

The Union Hospital of Cecil County, Inc.

Financial Statements

June 30, 2017 and 2016



BAKER TILLY

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The Union Hospital of Cecil County, Inc.

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Independent Auditors' Report

Board of Directors
The Union Hospital of Cecil County, Inc.

We have audited the accompanying financial statements of The Union Hospital of Cecil County, Inc. (a Maryland not-for-profit corporation) (the "Hospital"), which comprise the balance sheet as of June 30, 2017 and 2016, and the related statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Union Hospital of Cecil County as of June 30, 2017 and 2016, and the results of its operations, changes in net assets and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Baker Tilly Virchow Krause, LLP

Philadelphia, Pennsylvania
October 20, 2017

The Union Hospital of Cecil County, Inc.

Balance Sheet
June 30, 2017 and 2016

	2017	2016		2017	2016
Assets				Liabilities and Net Assets	
Current Assets				Current Liabilities	
Cash and cash equivalents	\$ 5,853,127	\$ 3,939,028		Accounts payable and accrued expenses	\$ 4,813,703 \$ 4,695,136
Investments	40,780,859	53,675,995		Accrued salaries and benefits	4,843,522 4,787,380
Accounts receivable, patients (net of estimated allowances for doubtful accounts of \$15,756,000 in 2017 and \$16,637,000 in 2016)	17,252,373	14,660,149		Third-party advances	3,260,426 3,637,293
Other receivables	480,002	428,260		Current portion of long-term debt and capital lease obligations	3,546,960 3,388,034
Inventories of supplies	2,027,595	2,065,581		Total current liabilities	16,464,611 16,507,843
Prepaid expenses	3,231,364	3,520,101		Due to Affiliates, Net	2,065,236 -
Total current assets	69,625,320	78,289,114		Long-Term Debt and Capital Lease Obligations, Net	60,027,628 62,339,227
Property and Equipment, Net	89,053,840	93,559,816		Estimated Medical Malpractice Claims Liability	8,962,968 10,484,224
Due from Affiliates, Net	-	25,050		Total liabilities	87,520,443 89,331,294
Other Assets, Net	9,573,729	10,408,044		Net Assets	
Interest in Net Assets of Affiliate	5,117,999	5,481,265		Unrestricted	83,405,073 95,806,742
				Temporarily restricted	2,445,372 2,625,253
				Total net assets	85,850,445 98,431,995
Total assets	\$ 173,370,888	\$ 187,763,289		Total liabilities and net assets	\$ 173,370,888 \$ 187,763,289

See notes to financial statements

The Union Hospital of Cecil County, Inc.

Statement of Operations

Years Ended June 30, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Unrestricted Revenues, Gains, and Other Support		
Net patient service revenues	\$ 159,374,030	\$ 159,569,497
Provision for bad debts	<u>(5,273,173)</u>	<u>(6,826,331)</u>
Net patient service revenue less provision for bad debts	154,100,857	152,743,166
Other operating revenues	3,390,477	2,948,402
Net assets released from restrictions for use in operations	<u>732,110</u>	<u>279,557</u>
Total unrestricted revenues, gains, and other support	<u>158,223,444</u>	<u>155,971,125</u>
Expenses		
Salaries and employee benefits	83,471,093	80,133,060
Supplies and other expenses	28,008,393	30,150,111
Purchased services	32,539,389	29,481,360
Depreciation and amortization	11,378,371	11,135,283
Interest	<u>1,863,137</u>	<u>1,951,158</u>
Total expenses	<u>157,260,383</u>	<u>152,850,972</u>
Operating income	<u>963,061</u>	<u>3,120,153</u>
Nonoperating Income (Loss)		
Investment income (loss)	5,005,080	(310,763)
Other, net	<u>10,658</u>	<u>50,648</u>
Total nonoperating income (loss)	<u>5,015,738</u>	<u>(260,115)</u>
Revenues in excess of expenses	5,978,799	2,860,038
Change in Interest in Net Assets of Affiliate	(183,388)	(644,974)
Net transfers to Affiliates	(18,197,080)	(4,468,260)
Net Assets Released From Restriction for Purchase of Property and Equipment	<u>-</u>	<u>2,149</u>
Decrease in unrestricted net assets	<u>\$ (12,401,669)</u>	<u>\$ (2,251,047)</u>

See notes to financial statements

The Union Hospital of Cecil County, Inc.

Statement of Changes in Net Assets
Years Ended June 30, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Unrestricted Net Assets		
Revenues in excess of expenses	\$ 5,978,799	\$ 2,860,038
Changes in interest in net assets of affiliate	(183,388)	(644,974)
Net transfer to affiliates	(18,197,080)	(4,468,260)
Net assets released from restriction for purchase of property and equipment	-	2,149
	<u>(12,401,669)</u>	<u>(2,251,047)</u>
Decrease in unrestricted net assets		
Temporarily Restricted Net Assets		
Contributions, net of event expenses of \$152,727 and \$206,917 in 2017 and 2016, respectively	559,429	610,822
Net assets released from restriction	(739,310)	(325,294)
	<u>(179,881)</u>	<u>285,528</u>
(Decrease) increase in temporarily restricted net assets		
Decrease in net assets	(12,581,550)	(1,965,519)
Net Assets, Beginning	<u>98,431,995</u>	<u>100,397,514</u>
Net Assets, Ending	<u>\$ 85,850,445</u>	<u>\$ 98,431,995</u>

See notes to financial statements

The Union Hospital of Cecil County, Inc.

Statement of Cash Flows

Years Ended June 30, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Cash Flows from Operating Activities		
Decrease in net assets	\$ (12,581,550)	\$ (1,965,519)
Adjustments to reconcile decrease in net assets to net cash provided by operating activities:		
Depreciation and amortization	11,378,371	11,135,283
Loss on disposal of property plant and equipment	9,441	10,307
Provision for bad debts	5,273,173	6,826,331
Amortization of bond premium and deferred financing costs	66,584	66,584
Net transfers to affiliates	18,197,080	4,468,260
Net realized and unrealized gains and losses on investments	(3,412,562)	3,506,242
Restricted contributions	(559,429)	(610,822)
Changes in assets and liabilities:		
Accounts receivable, patient	(7,865,397)	(8,487,342)
Other receivables, inventories, and prepaid expenses	274,981	(851,247)
Due to/from affiliates	2,090,286	(147,111)
Other assets, net	834,315	(2,826,392)
Accounts payable and accrued expenses	(893,269)	(2,140,988)
Accrued salaries and benefits	56,142	(2,018,496)
Third-party advances	(376,867)	745,688
Estimated medical malpractice claims liability	(1,521,256)	2,720,115
Net cash provided by operating activities	<u>10,970,043</u>	<u>10,430,893</u>
Cash Flows from Investing Activities		
Purchases of property and equipment	(14,668,393)	(8,745,431)
Purchases and sales of investments	16,307,698	(654,139)
Change in beneficial interest in net assets of The Union Hospital of Cecil County Foundation, Inc. and Subsidiary	363,266	322,101
Net cash flows used in investing activities	<u>2,002,571</u>	<u>(9,077,469)</u>
Cash Flows from Financing Activities		
Restricted contributions	559,429	610,822
Transfers to affiliates	(8,072,570)	(4,468,260)
Payment of long-term debt and capital lease obligations	(3,545,374)	(3,404,693)
Net cash used in by financing activities	<u>(11,058,515)</u>	<u>(7,262,131)</u>
Net increase (decrease) in cash and cash equivalents	1,914,099	(5,908,707)
Cash and Cash Equivalents, Beginning	<u>3,939,028</u>	<u>9,847,735</u>
Cash and Cash Equivalents, Ending	<u>\$ 5,853,127</u>	<u>\$ 3,939,028</u>
Supplemental Disclosure of Cash Flow Information		
Cash paid for interest	<u>\$ 1,710,532</u>	<u>\$ 1,780,437</u>
Supplemental Disclosure of Noncash Investing and Financing Activities		
Payable for property and equipment	<u>\$ 1,011,836</u>	<u>\$ 960,456</u>
Capital lease obligation incurred for equipment	<u>\$ 1,326,117</u>	<u>\$ 431,484</u>
Net transfer of property plant and equipment to affiliates	<u>\$ 10,124,510</u>	<u>\$ 137,382</u>

See notes to financial statements

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements
June 30, 2017 and 2016

1. Organizational Structure and Nature of Operations

The Union Hospital of Cecil County, Inc. (the "Hospital") is a Maryland not-for-profit corporation and is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The Hospital operates a general community hospital in Elkton, Maryland, which serves residents from Cecil County and the surrounding area.

Affinity Health Alliance, Inc. (the "Health System") is a nonstock, not-for-profit corporation and the sole corporate member of the Hospital. The Health System is also the sole corporate member or sole stockholder of other related healthcare organizations, one of which is a for-profit corporation.

Subsequent Events

The Hospital evaluated subsequent events for recognition or disclosure through October 20, 2017, the date the financial statements were issued.

2. Summary of Significant Accounting Policies

Use of Estimates

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

Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less at date of purchase, excluding investments and assets held in trust.

Patient Accounts Receivable

Patient accounts receivable are reported at net realizable value. Accounts are written off when they are determined to be uncollectible based upon management's assessment of individual accounts. In evaluating the collectability of patient accounts receivable, the Hospital analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. For receivables associated with services provided to patients who have third-party coverage (which includes patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Hospital analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary. For receivables associated with self-pay patients, the Hospital records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable to pay the portion of their bill for which they are financially responsible. The difference between the billed rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements

June 30, 2017 and 2016

The Hospital's self-pay account writeoffs (net of recoveries) increased from approximately \$3,666,000 in 2016 to approximately \$5,423,000 in 2017. The increase was the result of the availability of higher deductible insurance plans through Maryland's healthcare exchange effective January 1, 2014 offset by a change in the charity care policy in June 2016 which resulted in an increase in patients qualifying for charity care. The Hospital has not changed their financial assistance policy in 2017.

Other Receivables

Other receivables are reported at net realizable value. Accounts are written off when they are determined to be uncollectible based upon management's assessment of individual accounts. No allowance for doubtful accounts was recorded because management believes realization losses on other receivables will be immaterial.

Inventories of Supplies

Inventories, which consist primarily of medical supplies and drugs, are recorded at the lower of cost (using the weighted average method) or market.

Investments and Investment Risk

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value. Mutual funds are valued at quoted market prices, which represent the net asset value of shares held. Cash and cash equivalents are carried at cost which approximates fair value. Managed hedge funds represent ownership in limited partnerships that invest in hedge funds, limited partnerships and private equity capital funds. Managed hedge funds are valued based on the current market values of the underlying assets reported by the investment advisor using audited financial statements of the funds at year end using net asset value of shares held. Due to redemption restrictions, these funds are classified as level 3 on the fair value table. Investments in limited partnerships representing less than 3% ownership are recorded at cost and excluded from the fair value table. Investments representing greater than 3% ownership are accounted for under the equity method which approximates fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends and unrealized gains and losses on investments) is included in the determination of revenues in excess of expenses unless the income or loss is restricted by donor or law.

The Hospital's investments are comprised of a variety of financial instruments and are managed by investment advisors. The fair values reported in the balance sheet are subject to various risks including changes in the equity markets, the interest rate environment, and general economic conditions. Due to the level of risk associated with certain investment securities and the level of uncertainties related to changes in the fair value of investment securities, it is reasonably possible that the amounts reported in the accompanying financial statements could change materially in the near term.

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements
June 30, 2017 and 2016

Property and Equipment

Property and equipment acquisitions are recorded at cost. Donated property and equipment are recorded at fair market value at the date of receipt. Depreciation is computed using the straight-line method based on estimated useful lives.

Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the improvements and equipment. Such amortization is included in depreciation and amortization in the financial statements.

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support 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.

Interest in Net Assets of Affiliate

Generally accepted accounting principles establish standards for transactions in which a donor makes a contribution by transferring assets to a not-for-profit recipient organization that agrees to use those assets on behalf of or transfer them to a beneficiary entity. Under certain circumstances, a beneficiary organization is required to recognize its rights to assets held by a recipient organization as an asset on the balance sheet, and changes in value of that asset as a change in net assets in the period of change. The Hospital is the beneficiary of the net assets of an unconsolidated affiliate, The Union Hospital of Cecil County Foundation, Inc. (the "Foundation"). Its interest in the net assets of the Foundation as of June 30, 2017 and 2016 was \$5,117,999 and \$5,481,265, respectively.

Temporarily Restricted Net Assets

Temporarily restricted net assets for various capital and other Hospital related expenditures are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Restricted net assets of \$739,310 and \$325,294 were released from restriction during 2017 and 2016, respectively, in accordance with donor restrictions.

Deferred Financing Costs

Due to the Financial Accounting Standards Board's ("FASB") issuance of Accounting Standards Update ("ASU") No. 2015-03, *Interest-Imputations of Interest: Simplifying the Presentation of Debt Issuance Costs*, the Hospital changed its method of presenting deferred financing costs. Prior to the issuance of ASU No. 2015-03, the Hospital presented deferred financing costs as an asset in its balance sheet. As required by ASU No. 2015-03, the Hospital now presents deferred financing costs as a direct reduction of its long-term debt. The effect of the required retrospective application of this change in presentation was to decrease the Hospital's deferred financing costs and long-term debt by \$584,710 as of June 30, 2016. In addition, amortization expense of the deferred financing costs was reclassified to interest expense in accordance with ASU No. 2015-03 which resulted in a decrease in depreciation and amortization and an increase in interest expense of \$66,584 in 2016.

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements

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Costs incurred in connection with the issuance of long-term debt have been deferred and are being amortized over the terms of the related debt using the straight-line method, which approximates the effective interest method. Amortization expense was \$66,584 in 2017 and 2016, respectively.

Donor-Restricted Gifts

Unconditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support as they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations. Donor-restricted contributions whose restrictions are met within the same year as received are reported as additions to unrestricted net assets in the accompanying financial statements.

Estimated Malpractice Claims Liability

The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported, including costs associated with litigating or settling claims. Anticipated insurance recoveries associated with reported claims are reported separately in the Hospital's balance sheet at net realizable value.

Revenues in Excess of Expenses

The statement of operations includes the determination of revenues in excess of expenses. Changes in unrestricted net assets which are excluded from the determination of revenues in excess of expenses, consistent with industry practice, include permanent transfers of assets to and from subsidiaries for other than goods and services, changes in unrestricted net assets of affiliate and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such long-lived assets).

Net Patient Service Revenues and Allowances

Patient service revenues are recorded at established rates on the accrual basis in the period during which the service is provided. Allowances to give recognition to third-party arrangements and charity care are also accounted for on the accrual basis. Revenues received under certain reimbursement agreements are subject to audit and retroactive adjustments by third-party payors. Provision for estimated retroactive adjustments under these agreements are recorded as required. There were no such adjustments in 2017 and 2016.

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements

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A substantial portion of the Hospital's revenue is from patient services reimbursed by the Medicare and Medicaid programs and by Blue Cross plans. For Medicare and Medicaid patients, payments for services are based upon the Hospital's standard billing rates less a six percent discount. In addition, Blue Cross and other payors are eligible for discounts of two percent based on advances made to the Hospital or one percent of the payment of services within 30 days from the date billed. The differences between the payments (the reimbursable amount) and the standard billing rates have been recorded as contractual allowances in arriving at net patient service revenues in the accompanying statement of operations.

Patient accounts receivables are reported at net realizable value and include charges for accounts due from Medicare, Medicaid, other commercial and managed care insurers, and self-paying patients. Patient account receivable also includes management's estimate of the impact of certain undercharges to be recouped or overcharges to be paid back for inpatient and outpatient services in subsequent years rates as discussed above. Deducted from patient accounts receivable are estimates of doubtful collections related to patients and allowances for the excess of charges over the payments to be received from third party payors.

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. The Hospital recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of these established rates for the services rendered. For uninsured patients that do not qualify for charity care, the Hospital recognizes revenues on the basis of its standard rates, discounted in accordance with the Hospital's policy. On the basis of historical experience, a significant portion of the Hospital's uninsured patients will be unable to pay for the services provided. Thus, the Hospital records a significant provision for bad debts related to the uninsured patients in the period the services are provided. Patient service revenues, net of contractual allowances and discounts (but before the provision for bad debts), recognized in 2017 and 2016 from these major payor sources, are as follows:

	June 30, 2017			
	Third-Party Government Payors	Third-Party Commercial Payors	Self-Pay	Total All Payors
Patient service revenues (net of contractual allowances and discounts)	<u>\$ 65,648,000</u>	<u>\$ 88,249,000</u>	<u>\$ 6,093,000</u>	<u>\$ 159,990,000</u>
	June 30, 2016			
Patient service revenues (net of contractual allowances and discounts)	<u>\$ 66,785,000</u>	<u>\$ 87,016,000</u>	<u>\$ 5,768,000</u>	<u>\$ 159,569,000</u>

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements
June 30, 2017 and 2016

Uncompensated Care

The Hospital provides care to patients who meet certain criteria under its uncompensated care programs; the services are offered and/or provided at a reduced cost based on demonstrated inability to pay or at amounts less than its established rates. Records are maintained to estimate the level of patient service revenue forgone. Uncompensated care includes charity care, amounts in excess of allowable day limits for out of state Medicaid, and bad debt write-offs.

The amount of uncompensated care, based on estimated direct and indirect costs incurred, provided during fiscal years 2017 and 2016 was approximately \$6,685,000 and \$7,726,000, respectively.

Income Taxes

The Hospital is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes on their exempt income under Section 501(a) of the Internal Revenue Code.

The Hospital accounts for uncertainty in income taxes by prescribing a recognition threshold of more-likely-than-not to be sustained upon examination by the appropriate taxing authority. Measurement of the tax uncertainty occurs if the recognition threshold has been met. There were no tax uncertainties that met the recognition threshold in 2017 and 2016.

The Hospital's policy is to recognize interest related to unrecognized tax benefits in interest expense and penalties in operating expenses.

3. Regulatory Environment

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, governmental activity has increased with respect to investigations and allegations concerning possible violations and fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Hospital is in compliance with fraud and abuse as well as other applicable government laws and regulations. While no regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time. Also, future changes in federal and state reimbursement funding mechanisms and related government budgeting constraints could have an adverse effect on the Hospital.

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements

June 30, 2017 and 2016

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendment Act of 1983. Hospitals in Maryland are currently exempt from these federal reimbursement regulations under a special waiver. The waiver currently in effect is subject to renewal based upon criteria defined in the federal law. Under these payment arrangements with Medicare, a retroactive adjustment could occur if certain performance standards are not attained by all hospitals on a statewide basis. The impact, if any, of any retroactive adjustment of the Medicare prospective payment system, should hospitals in Maryland become subject to such system, on future operations of the Hospital has not been determined.

The Hospital's rate structure is subject to review and approval by the Maryland Health Services Cost Review Commission ("HSCRC"). During 2011, the Hospital adopted the Total Patient Revenue Reimbursement System ("TPR"). The Hospital's patient revenue is 100% fixed regardless of increases and decreases in volumes and changes in case mix. The original TPR system was in effect for a three-year period ending June 30, 2013.

The agreement was renewed for another three-year period commencing on July 1, 2016. The renewal does not include any additional incentives, but does include a provision for an annual rate increase for inflation and a population adjustment. The agreement was amended to bring all existing TPR agreements into the global budget revenue format, but this process made no material modifications to the Hospital's existing agreement.

4. New Accounting Standards

Revenue Recognition

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU No. 2014-09 supersedes the revenue recognition requirements in *Topic 605, Revenue Recognition*, and most industry-specific guidance. Under the requirements of ASU No. 2014-09, the core principle is that entities should recognize revenue to depict the transfer of promised goods or services to customers (patients) in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The Hospital will be required to retrospectively adopt the guidance in ASU No. 2014-09 in the year ending June 30, 2019. The Hospital has not yet determined the impact of adoption of ASU No. 2014-09 on its financial statements.

Not-for-Profit Entities

In August 2016, the FASB issued ASU No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. The new guidance is intended to improve and simplify the current net asset classification requirements and information presented in financial statements and notes that is useful in assessing a not-for-profit's liquidity, financial performance and cash flows. The Hospital will be required to adopt the guidance in ASU No 2016-14 in the year ending June 30, 2019, with early adoption permitted. ASU 2016-14 is to be applied retrospectively with transition provisions. The Hospital is assessing the impact ASU No. 2016-14 will have on its financial statements.

The Union Hospital of Cecil County, Inc.

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Financial Instruments

In 2016, FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10)*. ASU No. 2016-01 was issued to enhance the reporting model for financial instruments in financial statements. The provisions of ASU 2016-01 requires marketable equity securities to be reported at fair value with changes in fair value recognized within the performance indicator, establishes a qualitative factor in evaluating impairment on equity investments without readily determinable fair values, and eliminates the requirement to disclose the fair value on financial instruments measured at amortized cost. The Hospital will be required to prospectively adopt the guidance in ASU 2016-01 in the year ending June 30, 2019. The Hospital has not yet determined the impact of adoption of ASU No. 2016-01 on its financial statements.

Lease Accounting

In February 2016, FASB issued ASU No. 2016-02, *Leases (Topic 842)*. ASU No. 2016-02 was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Under the provisions of ASU No. 2016-02, a lessee is required to recognize a right-to-use asset and lease liability, initially measured at the present value of the lease payments, in the balance sheet. In addition, lessees are required to provide qualitative and quantitative disclosures that enable users to understand more about the nature of the Hospital's leasing activities. The Hospital will be required to retrospectively adopt the guidance in ASU No. 2016-02 in the year ending June 30, 2020. The Hospital has not yet determined the impact of adoption of ASU No. 2016-02 on its financial statements.

5. Investments

Investments consist of the following as of June 30:

	<u>2017</u>	<u>2016</u>
Investments:		
Cash and cash equivalents	\$ 325,393	\$ 102,605
Common stock	700,000	-
Corporate bonds	2,000,815	1,697,617
Mutual funds:		
Fixed income	7,524,444	13,363,285
International equities	6,422,141	7,470,691
Large value	2,545,977	3,725,679
Large growth	2,731,935	3,633,567
Mid cap	828,198	1,091,197
Small growth	428,472	489,796
Small cap	298,302	515,815
Other	4,943,883	5,648,480
Exchange-traded products	4,409,645	5,632,053
Managed hedge funds	7,621,654	10,305,210
	<u>\$ 40,780,859</u>	<u>\$ 53,675,995</u>

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements
June 30, 2017 and 2016

Investment income and unrealized gains and losses for investments and cash and cash equivalents are comprised of the following for the years ended June 30:

	<u>2017</u>	<u>2016</u>
Investment income (loss):		
Interest and dividend income, net	\$ 1,592,518	\$ 3,195,479
Changes in unrealized gains and losses on investments	<u>3,412,562</u>	<u>(3,506,242)</u>
Total	<u>\$ 5,005,080</u>	<u>\$ (310,763)</u>

6. Fair Value Measurements

The Hospital measured its investments on a recurring basis in accordance with accounting principles generally accepted in the United States of America.

Fair value is defined as the price that would be received to sell an asset or the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. The framework that the authoritative guidance establishes for measuring fair value includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement.

The levels of the fair value hierarchy are as follows:

Level 1 - Fair value is based on unadjusted quoted prices in active markets that are accessible to the Hospital for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.

Level 2 - Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices in markets that are not active for identical or similar assets, and other observable inputs.

Level 3 - Fair value would be based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows, and other similar techniques.

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The following tables present financial instruments measured at fair value at June 30, 2017 and 2016, by caption on the balance sheet:

	June 30, 2017			
	Total	Level 1	Level 2	Level 3
Reported at Fair Value				
Cash and cash equivalents	\$ 325,393	\$ 325,393	\$ -	\$ -
Common stock	700,000	700,000	-	-
Corporate bonds	2,000,815	-	2,000,815	-
Mutual funds	25,723,352	24,724,030	-	-
Exchange-traded products	4,409,645	4,409,645	-	-
Managed hedge funds	2,731,658	-	-	2,731,658
Managed hedge funds at cost	4,889,996			
Disclosed at Fair Value				
Cash and cash equivalents	5,853,127	5,853,127	-	-
Long-term debt, excluding capital leases (carrying value of \$61,640,224)	61,640,224	-	61,640,224	-
June 30, 2016				
	Total	Level 1	Level 2	Level 3
Reported at Fair Value				
Cash and cash equivalents	\$ 102,605	\$ 102,605	\$ -	\$ -
Corporate bonds	1,697,617	-	1,697,617	-
Mutual funds	35,938,510	35,938,510	-	-
Exchange-traded products	5,632,053	5,632,053	-	-
Managed hedge funds	5,365,210	-	-	5,365,210
Managed hedge funds at cost	4,940,000			
Disclosed at Fair Value				
Cash and cash equivalents	3,939,028	3,939,028	-	-
Long-term debt, excluding capital leases (carrying value of \$64,045,962)	64,045,962	-	64,045,962	-

The following is a description of the valuation methodologies used for assets measured at fair value and for financial instruments disclosed at fair value. There have been no changes in methodologies used at June 30, 2017.

Cash and cash equivalents: Include certain investments in highly liquid debt instruments with original maturities of three months or less at date of purchase. The carrying amount approximates fair value due to the short-term nature of these investments.

Mutual funds and exchange-traded products: Valued at the net asset value ("NAV") of shares held by the Hospital at year end.

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Managed hedge funds: These investments are not readily marketable, and are recognized using the cost method or equity method of accounting based on the percentage of the fund owned. Those with redemption restrictions are valued based on the current market values of the underlying assets reported by the investment advisor using audited financial statements of the funds at year end using NAV. Investments in limited partnerships representing less than 3% ownership are recorded at cost. Funds in which the Hospital owns greater than 3% of the fund are recognized on the equity method. The equity method recognizes gains and losses on these investments.

Corporate bonds: Based on quoted market prices, if available, or estimated using quoted market prices of similar securities.

Common stock is valued based on quoted market prices in the active markets on which the individual securities are traded.

Long-term debt, excluding capital lease obligations: Fair value is calculated based on quoted market prices, if available, or estimated using quoted market prices of similar securities.

7. Property and Equipment and Accumulated Depreciation and Amortization

Property and equipment consisted of the following as of June 30:

	<u>2017</u>	<u>2016</u>
Land and improvements	\$ 2,707,340	\$ 2,690,781
Buildings and improvements	83,703,974	83,303,394
Fixed equipment	46,741,976	43,789,967
Major movable equipment	78,585,379	77,141,381
Construction in progress	1,641,903	3,671,226
Total	213,380,572	210,596,749
Less accumulated depreciation and amortization	<u>(124,326,732)</u>	<u>(117,036,933)</u>
Property and equipment, net	<u>\$ 89,053,840</u>	<u>\$ 93,559,816</u>

Included above is leased equipment at a cost of \$7,831,572 and \$6,897,864 with accumulated amortization of \$4,828,304 and \$4,659,369 as of June 30, 2017 and 2016, respectively.

During 2017, \$10,250,031 in assets were transferred to an affiliate of the Hospital and subsidiary of the Health System and \$125,521 in assets were transferred to the Hospital from an affiliate and subsidiary of the Health System.

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8. Long-Term Debt

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

	<u>2017</u>	<u>2016</u>
MHHEFA Series 2014 Revenue Bonds	\$ 30,478,000	\$ 30,598,000
MHHEFA Series 2012 Revenue Bonds	7,707,841	9,124,804
Town of Elkton, Maryland Series 2012 Revenue Bonds (held by SunTrust Bank)	23,454,383	24,323,158
Capital lease obligations (Note 9)	<u>2,452,490</u>	<u>2,266,009</u>
Total	64,092,714	66,311,971
Less: unamortized deferred financing costs, net	(518,126)	(584,710)
Less current portion	<u>(3,546,960)</u>	<u>(3,388,034)</u>
Long-term debt and capital lease obligations, net	<u>\$ 60,027,628</u>	<u>\$ 62,339,227</u>

On December 1, 2014, the Hospital participated in MHHEFA revenue bond issuances that totaled \$30,778,000. The MHHEFA Series 2014 Revenue Bonds (the "2014 Revenue Bonds") were issued to refund the remaining portion of the MHHEFA Series 2005 Revenue Bonds and finance certain capital projects. The 2014 Revenue Bonds bear interest at 3.01% and are payable in monthly annual installments through July 2039.

On July 18, 2012, the Hospital participated in MHHEFA revenue bond issuances that totaled \$13,931,000. The MHHEFA Series 2012 Revenue Bonds (the "2012 Revenue Bonds") were issued to refund the remaining portion of the MHHEFA Series 2002 Revenue Bonds, finance certain capital projects and increase the debt service reserve fund for the 2005 Revenue Bonds. The 2012 Revenue Bonds bear interest at 2.75% and are payable in monthly annual installments through June 2022.

On May 18, 2012, the Town of Elkton, Maryland ("Elkton") issued \$27,662,336 in Economic Development Refunding Revenue Bonds ("EDRRB"), Series 2012 ("Series 2012 Bonds"). Also on May 18, 2012, the Hospital entered into a Loan and Financing Agreement with Elkton (the "Agreement") to borrow the proceeds from the Series 2012 Bonds in a series of notes as follows:

- \$10,000,000 from the EDRRB, Series 2012A Bonds to partially refund the Economic Development Revenue Bond, Series 2009, and pay costs of issuance. The note bears interest at 2.25% and is payable in monthly installments of \$44,477 through December 2036.
- \$5,842,234 from the EDRRB, Series 2012B-1 Bonds to refund the remaining portion of the Economic Development Revenue Bond, Series 2009, and pay costs of issuance. This note bears interest at 2.25% and is payable in monthly installments of \$25,995 through December 2036.
- \$2,820,102 from the EDRRB, Series 2012B-2 Bonds to refund Elkton's 2000 Revenue Bonds and pay costs of issuance. This note bears interest at 1.87% and is payable in monthly installments of \$31,708 through June 2020.

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- \$9,000,000 from the EDRRB, Series 2012C Bonds to partially refund the MHHEFA Series 2002 Revenue Bonds and pay costs of issuance. This note bears interest at 2.25% and provides interest-only installments until July 2022, at which time \$92,268 in monthly installments through June 2031.

Scheduled repayments of long-term debt, exclusive of capital lease obligations discussed in Note 9, are as follows:

Years ending June 30:	
2018	\$ 2,487,479
2019	2,548,191
2020	2,609,453
2021	2,290,577
2022	2,348,833
Thereafter	<u>49,355,691</u>
Total	<u>\$ 61,640,224</u>

9. Capital Lease Obligations

The Hospital has various capital lease agreements for medical equipment, which expire through 2022. Future minimum lease payments under these agreements are as follows:

Years ending June 30:	
2018	\$ 1,135,087
2019	642,145
2020	370,188
2021	262,126
2022	<u>194,750</u>
Total minimum lease payments	2,604,296
Less amount representing interest	<u>151,806</u>
Total	2,452,490
Less current portion, principal	<u>1,059,481</u>
Long term portion, principal	<u>\$ 1,393,009</u>

The Union Hospital of Cecil County, Inc.

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10. Pension Plan

Effective January 1, 1999, the Hospital established a 403(b) defined contribution plan (the "403(b) plan") which includes a matching provision, for employees of the Health System, the Hospital and the Foundation. The Hospital has used the 403(b) plan as its primary retirement plan as of January 1, 2000. The 403(b) plan expenses may include a discretionary employer contribution for employees who work at least 1,000 hours in a calendar year and a 50% employer match contribution up to 1.5% of gross wages for those employees who choose to make voluntary contributions. Pension expense related to the 403(b) plan was \$727,008 and \$709,907 for the years ended June 30, 2017 and 2016, respectively, and is included in salaries and employee benefits in the accompanying statement of operations. There was no discretionary contribution made during 2017 and 2016.

11. Concentration of Credit Risk

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of gross revenues from patients and third-party payors was as follows for the years ended June 30:

	<u>2017</u>	<u>2016</u>
Medicare	43 %	42 %
Medicaid	26	26
Blue Cross/Blue Shield	16	17
Health maintenance organizations	1	1
Self-pay patients	3	3
Other third-party payors	<u>11</u>	<u>11</u>
Total	<u>100 %</u>	<u>100 %</u>

The Hospital maintains its cash and cash equivalents with several financial institutions. Cash and cash equivalents on deposit with any one financial institution exceed FDIC coverage from time to time.

12. Functional Expenses

The Hospital provides health care services to residents within its geographic location. Expenses related to providing these services are approximately as follows for the years ended June 30:

	<u>2017</u>	<u>2016</u>
Healthcare services	\$ 102,101,000	\$ 99,438,000
Support services	<u>55,159,000</u>	<u>53,413,000</u>
Total	<u>\$ 157,260,000</u>	<u>\$ 152,851,000</u>

The Union Hospital of Cecil County, Inc.

Notes to Financial Statements

June 30, 2017 and 2016

13. Commitments and Contingencies

The Hospital has been named as a defendant in several lawsuits arising from the performance of its normal activities. In the opinion of the Hospital's management, after consultation with legal counsel, the amount, if any, of the Hospital's ultimate liability under these lawsuits will not have a significant impact on the financial position of the Hospital.

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations is subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time. Government activity continues to increase with respect to investigations and allegations concerning possible violations by healthcare providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed. Management is not aware of any material incidents or noncompliance that have not been provided for in the accompanying financial statements; however, the possible future financial effects of this matter on the Hospital, if any, are not presently determinable.

14. Medical Malpractice Claims Coverage

For the period October 17, 2003 through December 31, 2004, the Hospital maintained its malpractice insurance coverage with the Zurich Insurance Company under a claims-made policy.

As of January 1, 2005, when existing policies expired, the Hospital elected to obtain its professional and general liability insurance from Freestate Healthcare Insurance Company, Ltd., a Cayman Islands company ("Freestate"). Freestate was incorporated as of January 1, 2005 as a chartered captive insurance company for eight nonprofit hospitals in the State of Maryland, including the Hospital. Each of the hospitals contributed an equal amount of \$15,000 as capital to Freestate in return for a one-eighth share interest in Freestate. Freestate is governed by a Board of Directors selected by the shareholders. The policy has no stated deductible.

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Freestate's primary insurance is under the terms of a claims-made insurance policy and has limits of liability of \$1 million per claim and no aggregate limit per policy year. Freestate's excess liability coverage insures against losses in excess of the above primary coverage reported during the period of policy coverage. This excess liability insurance policy has an individual occurrence limit of \$10 million and an annual aggregate limit of \$10 million. Prior acts of coverage for newly employed physicians will not be provided without prior approval of Freestate's Board of Directors. Each hospital's annual premium will be established through a retrospective rating process, with initial premiums based on actuarial estimates. Initial premiums will be charged at the 75% confidence level and retrospective premium assessments will be capped at an amount equal to the expected losses for the policy period at an 85% confidence level, in each case as determined by an independent actuary.

The total estimated reported medical malpractice claims liability is \$8,962,968 at June 30, 2017 and \$10,484,224 at June 30, 2016. The Hospital has recorded a receivable, and related claim liability, for anticipated insurance recoveries of \$7,952,182 at June 30, 2017 and \$9,359,327 at June 30, 2016. The estimated insurance recoveries receivable is included in other assets in the balance sheet.

The Hospital believes that it has adequate insurance coverages for all asserted claims and has no knowledge of unasserted claims which would exceed insurance coverages. The Hospital would claim charitable immunity for claims exceeding coverage limits. Legal expenses associated with covered claims are also covered and included under policy limits.

15. Related Party Transactions

The Hospital periodically receives or advances funds for working capital purposes. Interest is not charged and there are no fixed repayment terms on these transactions. Receivables (payables) from (to) other affiliates within the Hospital as of June 30, 2017 and 2016 are shown below:

	<u>2017</u>	<u>2016</u>
Health System	\$ (2,129,889)	\$ (243,617)
Union Hospital of Cecil County Foundation, Inc.	<u>64,653</u>	<u>268,667</u>
Total	<u>\$ (2,065,236)</u>	<u>\$ 25,050</u>

The Hospital pays a management fee to the Health System for administrative, finance, and human resources services. The management fee was calculated as 1% of the Hospital's net operating revenues (including the provision for doubtful accounts) for fiscal years 2017 and 2016. Fees of \$1,603,663 and \$1,899,642 are included in purchased services in the accompanying statement of operations for the years ended June 30, 2017 and 2016, respectively.

During 2017 and 2016, the Hospital transferred net assets to affiliates of \$18,197,080 and \$4,468,258, respectively, including \$10,124,510 in fixed assets.

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Effective February 1, 2014, the Hospital entered into a 2 year management services agreement with the University of Maryland Medical System (“UMMS”). Under the agreement, UMMS provides support for quality initiatives, physician recruitment, supply chain saving and for the oncology programs. The agreement was renewed January 1, 2016 until June 30, 2018. For the years ending June 30, 2017 and 2016, the Hospital paid approximately \$715,000 and \$1,120,000, respectively, to UMMS.