50,000	1,454,508
Other revenue	17,865,617	425,891	7,127,195	9,639,920	(977,199)	48,139,884
Total unrestricted revenues, gains, and other support	30,422,326	22,375,894	35,931,340	33,610,915	(927,199)	359,736,787
Expenses:						
Salaries and wages	18,468,370	13,599,368	19,876,151	21,692,073	—	211,388,886
Employee benefits	3,385,204	2,549,866	3,848,704	4,183,527	—	47,376,426
Expendable supplies	3,182,691	1,334,053	1,734,509	1,444,982	—	19,824,467
Purchased services	4,419,149	4,163,607	7,677,382	3,429,245	(983,138)	45,659,073
Interest	65,311	270,179	230,326	220,566	—	2,677,426
Repairs and minor alterations	382,969	383,296	1,075,339	683,721	—	8,429,297
Depreciation and amortization	772,211	726,112	1,725,624	1,203,252	—	18,756,062
Impairment of long-lived assets	102,781	—	—	—	—	102,781
Realized loss on disposal of assets, net	—	201,894	2,046	(6,427)	—	246,004
Total expenses	30,778,686	23,228,375	36,170,081	32,850,939	(983,138)	354,460,422
Operating income (loss)	(356,360)	(852,481)	(238,741)	759,976	55,939	5,276,365
Other income (expense):						
Investment income	—	—	—	87,179	—	2,494,975
Realized gain on investments, net	—	—	—	50,107	—	2,420,056
Change in unrealized gain (loss) on investments, net	—	—	(12,414)	(113,410)	—	(6,964,040)
Other	—	—	—	—	—	1,082,382
Total other income (expense)	—	—	(12,414)	23,876	—	(966,627)
Excess (deficiency) of revenues over expenses	(356,360)	(852,481)	(251,155)	783,852	55,939	4,309,738
Other changes in net assets:						
Net assets released from restrictions used for purchases of property and equipment	—	—	3,739,458	123,077	(500,000)	4,295,009
Transfer from (to) affiliates	—	62,500	—	2,438	(55,939)	—
Pension liability adjustment	—	—	—	—	—	(16,483,713)
Capital grants and other	—	—	21,700	(49,530)	—	(27,830)
Increase (decrease) in unrestricted net assets	\$ (356,360)	(789,981)	3,510,003	859,837	(500,000)	(7,906,796)

See accompanying independent auditors' report.

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

Consolidating Statement of Changes in Net Assets Information

Year ended June 30, 2016

	<u>Sheppard and Enoch Pratt Foundation, Inc.</u>	<u>Sheppard Pratt Health System, Inc.</u>	<u>Sheppard Pratt Investment, Inc.</u>	<u>Sheppard Pratt Physicians, P.A.</u>	<u>Obligated group combining eliminations</u>	<u>Combined obligated group subtotal</u>
Unrestricted net assets:						
Excess (deficiency) of revenues over expenses	\$ (9,976)	13,721,964	(1,554,463)	(7,227,582)	—	4,929,943
Other changes in net assets:						
Net assets released from restrictions used for purchases of property and equipment	—	932,474	—	—	—	932,474
Transfer from (to) affiliates	(19,719)	(2,659,205)	(3,310,075)	5,980,000	—	(8,999)
Pension liability adjustment	—	(16,483,713)	—	—	—	(16,483,713)
Capital grants and other	—	—	—	—	—	—
Increase (decrease) in unrestricted net assets	<u>(29,695)</u>	<u>(4,488,480)</u>	<u>(4,864,538)</u>	<u>(1,247,582)</u>	<u>—</u>	<u>(10,630,295)</u>
Temporarily restricted net assets:						
Gifts and grants	1,279,877	—	—	—	—	1,279,877
Investment income	88,029	—	—	—	—	88,029
Net realized gain on investments	89,408	—	—	—	—	89,408
Net unrealized loss on investments	(257,136)	—	—	—	—	(257,136)
Interest in net assets of Foundation	—	(1,058,175)	—	—	1,058,175	—
Transfer from (to) affiliates	(208,550)	—	—	—	—	(208,550)
Net assets released from restrictions for operations	—	(1,170,992)	—	—	—	(1,170,992)
Net assets released from restrictions for purchases of property and equipment	—	(932,474)	—	—	—	(932,474)
Net assets released from restrictions for capital grants	—	—	—	—	—	—
Reclassification of net assets	(2,107,878)	2,103,466	—	—	—	(4,412)
Decrease in temporarily restricted net assets	<u>(1,116,250)</u>	<u>(1,058,175)</u>	<u>—</u>	<u>—</u>	<u>1,058,175</u>	<u>(1,116,250)</u>
Permanently restricted net assets:						
Gifts	53,663	—	—	—	—	53,663
Investment loss	(12,589)	—	—	—	—	(12,589)
Reclassification of net assets	4,412	—	—	—	—	4,412
Decrease in permanently restricted net assets	<u>45,486</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>45,486</u>
Increase (decrease) in net assets	<u>(1,100,459)</u>	<u>(5,546,655)</u>	<u>(4,864,538)</u>	<u>(1,247,582)</u>	<u>1,058,175</u>	<u>(11,701,059)</u>
Net assets (deficit), beginning of year	10,258,486	142,681,214	123,740,463	(6,239,615)	(8,000,136)	262,440,412
Net assets (deficit), end of year	\$ <u>9,158,027</u>	<u>137,134,559</u>	<u>118,875,925</u>	<u>(7,487,197)</u>	<u>(6,941,961)</u>	<u>250,739,353</u>

(Continued)

**SHEPPARD AND ENOCH PRATT FOUNDATION, INC.
AND SUBSIDIARIES**

Consolidating Statement of Changes in Net Assets Information

Year ended June 30, 2016

	<u>Alliance, Inc.</u>	<u>Family Services Agency, Inc.</u>	<u>Mosaic Community Services, Inc.</u>	<u>Way Station, Inc.</u>	<u>Consolidating eliminations</u>	<u>Consolidated totals</u>
Unrestricted net assets:						
Excess (deficiency) of revenues over expenses	\$ (356,360)	(852,481)	(251,155)	783,852	55,939	4,309,738
Other changes in net assets:						
Net assets released from restrictions used for purchases of property and equipment	—	—	3,739,458	123,077	(500,000)	4,295,009
Transfer from (to) affiliates	—	62,500	—	2,438	(55,939)	—
Pension liability adjustment	—	—	—	—	—	(16,483,713)
Capital grants and other	—	—	21,700	(49,530)	—	(27,830)
Increase (decrease) in unrestricted net assets	<u>(356,360)</u>	<u>(789,981)</u>	<u>3,510,003</u>	<u>859,837</u>	<u>(500,000)</u>	<u>(7,906,796)</u>
Temporarily restricted net assets:						
Gifts and grants	—	—	554,419	827,929	—	2,662,225
Investment income	—	—	7,798	—	—	95,827
Net realized gain on investments	—	—	—	—	—	89,408
Net unrealized loss on investments	—	—	—	—	—	(257,136)
Interest in net assets of Foundation	—	—	—	—	—	—
Transfer from (to) affiliates	50,000	—	58,550	50,000	50,000	—
Net assets released from restrictions for operations	(50,000)	—	(20,085)	(163,431)	(50,000)	(1,454,508)
Net assets released from restrictions for purchases of property and equipment	—	—	(3,739,458)	(123,077)	500,000	(4,295,009)
Net assets released from restrictions for capital grants	—	—	—	—	—	—
Reclassification of net assets	—	—	—	—	—	(4,412)
Increase (decrease) in temporarily restricted net assets	<u>—</u>	<u>—</u>	<u>(3,138,776)</u>	<u>591,421</u>	<u>500,000</u>	<u>(3,163,605)</u>
Permanently restricted net assets:						
Gifts	—	—	1,500	—	—	55,163
Investment loss	—	—	1,474	—	—	(11,115)
Reclassification of net assets	—	—	—	—	—	4,412
Increase in permanently restricted net assets	<u>—</u>	<u>—</u>	<u>2,974</u>	<u>—</u>	<u>—</u>	<u>48,460</u>
Increase (decrease) in net assets	(356,360)	(789,981)	374,201	1,451,258	—	(11,021,941)
Net assets (deficit), beginning of year	<u>9,501,439</u>	<u>4,671,359</u>	<u>14,143,180</u>	<u>25,331,759</u>	<u>—</u>	<u>316,088,149</u>
Net assets (deficit), end of year	<u>\$ 9,145,079</u>	<u>3,881,378</u>	<u>14,517,381</u>	<u>26,783,017</u>	<u>—</u>	<u>305,066,208</u>

See accompanying independent auditors' report.