



WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Financial Statements and Supplementary Information

June 30, 2015 and 2014

(With Independent Auditors' Report Thereon)

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Table of Contents

	Page(s)
Independent Auditors' Report	1-2
Consolidated Balance Sheets	3
Consolidated Statements of Operations	4
Consolidated Statements of Changes in Net Assets	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7-29
Supplementary Information	
Consolidating Balance Sheet Information	30-31
Consolidating Statement of Operations Information	32-33
Consolidating Statement of Changes in Net Assets Information	34



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

Independent Auditors' Report

The Board of Directors
Western Maryland Health System Corporation:

We have audited the accompanying consolidated financial statements of Western Maryland Health System Corporation and subsidiaries, which comprise the consolidated balance sheets as of June 30, 2015 and 2014, 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 Western Maryland Health System Corporation and subsidiaries as of June 30, 2015 and 2014, and the results of its operations and its cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.



Other Matter

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 1-3 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 15, 2015

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Balance Sheets

June 30, 2015 and 2014

(Dollars in thousands)

Assets	2015	2014
Current assets:		
Cash and cash equivalents	\$ 73,669	50,978
Investments	74,487	71,898
Funds on deposit with trustee	10,340	15,673
Accounts receivable, less allowance for doubtful accounts of \$3,467 in 2015 and \$4,353 in 2014	38,839	44,050
Pledge receivable, net	116	262
Other receivables, less allowance for uncollectible accounts of \$1,064 in 2015 and \$827 in 2014	4,567	4,025
Inventories and other current assets	10,077	10,025
Total current assets	212,095	196,911
Funds on deposit with trustee	—	40,644
Board designated investments	10,075	8,280
Other long-term investments	433	435
Investments restricted by donor or grantor	5,177	4,772
Beneficial interest in trustee held Foundation assets	2,033	2,039
Property and equipment, net	299,161	314,131
Unamortized financing fees	2,325	3,703
Investments in affiliates	23,552	16,481
Other assets	4,939	5,168
Total assets	\$ 559,790	592,564
Liabilities and Net Assets		
Current liabilities:		
Current portion of long-term debt	\$ 2,900	8,300
Accounts payable and accrued liabilities	11,692	9,053
Accrued bond interest payable	7,440	7,488
Accrued salaries and benefits	13,014	14,256
Payable to third-party payors	6,644	6,291
Total current liabilities	41,690	45,388
Long-term debt, net of current portion	266,058	310,466
Pension benefits in excess of pension assets	70,486	44,410
Other liabilities	12,439	13,939
Total liabilities	390,673	414,203
Commitments and contingencies		
Net assets:		
Unrestricted:		
Unrestricted net assets	160,550	169,861
Noncontrolling interest in consolidated subsidiaries	1,294	1,558
Total unrestricted net assets	161,844	171,419
Temporarily restricted	4,980	4,643
Permanently restricted	2,293	2,299
Total net assets	169,117	178,361
Total liabilities and net assets	\$ 559,790	592,564

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Operations

Years ended June 30, 2015 and 2014

(Dollars in thousands)

	2015	2014
Unrestricted revenues, gains and other support:		
Patient service revenue (net of contractual allowances and charity)	\$ 312,100	302,101
Provision for bad debts	(6,988)	(8,746)
Net patient service revenue	305,112	293,355
Other revenue	6,854	8,314
Total revenues, gains and other support	311,966	301,669
Expenses:		
Salaries and wages	96,401	104,974
Employee benefits	30,611	34,067
Professional fees	14,569	12,400
Purchased services	41,362	20,006
Supplies	50,488	49,828
Utilities	4,307	4,175
Insurance	3,284	3,693
Interest	13,601	15,083
Depreciation and amortization	25,932	27,204
Other	7,707	8,641
Total expenses	288,262	280,071
Operating income	23,704	21,598
Nonoperating income:		
Equity in income (loss) of affiliates	4,068	(365)
Investment income, including realized gains on trading portfolio	2,828	4,369
Unrealized gains on trading portfolio	1,724	2,382
Other	(9,190)	365
Total nonoperating (loss) income	(570)	6,751
Excess of revenues over expenses	\$ 23,134	28,349

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2015 and 2014

(Dollars in thousands)

	<u>Unrestricted net assets</u>	<u>Temporarily restricted net assets</u>	<u>Permanently restricted net assets</u>	<u>Total net assets</u>
Balance at June 30, 2013	\$ 151,590	4,790	2,068	158,448
Excess of revenues over expenses	28,349	—	—	28,349
Investment gain	—	73	—	73
Donations	—	884	—	884
Grants	—	97	—	97
Change in funded status of pension plan	(6,529)	—	—	(6,529)
Net assets released for operations	—	(692)	—	(692)
Net assets released for purchase of property and equipment	509	(509)	—	—
Change in beneficial interest of trustee-held Foundation assets	—	—	231	231
Distributions to noncontrolling interest in consolidated subsidiaries	(2,500)	—	—	(2,500)
Change in net assets	<u>19,829</u>	<u>(147)</u>	<u>231</u>	<u>19,913</u>
Balance at June 30, 2014	<u>171,419</u>	<u>4,643</u>	<u>2,299</u>	<u>178,361</u>
Excess of revenues over expenses	23,134	—	—	23,134
Investment gain	—	336	—	336
Donations	—	701	—	701
Grants	—	35	—	35
Change in funded status of pension plan	(30,076)	—	—	(30,076)
Net assets released for operations	—	(513)	—	(513)
Net assets released for purchase of property and equipment	222	(222)	—	—
Change in beneficial interest of trustee-held Foundation assets	—	—	(6)	(6)
Distributions to noncontrolling interest in consolidated subsidiaries	(2,855)	—	—	(2,855)
Change in net assets	<u>(9,575)</u>	<u>337</u>	<u>(6)</u>	<u>(9,244)</u>
Balance at June 30, 2015	\$ <u>161,844</u>	<u>4,980</u>	<u>2,293</u>	<u>169,117</u>

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Cash Flows

Years ended June 30, 2015 and 2014

(Dollars in thousands)

	2015	2014
Cash flows from operating activities:		
Change in net assets	\$ (9,244)	19,913
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	25,744	26,910
Amortization of bond financing costs and premiums	(946)	(363)
Loss on extinguishment of debt	9,152	—
Change in funded status of pension plan	30,076	6,529
Provision for bad debts	6,988	8,746
Distributions to noncontrolling interest holder	2,855	2,500
Equity in (income) loss of affiliates	(4,068)	365
Realized and unrealized losses (gains) on investments	616	(4,741)
Change in beneficial interest in trustee held Foundation assets	6	(231)
Changes in assets and liabilities:		
Accounts receivable	(1,777)	(11,949)
Other receivables	(542)	749
Inventories and other current assets	(52)	225
Accounts payable and accrued liabilities, accrued bond interest payable and accrued salaries and benefits	1,349	2,049
Payable to third-party payors	353	(665)
Other assets, funded status of pension plan, and other liabilities	(5,271)	(2,134)
Net cash provided by operating activities	55,239	47,903
Cash flows from investing activities:		
Purchase of long-lived assets	(10,774)	(8,705)
Change in funds on deposit with trustee	45,977	(4,402)
Net change in investments	259	(26,515)
Distributions from unconsolidated entities	—	1,592
Investment in related organizations	(1,000)	—
Net cash provided by (used in) investing activities	34,462	(38,030)
Cash flows from financing activities:		
Proceeds from long-term debt	269,914	—
Repayments of long-term debt	(331,556)	(8,135)
Payment of deferred issuance costs	(2,392)	—
Capital lease payments	(115)	(444)
Restricted investment (loss) income	(6)	231
Distributions to noncontrolling interest holder	(2,855)	(2,500)
Net cash used in financing activities	(67,010)	(10,848)
Net increase (decrease) in cash and cash equivalents	22,691	(975)
Cash and cash equivalents at beginning of year	50,978	51,953
Cash and cash equivalents at end of year	\$ 73,669	50,978
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 7,488	15,286
Capital additions accrued but not paid	777	656

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(1) **Mission and Organization**

Western Maryland Health System Corporation (the Health System or WMHS) is a not-for-profit community health system. The mission of the Health System is to improve the health status and quality of life of the individuals and the communities served, especially those in need. The Health System provides patient and family centered services through responsible management of human and fiscal resources. The Health System is a values-driven health system that respects and supports life, preserves the dignity of each individual, and promotes a healthy and just society through collaboration with others who share the Health System's values.

The Health System accepts patients regardless of their ability to pay. Those patients who meet certain criteria under its charity care policies receive services at no charge or at an amount less than full charges. Essentially, these policies define charity services as those services for which no payment is anticipated. In addition to providing charity care, the Health System provides other programs and services for the general community. The Health System offers over 90 community health programs that include programs that target health education programs and health screenings to patients. A wide variety of health screenings are offered throughout the year for the general community that are free of charge or offered for a nominal fee. The Health System provides free education programs on a variety of health topics. The Health System also sponsors an annual community health fair, which provides health screenings, education and activities targeted to health and safety.

The Health System comprises the following wholly or partially owned, and controlled, consolidated subsidiaries in Cumberland, Maryland:

(a) *Acute Care Hospital*

Western Maryland Regional Medical Center – a full service community hospital located in Cumberland, Maryland, licensed for 225 acute care beds, owned and operated by the Health System.

(b) *Long-Term Care*

Frostburg Nursing and Rehabilitation Center (Frostburg)

(c) *Other*

Western Maryland Health System Foundation, Inc. (Foundation)

Western Maryland Insurance Company, Ltd. (WMIC)

Haystack Consolidated Services Inc. (Haystack)

Cumberland Properties, Inc.

Memorial Medical Center Services, Inc. (MMCS)

Johnson Heights Medical Building Partnership (Johnson Heights)

Haystack Imaging Services, LLC (Haystack Imaging)

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

In addition, the Health System has investments in several unconsolidated affiliates, which are accounted for on the cost or equity methods of accounting, as appropriate (see note 6).

(2) Summary of Significant Accounting Policies

(a) *Principles of Consolidation*

The consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles, and include the accounts of the Health System and its subsidiaries and controlled entities. Significant intercompany accounts and transactions have been eliminated in consolidation. The Health System's consolidated financial statements reflect the respective interests of the minority investors in the joint ventures' net assets and changes in net assets.

(b) *Investments in Affiliates*

Investments in certain joint ventures, which are not controlled by the Health System, are accounted for using the cost or equity method of accounting as appropriate (see note 6). These investments are included as investments in affiliates in the accompanying consolidated balance sheets. The Health System's proportionate share of income or loss of the unconsolidated joint ventures is included in nonoperating income in the accompanying consolidated statements of operations.

(c) *Cash Equivalents*

Cash equivalents consist primarily of temporary investments with maturities of three months or less when purchased and certain overnight repurchase agreements. Overnight repurchases are principally unsecured and are subject to normal credit risk.

(d) *Accounts Receivable*

Patient accounts receivable are stated at estimated net realizable amounts from patients, third-party payors and other insurers when services are provided. The Health System bills the insurer directly for services provided. Insurance coverage and credit information is obtained from patients when available. No collateral is obtained for accounts receivable.

(e) *Inventories*

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

(f) *Investments*

The Health System's investment portfolio, including board designated investments and investments restricted by donor or grantor, is considered a trading portfolio and is classified as current or noncurrent assets based on management's intention as to use. Accordingly, realized and unrealized gains and losses are included in investment income in the accompanying consolidated statements of operations. Dividend and interest income, as well as realized gains on sales of securities, are included in investment income.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the balance sheet. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities.

The Health System maintains operating reserves in investments equivalent to three months of operating reserves. That balance is maintained in the current asset section of the accompanying consolidated balance sheets.

(g) *Property and Equipment*

Property and equipment are stated at cost or, if donated, at fair market value at date of gift. Depreciation is determined using a straight-line basis over the estimated useful lives of the related assets. Repairs and maintenance are expensed as incurred.

Gifts of long-lived assets, such as land, building or equipment, or cash gifts to be used for purchase of long-lived assets, are reported as unrestricted support, 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 reported are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted net assets. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported as released from restrictions when the donated or acquired long-lived assets are placed in service.

The Health System opened a 275-bed, state-of-the-art hospital on November 21, 2009. Adjacent to the hospital is a 120,000-square-foot medical office building (MOB) previously owned and operated by a third-party medical office building developer until the purchase of the MOB by WMHS on February 17, 2011. The MOB includes both hospital services and physicians' office space.

(h) *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 Accounting Standards Codification (ASC) Subtopic 360-10, *Accounting for the Impairment or Disposal of Long-Lived Assets*, if there is an indication that the carrying amount of an asset is not recoverable, the Health System projects 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 discounted cash flows.

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.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

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, the Health System groups the assets at the lowest level for which there are identifiable cash flows independent of other groups of assets. If such assets are impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets.

(i) *Financing Costs*

Financing costs incurred in issuing long-term debt have been deferred and are shown separately on the balance sheet. These costs are being amortized using the effective interest method over the term of the related debt. In November 2014, the Health System issued new debt and refunded the previous debt. The unamortized balances were \$2,325 and \$3,703 at June 30, 2015 and 2014, respectively. Prior unamortized balances were eliminated in conjunction with the refunding of prior debt.

(j) *Temporarily and Permanently Restricted Net Assets*

Temporarily restricted net assets are limited as to use by donors to a specific time period or purpose. Permanently restricted net assets are to be held in perpetuity at the instruction of the donor. Income from permanently restricted net assets is used as defined by the donor.

(k) *Net Patient Service Revenue*

In 1971, the Health Services Cost Review Commission (HSCRC) adopted a voluntary alternative rate system known as the Total Patient Revenue (TPR) program, initially established as a demonstration project. Under TPR, a prospective, fixed revenue budget is established by the HSCRC for the upcoming year. This fixed revenue budget incorporates all payors and is not adjusted for changes in volume, casemix or mix of inpatient services that occur during the year. The TPR revenue budget is adjusted annually for inflation and for population in a hospital's service area.

Consistent with the objectives of healthcare reform, the TPR model eliminates "payment for volume" and is designed to encourage hospitals to operate efficiently by reducing utilization and managing patients in the most appropriate care delivery setting. TPR does not include physician services or other kinds of unregulated services (i.e. freestanding ambulatory centers) that fall outside of the jurisdiction of the HSCRC. The TPR agreement allows the Health System to adjust unit rates, within certain limits, to achieve the overall revenue budget for the Health System at year end. Any overcharge or undercharge versus the revenue budget is prospectively added to the subsequent year's budget.

Effective July 1, 2013, the Health System and the HSCRC agreed to a three-year TPR contract.

Contractual adjustments, which represent the difference between amounts billed as patient service revenue and amounts paid by third-party payors, are accrued in the period in which the related services are rendered. Because the Health System does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as revenue.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

The Maryland Medicaid program is administered primarily through independent licensed managed care organizations. The State of Maryland has contracts with these independent managed care organizations to manage the care to eligible participants. Amounts due from the Medicaid program in Maryland are primarily due from the independent managed care organizations.

Under certain provisions of the American Recovery and Reinvestment Act of 2009 (ARRA), federal incentive payments are available to hospitals, physicians and certain other professionals (Providers) when they adopt, implement or upgrade (AIU) certified electronic health record (EHR) technology or become "meaningful users," as defined under ARRA, of EHR technology in ways that demonstrate improved quality, safety and effectiveness of care. Providers can become eligible for annual Medicare incentive payments by demonstrating meaningful use of EHR technology in each period over four periods. Medicaid providers can receive their initial incentive payment by satisfying AIU criteria, but must demonstrate meaningful use of EHR technology in subsequent years in order to qualify for additional payments. Hospitals may be eligible for both Medicare and Medicaid EHR incentive payments; however, physicians and other professionals may be eligible for either Medicare or Medicaid incentive payments, but not both. The Health System recognizes Medicare EHR incentive payments when it is reasonably assured that the Health System will successfully demonstrate compliance with the specified meaningful use criteria. The Health System satisfied the CMS AIU and/or meaningful use criteria. As a result, the Health System recognized \$1,616 and \$3,035 for the years ended June 30, 2015 and 2014, respectively, of Medicare and Medicaid EHR incentive payments in other operating revenues in the consolidated statement of operations.

(l) Excess of Revenues over Expenses

The consolidated statement of operations includes the performance indicator, excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, include unrealized gains and losses on other than trading securities, change in funded status of the pension plan, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions, which by donor restriction were to be used for the purposes of acquiring such assets).

(m) Charity Care

The Health System, as an integral part of its mission, accepts and treats all patients without regard to their ability to pay. A patient is classified as a charity patient in accordance with established criteria. Charity care is the recognition of services rendered for which no payment is expected.

(n) Donations

Unconditional donations are included in income when pledged or received. Donations restricted as to use by the donor are reflected as additions to temporarily or permanently restricted net assets. Expenditures of temporarily restricted net assets are transferred to unrestricted net assets if for capital additions, or reported as other revenue if for operating purposes.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(o) *Income Taxes*

The Health System and substantially all of its affiliates are tax exempt organizations under section 501(c)(3) of the Internal Revenue Code (IRC) and are not subject to income taxes except to the extent it has taxable income from activities that are not related to its exempt purpose. No provision for income taxes was required to be made in the consolidated financial statements for these entities.

Johnson Heights is a general partnership and Haystack Imaging is a limited liability company and both are not directly subject to income taxes. The results of their operations are included in the tax returns of their partners. Haystack and MMCS are taxable for profit entities, which recognized an immaterial amount of taxable losses during 2015 and 2014.

The Health System and affiliates account for tax provisions in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 740-10, *Accounting for Uncertainty in Income Taxes*, which creates a single model to address uncertainty in tax positions and clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. Under the requirements of ASC Subtopic 740-10, an entity could be required to record an obligation as the result of a tax position they have historically taken on various tax exposure items. The Health System and affiliates have determined that it did not have any uncertain tax positions as of June 30, 2015 and 2014.

(p) *Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

(q) *Western Maryland Health System Foundation*

The Foundation is controlled by the Health System and thus its assets, liabilities, net assets and results of operations are consolidated within the Health System's financial statements.

(r) *Beneficial Interest in Trustee Held Assets*

The Health System records a beneficial interest in several trusts (the assets of which are to be held in perpetuity) for which a portion of the income is to be distributed to the Health System. These changes in the fair value of the trusts are recorded as unrealized gains/losses in permanently restricted net assets.

(s) *Trivergent Health Alliance MSO*

On July 6, 2014, Western Maryland Health System Corporation, Frederick Regional Health System, and Meritus Health, three regional nonprofit health systems, formed Trivergent Health Alliance, LLC. The three key objectives of the Alliance are to improve the health of the population served by the three hospitals, improve the quality of care rendered by the hospitals and to reduce the cost of healthcare provided as embodied in the Management Services Organization (MSO). A subsidiary, Trivergent

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

Health Alliance MSO, LLC, was created to oversee six key service lines for the three hospitals: supply chain, revenue cycle, laboratory, pharmacy, information systems, and human resources. The Health System incurred \$21,424 in expenses related to Trivergent during the year ending June 30, 2015 for these services. These amounts are currently recorded in the purchased services caption in the consolidated statement of operations.

(t) Pension Plan

For employees hired prior to July 1, 2011, the Health System has a noncontributory defined benefit pension plan covering substantially all of its employees upon their retirement. Since 2008, the benefits are based on age, years of service and career average pay. Grandfathered employees prior to 2008 are based on age, years of service and final average pay based on their five highest paid years of their last 10 years of service. Effective July 1, 2011, employees hired or rehired will not participate in the plan. These employees will participate in a defined contribution plan that has been developed.

For the defined benefit pension plan, the Health System records annual amounts relating to its pension plan based on calculations that incorporate various actuarial and other assumptions including, discount rates, mortality, assumed rates of return, compensation increases, turnover rates and healthcare cost trend rates. The Health System reviews its assumptions on an annual basis and makes modifications to the assumptions based on current rates and trends when it is appropriate to do so. The Health System believes that the assumptions utilized in recording its obligations under its plans are reasonable based on its experience and market conditions.

(u) Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation.

(3) Accounts Receivable, Allowance for Doubtful Accounts and Business Concentrations

During fiscal years 2015 and 2014, net patient service revenue was received from the following payors:

	<u>2015</u>	<u>2014</u>
Medicare	55%	55%
Medicaid	19	16
Blue Cross	10	14
Self-pay	2	4
Other	14	11
	<u>100%</u>	<u>100%</u>

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

Gross accounts receivable at June 30, 2015 and 2014 consisted of the following payors:

	2015	2014
Medicare	47%	46%
Medicaid	19	18
Blue Cross	9	11
Self-pay	10	11
Other	15	14
	100%	100%

Patient accounts receivable are reduced by allowances for bad debts. In evaluation the collectability of accounts receivable, the Health System 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. The Health System 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 insurance coverage for a portion of the bill, the Health System 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 has been exhausted.

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

	2015	2014
Beginning balance as of July 1	\$ 4,353	5,093
Provision for uncollectible accounts	6,988	8,746
Less write offs	(7,874)	(9,486)
Ending balance as of June 30	\$ 3,467	4,353

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(4) Investments

Investments, which include Funds on deposit with trustees, Board designated investments, Investments restricted by donor or grantor, and other long-term investments consist of the following as of June 30:

	2015	2014
U.S. government obligations	\$ 14,158	22,652
Money market funds	27,689	60,811
Corporate stocks and other	29,732	26,863
Fixed income securities	28,933	31,376
	\$ 100,512	141,702

Investments have been classified in the accompanying consolidated balance sheets as follows as of June 30:

	2015	2014
Short-term investments	\$ 74,487	71,898
Funds on deposit with trustee	10,340	56,317
Board designated investments	10,075	8,280
Other long-term investments	433	435
Investments restricted by donor or grantor	5,177	4,772
	\$ 100,512	141,702

Investment income and gains for assets limited as to use, cash equivalents, and other investments comprise the following for the years ended June 30:

	2015	2014
Income:		
Investment income	\$ 1,933	2,010
Realized gains on trading investment portfolio	895	2,359
Unrealized gains on trading investment portfolio	1,724	2,382
	\$ 4,552	6,751

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(5) Property and Equipment

Property and equipment and estimated useful lives (in years) are summarized as follows as of June 30:

	2015	2014
Land and land improvements (2–25 years)	\$ 14,756	14,725
Buildings and improvements (5–40 years)	333,157	333,285
Equipment (3–20 years)	190,568	180,720
Construction in progress	46	1,009
	538,527	529,739
Less accumulated depreciation	239,366	215,608
Property and equipment, net	\$ 299,161	314,131

Depreciation expense for the year ended June 30, 2015 was \$25,744. Depreciation expense for the year ended June 30, 2014 was \$26,910.

(6) Investments in Affiliates

Investments in affiliates and equity in income (loss) of affiliates are as follows as of and for the years ended June 30:

Name	Interest	Business	Investment		Equity in income (loss)	
			2015	2014	2015	2014
Maryland Physicians Care, Inc.	20.00%	State of Maryland Medicaid managed care	\$ 20,064	16,005	4,058	(354)
Other affiliates	0.14% to 33.33%	Supply purchasing and medical equipment	3,488	476	10	(11)
			\$ 23,552	16,481	4,068	(365)

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(7) Long-Term Debt

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

	2015	2014
Maryland Health and Higher Educational Facilities Authority (MHHEFA) Series 2006, Series A and B Revenue (FHA Insured) Bonds, interest rate 4.0 to 5.0%	\$ —	309,780
MHHEFA Series 2014 Revenue Bonds, interest rate 4.0 to 5.25%	236,170	—
Capital leases	—	115
Net unamortized bond premium	32,788	8,871
Long-term debt	268,958	318,766
Less current portion of long-term debt	2,900	8,300
Long-term debt less current portion	\$ 266,058	310,466

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

2016	\$ 2,900
2017	11,230
2018	11,795
2019	12,385
2020	13,000
Thereafter	184,860

In November 2006, proceeds from issuance of \$348,650 and \$2,180 Maryland Health and Higher Education Facilities Authority Series 2006, Series A and B bonds were obtained for the purpose of (1) financing the costs of acquisition, construction and equipping of the Western Maryland Regional Medical Center (see note 1) and (2) to refund prior debt issuances. The Health System redeemed \$11,360 of the Series 2006A bonds in conjunction with their final endorsement in 2010.

Principal payments on the Series 2006A revenue bonds commenced on July 1, 2010, and are due semi-annually through January 1, 2035. Interest payments are due semi-annually commencing July 1, 2007. The total outstanding balance on the Series 2006B revenue bonds was paid on July 1, 2010. Interest on the Series 2006A bonds accrues at a rate of 4.0% to 5.0% per annum.

The Federal Housing Authority (FHA) issued a commitment for mortgage insurance with respect to the project. The financing document contains quantitative and qualitative covenants (measured quarterly). The quantitative covenants include a debt service coverage ratio, a day's cash on hand requirement, current ratio requirement, a net days in accounts receivable requirement, and restrictions on operating losses and revenue over expenses.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

In November 2014, MHHEFA issued \$236,170 in bonds (Series 2014 Bonds) on behalf of the System. The Series 2014 Bonds were issued as \$171,035 serial bonds maturing 2015 through 2035 (\$2,900 repaid through June 2016), and \$65,135 term bonds maturing 2034. The Series 2014 Bonds maturing on or after July 2025 are subject to redemption at the option of MHHEFA prior to maturity, beginning July 2024. The Series 2014 Bonds were issued at fixed rates. The proceeds from the transaction were used to refund the Series 2006 A and B revenue bonds.

Principal payments on the Series 2014 revenue bonds commences on July 1, 2015, and are due annually through July 1, 2035. Interest payments are due semi-annually commencing July 1, 2015. Interest on the Series 2014 bonds accrues at a rate of 4.0% to 5.25% per annum.

In 2009, the Health System amended their line of credit agreement with a bank that permits the Health System to borrow up to \$1,000. There is no expiration date on the line of credit and the interest rate as of June 30, 2015 was 4.5%. The line of credit primarily supports a letter of credit agreement in the amount of \$700. There was no outstanding balance as of June 30, 2015.

(8) Charity Care

The Health System utilizes a cost to charge ratio methodology to convert charity care to cost. Costs incurred are estimated based on the ratio of total operating expenses to gross charges applied to charity care charges. The amount of charges foregone for services and supplies furnished under the Health System's Charity Care policy aggregated approximately \$9,705 and \$14,414 for the years ended June 30, 2015 and 2014, respectively. The total direct and indirect costs to provide the care amounted to approximately \$7,182 and \$10,666 for the years ended June 30, 2015 and 2014, respectively.

(9) Retirement Plans

The WMHS Retirement Plan (the Plan) is a noncontributory defined benefit plan, which covers substantially all full-time employees who meet certain age and service requirements. The Plan's funding policy is to contribute, annually, the pension costs as determined by the Plan's actuary, subject to adjustment for full funding limitations as defined by the IRC.

The Health System's investment policy, established by the Investment Committee of the Finance Committee and approved by the Health System's Board of Directors, is to ensure current and future benefit obligations are adequately funded in a cost effective manner. The investment guidelines are based on a time horizon of greater than five years. In establishing the risk tolerances, the ability to withstand short and intermediate term variability with some interim fluctuations in market value and rates of return may be tolerated in order to achieve the longer-term objectives.

The measurement date of the Plan is June 30.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

The component of the Plan's funded status, net periodic benefit costs and actuarial assumptions used in accounting for defined benefit plans for the years ended June 30, 2015 and 2014 are as follows:

	<u>2015</u>	<u>2014</u>
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 225,332	199,141
Service cost	5,453	6,380
Interest cost	9,911	9,574
Assumptions	15,397	13,481
Actuarial loss	9,777	4,581
Benefits paid	<u>(8,792)</u>	<u>(7,825)</u>
Projected benefit obligation at end of year	<u>257,078</u>	<u>225,332</u>
Change in plan assets:		
Plan assets at fair value at beginning of year	180,922	160,094
Actual return	4,462	19,154
Employer contributions	10,000	9,500
Benefits paid	<u>(8,792)</u>	<u>(7,826)</u>
Fair value of plan assets at end of year	<u>186,592</u>	<u>180,922</u>
Funded status at end of year	\$ <u><u>(70,486)</u></u>	\$ <u><u>(44,410)</u></u>
	<u>2015</u>	<u>2014</u>
Amounts recognized in unrestricted net assets:		
Net prior service costs	\$ (4,985)	(6,964)
Net actuarial loss	<u>93,975</u>	<u>65,878</u>
Amounts recognized in unrestricted net assets	\$ <u><u>88,990</u></u>	\$ <u><u>58,914</u></u>
	<u>2015</u>	<u>2014</u>
Components of net periodic benefit costs:		
Service cost	\$ 5,453	6,380
Interest cost	9,911	9,574
Expected return on plan assets	(12,380)	(10,937)
Recognized prior service cost	(665)	(819)
Recognized net loss	4,995	4,136
Curtailment effect	<u>(1,314)</u>	<u>—</u>
Net periodic pension cost	\$ <u><u>6,000</u></u>	\$ <u><u>8,334</u></u>

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

Deferred pension costs, which have not yet been recognized in periodic pension expense but are accrued in unrestricted net assets, are \$88,990 and \$58,914 at June 30, 2015 and 2014, respectively. Deferred pension costs represents unrecognized actuarial losses or 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 costs, which is the impact of changes in plan benefits applied retrospectively to employee service previously rendered. The amount of deferred pension costs expected to be recognized as a component of net period pension costs during the year ending June 30, 2016 is \$6,444.

	<u>2015</u>	<u>2014</u>
Weighted average assumptions – benefit obligations:		
Discount rate	4.37%	4.29%
Salary scale	3.50	3.50
Return on assets	7.00	7.00
Weighted average assumptions – net periodic expense:		
Discount rate	4.29%	4.79%
Salary scale	3.50	3.50
Return on assets	7.00	7.00

The accumulated benefit obligation for the defined benefit pension plan was \$236,660 and \$219,582 at June 30, 2015 and 2014, respectively.

The Health System’s pension plan weighted average asset allocations at the measurement dates of June 30, 2015 and 2014, by asset category, are as follows:

	<u>Percentage of plan assets</u>		
	<u>Target allocation</u>	<u>2015</u>	<u>2014</u>
Asset class:			
Equities	60%	56%	56%
Fixed	40	44	44

The Health System expects to contribute \$10,000 to the Plan for the fiscal year ending June 30, 2016.

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

2016	\$	8,540
2017		9,053
2018		9,845
2019		10,713
2020		11,715
2021–2025		73,126

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

The expected benefits to be paid are based on the same assumptions used to measure the Health System's benefit obligation as of June 30, 2015.

Effective July 1, 2011, employees hired or rehired will not participate in the Plan. These employees will participate in the Health System sponsored defined contributions plan whereby the Health System will make a contribution on behalf of the employee into a retirement account in the name of the employee. The contribution amount is based on several factors including years of service and salary levels. The Health System recorded expense related to these employees of \$723 and \$301 for the years ended June 30, 2015 and 2014, respectively. All Health System employees are eligible to contribute a portion of their compensation to the defined contribution plan.

The Health System will match the employee contribution of the employee compensation at some level based on several factors. The Health System's expense related to the matching component of the plan for the years ended June 30, 2015 and 2014 was \$1,640 and \$1,887, respectively, and is included in employee benefits in the accompanying consolidated statements of operations.

(10) Self-Insurance Programs

(a) *General and Professional Liability (GLPL)*

On December 14, 2004, the Health System formed a new wholly owned insurance subsidiary, Western Maryland Insurance Company, Ltd. (WMIC), an exempted company under the Companies Law of the Cayman Islands, to provide GLPL insurance to the Health System and certain affiliates. Effective January 1, 2005, this subsidiary insures the Health System for its GLPL risks under a claims-made policy with a limit of \$1,000 per claim and \$8,000 in the aggregate. Claims in excess of \$1,000 per claim and \$8,000 in the aggregate, up to a limit of \$25,000, have been reinsured with Zurich American Insurance Company, an independent third-party insurance company. The Health System's retained self-insurance risk under these policies is \$1,000 per occurrence.

Management's estimate of the liability for GLPL claims, including incurred but not reported claims, is principally based on actuarial estimates performed by an independent third-party actuary. The Health System's estimated liability for GLPL claims, including incurred but not reported claims, totaled \$11,603 and \$13,227 as of June 30, 2015 and 2014, respectively. These amounts are included in other noncurrent liabilities in the accompanying consolidated financial statements. While management believes that this liability is adequate as of June 30, 2015, the ultimate liability may exceed the amount recorded. Additionally, the Health System has recorded an additional insurance recoveries receivable of \$4,441 and \$4,764 as of June 30, 2015 and 2014, respectively, included in other noncurrent assets.

(b) *Workers' Compensation Insurance*

In 2015 and 2014, the Health System participated in a self-insured plan for workers' compensation claims. Stop-loss coverage has been purchased through a commercial carrier for claims in excess of \$500.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

The Health System has accrued a liability of \$1,963 and \$2,115 as of June 30, 2015 and 2014, respectively, for known and incurred but not reported claims. Management believes this accrual is adequate to provide for all workers' compensation claims that have been incurred through June 30, 2015. Additionally, there are no material insurance recoveries related to workers' compensation as of June 30, 2015.

(c) Health Insurance

The Health System is self-insured for employee health claims. Under these self-insurance plans, the Health System has accrued a liability of \$1,462 and \$1,596 as of June 30, 2015 and 2014, respectively, for known claims and incurred but not reported claims. Management believes this accrual is adequate to provide for all employee health claims that may have been incurred through June 30, 2015. Additionally, there are no material insurance recoveries related to employee health claims as of June 30, 2015.

(11) Lease Commitments

Future minimum payments under noncancelable operating leases with terms in excess of one year or more for the years ending June 30 are as follows:

2016	\$	3,536
2017		3,350
2018		3,121
2019		971
2020		9
Thereafter		—
Total	\$	10,987

Rental expense under operating leases amounted to \$2,575 and \$2,442 for the years ended June 30, 2015 and 2014, respectively.

(12) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets as of June 30, 2015 and 2014 are available for the following purposes:

	2015	2014
Temporary restrictions:		
Specific support of healthcare services	\$ 4,980	4,643
Permanent restrictions:		
Trustee held assets to be held in perpetuity, the income from which primarily is expendable to support health care services	2,293	2,299

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(13) Fair Value of Financial Instruments

(a) *Fair Value of Financial Instruments*

The following methods and assumptions were used by the Health System in estimating the fair value of their financial instruments:

Cash and cash equivalents, investments, funds on deposit with trustee, board designated investments, patient accounts receivable, other assets, accounts payable, and accrued liabilities, payable to third-party payors, and other long term liabilities – The carrying amounts reported in the consolidated balance sheets approximate the related fair values.

The fair value of a financial instrument is the amount 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. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Health System's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Health System based on the best information available in the circumstances.

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

Cash and cash equivalents, accounts receivable, due from affiliates, other assets, line of credit, accounts payable, advances from third-party payors, due to affiliates, and accrued expenses – The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments.

Board designated and other investments – Equity and debt securities classified as trading are measured using quoted market prices at the reporting date multiplied by the quantity held.

(b) *Long-Term Debt*

The Series 2014 Bonds bear interest at fixed rates and, accordingly, had a carrying amount of \$268,958 and a fair value of \$266,816 as of June 30, 2015 and the Series 2006 Bonds a carrying amount of \$318,651 and a fair value of \$321,547 as of June 30, 2014.

The fair value of the Health System's long-term debt is measured using quoted offered-side prices when quoted market prices are available. If quoted market prices are not available, the fair value is determined by discounting the future cash flows of each instrument at rates that reflect, among other things, market interest rates and the Health System's credit standing. In determining an appropriate spread to reflect its credit standing, the Health System considers credit default swap spreads, bond yields of other long-term debt offered by the Health System, and interest rates currently offered for similar debt instruments of comparable maturities by the Health System's bankers as well as other banks that regularly compete to provide financing to the Health System.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(c) ***Fair Value Hierarchy***

The Health System adopted ASC Topic 820, *Fair Value Measurement*, on July 1, 2008 for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Health System has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The table below presents assets that are measured at fair value as of June 30, 2015 aggregated by the three level valuation hierarchy:

		2015			
		Level 1	Level 2	Level 3	Total
Assets:					
U.S. government obligations	\$	14,158	—	—	14,158
Money market funds		27,689	—	—	27,689
Corporate stocks and other		29,732	—	—	29,732
Fixed income securities		—	28,933	—	28,933
Total assets	\$	71,579	28,933	—	100,512

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

The table below presents assets that are measured at fair values as of June 30, 2014 aggregated by the three level valuation hierarchy:

		2014			
		Level 1	Level 2	Level 3	Total
Assets:					
U.S. government obligations	\$	22,652	—	—	22,652
Money market funds		60,811	—	—	60,811
Corporate stocks and other		26,863	—	—	26,863
Fixed income securities		—	31,376	—	31,376
Total assets	\$	<u>110,326</u>	<u>31,376</u>	<u>—</u>	<u>141,702</u>

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

		2015			
		Level 1	Level 2	Level 3	Total
Assets:					
Money market funds	\$	155	—	—	155
Mutual funds		50,942	—	—	50,942
Fixed income securities		—	47,036	—	47,036
Other funds		—	82,151	6,308	88,459
Total assets	\$	<u>51,097</u>	<u>129,187</u>	<u>6,308</u>	<u>186,592</u>

The table below presents the pension plan's investable assets as of June 30, 2014 aggregated by the three level valuation hierarchy:

		2014			
		Level 1	Level 2	Level 3	Total
Assets:					
Money market funds	\$	746	—	—	746
Mutual funds		55,837	—	—	55,837
Fixed income securities		—	39,436	—	39,436
Other funds		—	78,143	6,760	84,903
Total assets	\$	<u>56,583</u>	<u>117,579</u>	<u>6,760</u>	<u>180,922</u>

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(14) Commitments and Contingencies

(a) *Litigation*

From time to time, the Health System and its subsidiaries are involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Health System's future financial position or results from operations.

(b) *Other Matters*

The Health System has contracts with various physician groups to provide certain emergency, obstetric, hospitalists, and surgical services. Those contracts include certain income guarantee levels, which eliminate as volumes related to services provided increase. The Health System paid \$3,230 and \$4,364 related to the guarantee provisions of the contracts in 2015 and 2014, respectively.

(15) Regulation and Reimbursement

The Health System provides health care services primarily through one general acute care hospital. The Health System and other healthcare providers in Maryland 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 HSCRC;
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging malpractice and related claims.

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

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

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

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

The current rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on an agreement between the Center for Medicaid and Medicare Services (CMS) and the HSCRC. This agreement is based upon a waiver from Medicare prospective pay system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as all third-party payors elect to be reimbursed in Maryland under this program and the rate of increase for costs per hospital inpatient admission in Maryland is below the national average.

In January 2014, CMS approved Maryland's new waiver for a five-year period beginning January 1, 2014 for inpatient and outpatient hospital services. The new waiver ties hospital per capital revenue growth to the state's economic growth of 3.58%. CMS can require the state to submit a corrective action plan if targets for a given performance year are not met. The new waiver also imposes quality measures and encourages population health.

Under TPR, a prospective, fixed revenue budget is established by the HSCRC for the upcoming year. This fixed revenue budget incorporates all payors and is not adjusted for changes in volume, casemix or mix of inpatient services that occur during the year. The TPR revenue budget is adjusted annually for inflation and for population in a hospital's service area.

Consistent with the objectives of healthcare reform, the TPR model eliminates "payment for volume" and is designed to encourage hospitals to operate efficiently by reducing utilization and managing patients in the most appropriate care delivery setting. TPR does not include physician services or other kinds of unregulated services (i.e. freestanding ambulatory centers) that fall outside of the jurisdiction of the HSCRC. The TPR agreement allows the Health System to adjust unit rates, within certain limits, to achieve the overall revenue budget for the Health System at year end. Any overcharge or undercharge versus the revenue budget is prospectively added to the subsequent year's budget.

Effective July 1, 2013, the Health System and the HSCRC agreed to a three-year TPR contract.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(16) Noncontrolling Interest

Effective June 30, 2012, the Health System adopted accounting guidance that requires a not-for-profit reporting entity to account for and present noncontrolling interests in a consolidated subsidiary as separate component of the appropriate class of consolidated net assets (equity). The reconciliation of noncontrolling interest reported in unrestricted net assets is as follows:

	WMHS Corporation	Noncontrolling interest	Unrestricted net assets
Balance at June 30, 2013	\$ 150,080	1,510	151,590
Operating income	19,050	2,548	21,598
Nonoperating income	6,751	—	6,751
Excess of revenues over expenses	25,801	2,548	28,349
Change in funded status of pension plan	(6,529)	—	(6,529)
Net assets released for purchase of property and equipment	509	—	509
Distributions to noncontrolling interest in consolidated subsidiaries	—	(2,500)	(2,500)
Change in unrestricted net assets	19,781	48	19,829
Balance at June 30, 2014	169,861	1,558	171,419
Operating income	21,113	2,591	23,704
Nonoperating income	(570)	—	(570)
Excess of revenues over expenses	20,543	2,591	23,134
Change in funded status of pension plan	(30,076)	—	(30,076)
Net assets released for purchase of property and equipment	222	—	222
Distributions to noncontrolling interest in consolidated subsidiaries	—	(2,855)	(2,855)
Change in net assets	(9,311)	(264)	(9,575)
Balance at June 30, 2015	\$ 160,550	1,294	161,844

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2015 and 2014

(Dollars in thousands)

(17) Functional Expenses

The Health System considers healthcare services and general and administrative to be its primary functional categories for purposes of expense classification. The Health System's operating expenses by functional classification are as follows for the years ended June 30:

	<u>2015</u>	<u>2014</u>
Healthcare services	\$ 256,551	249,263
General and administrative	31,711	30,808
	<u>\$ 288,262</u>	<u>280,071</u>

(18) Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2015 and through October 15, 2015. The Health System did not have any material recognizable subsequent events during this period.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Balance Sheet Information

June 30, 2015

(Dollars in thousands)

Assets	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Current assets:						
Cash and cash equivalents	\$ 65,379	6,263	1,400	627	—	73,669
Investments	68,336	—	758	5,393	—	74,487
Funds on deposit with trustee	10,340	—	—	—	—	10,340
Accounts receivable, net	38,082	757	—	—	—	38,839
Pledge receivable, net	—	—	—	116	—	116
Other receivables, net	5,704	(8)	132	25	(1,286)	4,567
Inventories and other current assets	12,360	2	—	—	(2,285)	10,077
Total current assets	200,201	7,014	2,290	6,161	(3,571)	212,095
Funds on deposit with trustee	—	—	—	—	—	—
Board designated investments	10,075	—	—	—	—	10,075
Other long-term investments	79	—	—	354	—	433
Investments restricted by donor or grantor	318	—	—	4,859	—	5,177
Beneficial interest in trustee held and Foundation assets	—	—	—	2,033	—	2,033
Property and equipment, net	298,655	506	—	—	—	299,161
Unamortized financing fees	2,325	—	—	—	—	2,325
Investments in affiliates	23,485	—	67	—	—	23,552
Other assets	4,939	—	—	—	—	4,939
Total assets	\$ 540,077	7,520	2,357	13,407	(3,571)	559,790

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Balance Sheet Information

June 30, 2015

(Dollars in thousands)

Liabilities and Net Assets	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Current liabilities:						
Current portion of long-term debt	\$ 2,900	—	—	—	—	2,900
Accounts payable and accrued liabilities	11,397	1,405	1,175	1,286	(3,571)	11,692
Accrued bond interest payable	7,440	—	—	—	—	7,440
Accrued salaries and benefits	12,628	386	—	—	—	13,014
Payable to third-party payors	6,644	—	—	—	—	6,644
Total current liabilities	41,009	1,791	1,175	1,286	(3,571)	41,690
Long-term debt, net of current portion	266,058	—	—	—	—	266,058
Pension benefits in excess of pension assets	70,486	—	—	—	—	70,486
Other liabilities	12,439	—	—	—	—	12,439
Total liabilities	389,992	1,791	1,175	1,286	(3,571)	390,673
Net assets:						
Unrestricted:						
Unrestricted net assets	148,473	5,729	1,182	5,166	—	160,550
Noncontrolling interest in consolidated subsidiaries	1,294	—	—	—	—	1,294
Total unrestricted net assets	149,767	5,729	1,182	5,166	—	161,844
Temporarily restricted	58	—	—	4,922	—	4,980
Permanently restricted	260	—	—	2,033	—	2,293
Total net assets	150,085	5,729	1,182	12,121	—	169,117
Total liabilities and net assets	\$ 540,077	7,520	2,357	13,407	(3,571)	559,790

See accompanying independent auditors' report.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Operations Information

Year ended June 30, 2015

(Dollars in thousands)

	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Unrestricted revenues, gains and other support:						
Patient service revenue (net of contractual allowances and charity)	\$ 304,710	7,390	—	—	—	312,100
Provision for bad debts	(6,728)	(260)	—	—	—	(6,988)
Net patient service revenue	297,982	7,130	—	—	—	305,112
Other revenue	7,286	7	—	—	(439)	6,854
Total revenues, gains and other support	305,268	7,137	—	—	(439)	311,966
Expenses:						
Salaries and wages	92,305	4,096	—	—	—	96,401
Employee benefits	29,571	1,040	—	—	—	30,611
Professional fees	14,502	67	—	—	—	14,569
Purchased services	40,431	931	—	405	(405)	41,362
Supplies	49,917	571	—	10	(10)	50,488
Utilities	4,119	188	—	—	—	4,307
Insurance	3,279	3	—	2	—	3,284
Interest	13,601	—	—	—	—	13,601
Depreciation and amortization	25,836	96	—	—	—	25,932
Other	6,777	847	2	105	(24)	7,707
Total expenses	280,338	7,839	2	522	(439)	288,262
Operating income (loss)	24,930	(702)	(2)	(522)	—	23,704

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Operations Information

Year ended June 30, 2015

(Dollars in thousands)

	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Eliminations	Consolidated
Nonoperating income:						
Equity in income of affiliates	\$ 4,058	—	10	—	—	4,068
Investment income	2,407	11	24	386	—	2,828
Unrealized gains (loss) on trading portfolio	2,161	—	2	(439)	—	1,724
Other	(9,087)	—	—	(103)	—	(9,190)
	<u>(461)</u>	<u>11</u>	<u>36</u>	<u>(156)</u>	<u>—</u>	<u>(570)</u>
Total nonoperating (loss) income						
Excess (deficiency) of revenues over (under) expenses	<u>\$ 24,469</u>	<u>(691)</u>	<u>34</u>	<u>(678)</u>	<u>—</u>	<u>23,134</u>

See accompanying independent auditors' report.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Changes in Net Assets Information

Year ended June 30, 2015

(Dollars in thousands)

	Western Maryland Health System Corporation	Frostburg Nursing & Rehabilitation Center	Haystack Consolidated Services, Inc.	Western Maryland Health System Foundation Inc.	Consolidated
Unrestricted net assets:					
Balance at June 30, 2014	\$ 158,007	6,420	1,148	5,844	171,419
Excess of revenues over expenses	24,469	(691)	34	(678)	23,134
Change in funded status of pension plan	(30,076)	—	—	—	(30,076)
Net assets released for purchase of property and equipment	222	—	—	—	222
Distributions to noncontrolling interest in consolidated interest	(2,855)	—	—	—	(2,855)
Balance at June 30, 2015	<u>149,767</u>	<u>5,729</u>	<u>1,182</u>	<u>5,166</u>	<u>161,844</u>
Temporarily restricted net assets:					
Balance at June 30, 2014	107	—	—	4,536	4,643
Investment gain	—	—	—	336	336
Donations	164	—	—	537	701
Grants	35	—	—	—	35
Net assets released for operations	(26)	—	—	(487)	(513)
Net assets released for purchase of property and equipment	(222)	—	—	—	(222)
Balance at June 30, 2015	<u>58</u>	<u>—</u>	<u>—</u>	<u>4,922</u>	<u>4,980</u>
Permanently restricted net assets:					
Balance at June 30, 2014	260	—	—	2,039	2,299
Change in beneficial interest of trustee-held Foundation assets	—	—	—	(6)	(6)
Balance at June 30, 2015	<u>260</u>	<u>—</u>	<u>—</u>	<u>2,033</u>	<u>2,293</u>
Net assets at June 30, 2015	<u>\$ 150,085</u>	<u>5,729</u>	<u>1,182</u>	<u>12,121</u>	<u>169,117</u>

See accompanying independent auditors' report.