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SEPTEMBER 30, 2017 AND 2016

CPAs / ADVISORS



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CONSOLIDATED FINANCIAL STATEMENTS

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CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2017 AND 2016

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DEKALB HEALTH

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REPORT OF INDEPENDENT AUDITORS

Board of Directors
DeKalb Memorial Hospital, Inc.
Auburn, Indiana

We have audited the accompanying consolidated financial statements of DeKalb Memorial Hospital, Inc. d/b/a DeKalb Health (the Hospital), which comprise the consolidated balance sheet as of September 30, 2017, and the related consolidated statements of operations and changes in net assets, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the 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.

Board of Directors
DeKalb Memorial Hospital, Inc.
Auburn, Indiana

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 the Hospital as of September 30, 2017, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Prior Period Financial Statements

The consolidated financial statements of the Hospital as of September 30, 2016, were audited by other auditors whose opinion, dated November 23, 2016, expressed an unmodified opinion on those consolidated financial statements.

Blue & Co., LLC

Indianapolis, Indiana
November 30, 2017

DEKALB HEALTH

CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2017 AND 2016

ASSETS

	2017	2016
Current assets		
Cash and cash equivalents	\$ -0-	\$ 1,049,131
Patient accounts receivable, less allowances for uncollectible accounts of \$4,651,107 in 2017 and \$5,507,717 in 2016	8,238,232	8,067,311
Inventories	1,579,003	1,267,616
Prepaid expenses and other current assets	652,878	669,401
Estimated settlements due from third-party payors	72,689	-0-
Total current assets	10,542,802	11,053,459
Assets limited as to use		
Internally designated funds	17,669,520	15,957,764
Externally restricted by donors	54,110	-0-
Total assets limited as to use	17,723,630	15,957,764
Property and equipment, net	36,671,600	38,691,458
Other assets	120,666	68,074
Total assets	\$ 65,058,698	\$ 65,770,755

LIABILITIES AND NET ASSETS

	2017	2016
Current liabilities		
Accounts payable	\$ 3,531,328	\$ 2,338,779
Accrued salaries and related liabilities	2,632,760	2,690,099
Estimated settlements due to third-party payors	-0-	474,816
Other accrued liabilities	545,574	769,722
Line of credit	1,145,973	-0-
Current portion of capital leases	257,455	295,899
Current portion of long-term debt	826,886	826,886
Total current liabilities	8,939,976	7,396,201
Long-term liabilities		
Interest rate swap liability	228,857	680,509
Capital leases, less current portion	415,909	684,298
Long-term debt, less current portion	7,579,643	8,406,529
Total long-term liabilities	8,224,409	9,771,336
Total liabilities	17,164,385	17,167,537
Net assets		
Unrestricted	47,840,203	48,603,218
Temporarily restricted	54,110	-0-
Total net assets	47,894,313	48,603,218
Total liabilities and net assets	\$ 65,058,698	\$ 65,770,755

See accompanying notes to consolidated financial statements.

DEKALB HEALTH

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2017 AND 2016

	2017	2016
Unrestricted revenue and other support		
Net patient service revenue	\$ 67,836,343	\$ 69,806,284
Less provision for uncollectible accounts	4,633,159	6,508,801
Net patient service revenue net of provision for bad debts	63,203,184	63,297,483
Rental income	747,933	589,962
Contributions	6,602	706,119
Other revenue	1,199,690	1,136,624
Net assets released from restrictions used for operations	-0-	11,184
Total unrestricted revenue and other support	65,157,409	65,741,372
Expenses		
Salaries and wages	28,633,652	27,340,439
Employee benefits	8,190,739	7,615,888
Purchased other services	6,627,185	5,867,473
Supplies and drugs	11,578,962	11,911,442
Repairs and maintenance	1,731,232	1,914,210
Utilities	1,159,025	1,093,621
Insurance	774,142	775,541
Rent	237,859	220,662
Hospital assessment fee	1,964,450	1,335,370
Depreciation	4,751,892	4,937,376
Interest	419,726	541,801
Other	2,109,886	2,385,310
Total expenses	68,178,750	65,939,133
Loss from operations	(3,021,341)	(197,761)
Nonoperating gains (losses)		
Interest and dividends	496,538	536,421
Net unrealized gains (losses) on investments	(189,809)	1,024,851
Net realized gains (losses) on investments	1,466,795	(136,692)
Gain (loss) on disposal of property and equipment	33,150	(278,534)
Total nonoperating gains (losses), net	1,806,674	1,146,046
Revenue and other support over (under) expense	(1,214,667)	948,285
Other changes in unrestricted net assets		
Net assets released from restrictions used for purchase of property and equipment	-0-	475,982
Unrealized gain (loss) on interest rate swap	451,652	(115,348)
Total other changes in unrestricted net assets	451,652	360,634
Changes in unrestricted net assets	(763,015)	1,308,919
Temporarily restricted net assets		
Contributions	54,110	-0-
Net assets released from restriction	-0-	(487,166)
Changes in temporarily restricted net assets	54,110	(487,166)
Changes in net assets	(708,905)	821,753
Net assets		
Beginning of year	48,603,218	47,781,465
End of year	\$ 47,894,313	\$ 48,603,218

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2017 AND 2016

	2017	2016
Operating activities		
Changes in net assets	\$ (708,905)	\$ 821,753
Adjustments to reconcile change in net assets to net cash from operating activities:		
Depreciation	4,751,892	4,937,376
Provision for bad debts	4,633,159	6,508,801
(Gain) loss on disposal of property and equipment	(33,150)	278,534
Net realized (gains) losses on investments	(1,466,795)	136,692
Net unrealized (gains) losses on investments	189,809	(1,024,851)
Change in fair value of interest rate swap agreement	(451,652)	115,348
Contributions for long-lived assets	(54,110)	-0-
Changes in operating assets and liabilities:		
Patient accounts receivable, net	(4,804,080)	(6,884,394)
Inventories	(311,387)	329,178
Prepaid expenses and other current assets	16,523	427,394
Other assets	(52,592)	64,937
Accounts payable	1,192,549	480,194
Accrued salaries and related liabilities	(57,339)	(644,270)
Estimated settlements due/from to third-party payors	(547,505)	324,816
Other accrued liabilities	(224,148)	(80,960)
Net cash flows from operating activities	<u>2,072,269</u>	<u>5,790,548</u>
Investing activities		
Purchase of property and equipment	(2,732,034)	(2,449,736)
Purchase of investments	(7,223,777)	(857,874)
Proceeds from disposition of property and equipment	33,150	-0-
Proceeds from disposition of investments	6,734,897	3,425,248
Net cash flows from investing activities	<u>(3,187,764)</u>	<u>117,638</u>
Financing activities		
Principal payments on long-term debt	(1,133,719)	(4,888,954)
Payments on line of credit	-0-	(115,160)
Proceeds from line of credit	1,145,973	115,160
Proceeds from restricted contributions	54,110	-0-
Net cash flows from financing activities	<u>66,364</u>	<u>(4,888,954)</u>
Net change in cash and cash equivalents	<u>(1,049,131)</u>	<u>1,019,232</u>
Cash and cash equivalents		
Beginning of year	1,049,131	29,899
End of year	<u>\$ -0-</u>	<u>\$ 1,049,131</u>
Supplemental cash flows information		
Cash paid for interest	\$ 419,726	\$ 541,801
Property and equipment included in accounts payable	\$ -0-	\$ 626,446
Capital lease obligations incurred for property and equipment	\$ -0-	\$ 677,882

See accompanying notes to consolidated financial statements.

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

DeKalb Memorial Hospital, Inc., d/b/a DeKalb Health (Hospital), a not-for-profit organization, provides inpatient and outpatient health care services generally to residents of DeKalb County, Indiana and contiguous counties. Expenses relate to the provision of medical care and related general and administrative costs.

Principles of Consolidation

The consolidated financial statements include the accounts of the Hospital and its wholly owned subsidiaries, DeKalb Memorial Pharmacare LLC (Pharmacare), a single-member limited liability company which operates a retail pharmacy within the Hospital facility, and DeKalb Foundation (Foundation), a not-for-profit organization which raises funds on behalf of the Hospital and DeKalb County. The Hospital became the sole-member of the Foundation on August 10, 2016 and recognized a contribution of approximately \$461,000 in 2016.

All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of the 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 reported amounts of assets and liabilities, including the allowance for estimated uncollectible accounts and estimated third-party payor settlements, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

Charity Care

The Hospital provides care without charge or at amounts less than its established rates to patients meeting certain criteria under its charity care policy. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, these amounts are not reported as net patient service revenue. The Hospital did not change its charity care policies during the year. Of the Hospital's total expenses reported within the consolidated statements of operations and changes in net assets, an estimated \$378,000 and \$282,000 arose from providing services to charity patients during 2017 and 2016, respectively.

The estimated costs of providing charity services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the Hospital's total expenses divided by gross patient service revenue.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Cash and Cash Equivalents

The Hospital considers all liquid investments, other than those limited as to use, with an original maturity of 90 days or less to be cash equivalents and carried at cost, which approximates market value. At September 30, 2017 and 2016, cash equivalents consisted primarily of money market depository accounts with brokers. The Hospital maintains its cash in accounts, which at times may exceed federally insured limits. The Hospital has not experienced any losses in such accounts and believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Patient Accounts Receivable, Estimated Third-Party Payor Settlements and Patient Service Revenue

Patient service revenue and patient accounts receivable are recorded at the net realizable amounts based on established charges when the patient service is rendered. The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, discounted charges and per diem payments. Charges for services to patients are primarily based on the patients' ability to pay.

Patient accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the Hospital analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party coverage, the Hospital analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payer has not yet paid or for payers who are known to be having financial difficulties that make the realization of amounts due unlikely).

For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), 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 or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated or provided by policy) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

During 2017, the Hospital's allowance for uncollectible accounts changed from approximately \$5,508,000 for the year ended September 30, 2016, to approximately \$4,651,000 for the year ended September 30, 2017. As of September 30, 2017, the Hospital's allowance for uncollectible accounts was comprised of approximately \$1,831,000 reserved for self-pay balances and approximately \$2,820,000 reserved for third-party payor balances. As of September 30, 2016, the allowance for uncollectible accounts of \$5,508,000 was comprised of approximately \$2,777,000 reserved for self-pay balances and approximately \$2,731,000 reserved for third party payor balances. The decrease in allowance from 2016 to 2017 was the result of trends experienced in the collection of self-pay patients in fiscal year 2017 and the use of a collection agency.

Given the current regulatory and reimbursement environment, there can be no assurances that adequate reimbursement levels will continue to be available for the services provided by the Hospital. Significant limits on the scope of services reimbursed and on reimbursement rates and fees could have a material adverse effect on the Hospital's financial condition, results of operations and cash flows.

The Hospital is primarily located in Auburn, Indiana. The Hospital grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements.

The mix of gross receivables and gross revenue from patients and third-party payors as of September 30, 2017 and 2016 was as follows:

	Receivables		Revenue	
	2017	2016	2017	2016
Medicare	28%	31%	44%	43%
Medicaid	18%	13%	16%	16%
Commercial and other	33%	34%	37%	38%
Self-pay	21%	22%	3%	3%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Assets Limited as to Use and Investment Return

Assets limited as to use include (1) assets restricted by donors and (2) assets set aside by the Board of Directors for future capital improvements over which the Board retains control and may at its discretion subsequently use for other purposes. Amounts required to meet current liabilities of the Hospital, if any, are included in current assets.

Investments in equity securities having a readily determinable fair value and in all debt securities are carried at fair value. Other investments are valued at the lower of cost (or fair value at time of donation, if acquired by contribution) or fair value. The Hospital has classified all of its investments in debt and equity securities as trading securities. Investment return includes dividend, interest and other investment income and realized and unrealized gains and losses on investments carried at fair value.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Investment return that is initially restricted by donor stipulation and for which the restriction will be satisfied in the same year is included in unrestricted net assets. Other investment return is reflected in the consolidated statements of operations and changes in net assets as unrestricted, temporarily restricted or permanently restricted based upon the existence and nature of any donor or legally imposed restrictions.

Inventory

Inventory is valued at the lower of cost or market with cost being determined on the first-in, first-out (FIFO) method. Inventory at year-end consists mainly of pharmaceuticals and medical supplies.

Property and Equipment

Property and equipment are stated at cost, or if donated, at fair value at the date of donation, and include expenditures for new additions and repairs which substantially increase the useful lives of existing property and equipment. Maintenance repairs and minor renewals are expensed as incurred. When properties are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the accounts and any resulting gain or loss for the period is recognized. Provisions for depreciation of property and equipment are computed using the straight-line method based upon the estimated useful lives of the assets, which range from 5 to 40 years.

Contributions

Unconditional gifts expected to be collected within one year are reported at their net realizable value. Unconditional gifts expected to be collected in future years are initially reported at fair value determined using the discounted present value of estimated future cash flows technique. The resulting discount is amortized using the level-yield method and is reported as contribution revenue.

Gifts received with donor stipulations are reported as either temporarily or permanently restricted support. When a donor restriction expires, that is, when a time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified and reported as an increase in unrestricted net assets. Donor-restricted contributions whose restrictions are met within the same year as received are reported as temporarily restricted contributions and released from restriction.

Advertising Costs

Advertising costs are expenses as incurred. Total advertising expense for 2017 and 2016 was approximately \$338,000 and \$344,000, respectively, and are recorded as operating expenses within the consolidated statements of operations and changes in net assets.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Estimated Malpractice Costs

Medical malpractice coverage is provided through a program of self-insurance and commercial insurance, and considers limitations imposed by the Indiana Medical Malpractice Act, as amended (Act). The Act limits the amount of individual claims to \$1,250,000 of which \$1,000,000 would be paid by the State of Indiana Patient Compensation Fund (Fund) and \$250,000 by the Hospital, if self-insured, or by its commercial insurer. The Hospital maintains professional liability insurance coverage on a claims-made basis. Should the claims made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during its term but reported subsequently will be uninsured. Premiums are expensed in the period to which they relate.

Income Taxes

The Hospital and the Foundation have been recognized as exempt from income taxes under Section 501(c)(3) of the United States Internal Revenue Code. The exemption is on all income except unrelated business income as noted under Section 511 of the Internal Revenue Code. Internal Revenue Code Section 513(a) defines an unrelated trade or business of an exempt organization as any trade or business which is not substantially related to the exercise or performance of its exempt purpose.

As such, the Hospital and Foundation are generally exempt from income taxes. However, the Hospital and Foundation are required to file Federal Form 990 – Return of Organization Exempt from Income Tax which is an informational return only.

Pharmacare is considered a disregarded entity for tax purposes and is included in the Hospital's Federal Form 990 – Return of Organization Exempt from Income Tax (Form 990).

Performance Indicator

The consolidated statements of operations and changes in net assets include a performance indicator, revenue and other support over (under) expense. Changes in unrestricted net assets, which are excluded from revenue and other support over (under) expense, consistent with industry practice, include net assets released from restrictions, unrealized gain (loss) on the interest rate swap, contributions of long-lived assets and certain other items.

Going Concern Evaluation

Management evaluates whether there are conditions or events that raise substantial doubt about the Hospital's ability to continue as a going concern for a period of one year from the date the consolidated financial statements were available to be issued.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Reclassifications

Certain 2016 balances were reclassified to conform to the 2017 presentation. There was no effect on previously reported consolidated net assets or consolidated change in net assets as a result of these reclassifications.

Subsequent Events

The Hospital has evaluated events or transactions occurring subsequent to the consolidated balance sheet date for recognition and disclosure in the accompanying consolidated financial statements through the date the consolidated financial statements were available to be issued which was November 30, 2017.

Recently Issued Accounting Standards

On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The core principle of this new guidance is that "an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services". On August 12, 2015, the FASB further amended this guidance and issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)*, which deferred the effective date for all entities by one year. These new standards, which the Hospital is not required to adopt until its fiscal year ending September 30, 2020, deal with the timing of reporting revenues from contracts with customers, and disclosures related thereto.

On February 25, 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This new standard, which the Hospital is not required to adopt until its fiscal year ending September 30, 2021, is intended to improve financial reporting about leasing transactions by requiring entities that lease assets to recognize on their statement of financial position the assets and liabilities for the rights and obligations created by those leases, and to provide additional disclosures regarding the leases. Leases with terms (as defined in the ASU) of twelve months or less are not required to be reflected on an entity's statement of financial position.

On August 18, 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)* that amends how a not-for-profit organization classifies its net assets, as well as the information it presents in financial statements and notes about its liquidity, financial performance, and cash flows. This new standard, which the Hospital is not required to adopt until its year ending September 30, 2019, requires improved presentation and disclosures to help not-for-profits provide more relevant information about their resources (and the changes in those resources) to donors, grantors, creditors, and other users. This ASU completes the first phase of a two phase project to amend not-for-profit financial reporting requirements.

The Hospital is presently evaluating the effects that these ASUs will have on its future financial statements, including related disclosures.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

2. CHANGE IN ACCOUNTING PRINCIPLE

During 2017, the Hospital adopted Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements – Going Concern (Topic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. ASU No. 2014-15 requires management to evaluate whether there are conditions or events that raise substantial doubt about the Hospital's ability to continue as a going concern for a period of one year from the date the consolidated financial statements were available to be issued. When conditions or events that raise substantial doubt exist, additional disclosures will be required to enable consolidated financial statement users to understand those conditions or events, management's evaluation of them and management's plans that either alleviated substantial doubt or are intended to mitigate the conditions or events that raise substantial doubt. The adoption of ASU No. 2014-15 did not have a material effect on the accompanying consolidated financial statements.

3. NET PATIENT SERVICE REVENUE

The Board of Directors approves the fee schedule, which is administered with the expectation that clients are to pay for services at a rate commensurate with their ability to pay. No clients will be refused services because of their inability to pay. Essentially, the Hospital's policies define charity services as those services for which a discounted obligation for payment is anticipated. In assessing a client's ability to pay, the Hospital uses an ability-to-pay schedule based on income and dependents. The Hospital also adjusts charges based on contractual agreements with third-party payors.

The Hospital recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the Hospital recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of the Hospital's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Hospital records a significant provision for uncollectible accounts related to uninsured patients in the period the services are provided. This provision for uncollectible accounts is presented on the consolidated statement of operations as a component of net patient service revenue.

The Hospital has agreements with third-party payers including Medicare, Medicaid, the State of Indiana, and other commercial insurance carriers that provide for payments to the Hospital at amounts different from its established rates. A summary of the payment arrangements with major third-party payors include:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Medicare

Inpatient acute care services and substantially all outpatient services provided to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. The prospectively determined rates are not subject to retroactive adjustment although determination of certain elements of the rates can occur after the current period and generate final settlement after submission of annual cost reports by the Hospital and audits thereof by the fiscal intermediary.

Medicaid

Reimbursement for Medicaid services are paid at prospectively determined rates per discharge or per occasion of service. During fiscal year 2012, the State of Indiana implemented a Medicaid Hospital Fee Program (Program) whereby the Hospital pays an assessment fee. The Program also increased reimbursement from Medicaid. The assessment fee expenses of approximately \$1,964,000 and \$1,335,000 during 2017 and 2016, respectively, are included in operating expenses.

Other Reimbursement Arrangements

The Hospital also has entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. The Hospital believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigation involving allegations of potential wrongdoing.

While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretations, as well as significant regulatory action including fines, penalties, and exclusions from the Medicare and Medicaid programs. As a result, there is at least a possibility that recorded estimates will change by a material amount in the near term.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

The difference between established rates and payment under these agreements is reflected as contractual allowances. A reconciliation of the amount of services provided to patients at established rates to net patient service revenue for the years ended September 30, 2017 and 2016 is as follows:

	2017	2016
Inpatient services	\$ 43,453,253	\$ 42,884,684
Outpatient services	126,991,045	119,654,381
Gross patient service revenue	170,444,298	162,539,065
Charity care	(944,038)	(695,054)
Contractual allowances	(101,663,917)	(92,037,727)
Provision for bad debts	(4,633,159)	(6,508,801)
Deductions from revenue	(107,241,114)	(99,241,582)
Net patient service revenue	<u>\$ 63,203,184</u>	<u>\$ 63,297,483</u>

Reimbursement from the Medicare and Medicaid programs is determined from annual cost reports, which are subject to audit by the programs. The Hospital's management believes that amounts recorded in the consolidated financial statements for estimated settlements will approximate the final settlements for open cost reports. The Hospital's cost reports for substantially all of its controlled subsidiaries have been audited by the government or its agents and settled through September 30, 2016.

4. ASSETS LIMITED AS TO USE AND INVESTMENT RETURN

Assets limited as to use at September 30, composed of internally designated and externally restricted by donors, include:

	2017	2016
Cash	\$ 87,215	\$ 76,975
Common stocks	129,717	109,186
Mutual funds - equities	11,079,076	9,798,553
Mutual funds - fixed income	6,427,622	5,973,050
Total assets limited as to use	<u>\$ 17,723,630</u>	<u>\$ 15,957,764</u>

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Total investment return is comprised of the following:

	2017	2016
Interest and dividend income	\$ 496,538	\$ 536,421
Realized gains (losses) on sale of investments	1,466,795	(136,692)
Unrealized gains (losses) on investments	(189,809)	1,024,851
Investment return, net	<u>\$ 1,773,524</u>	<u>\$ 1,424,580</u>

5. FAIR VALUE MEASUREMENTS

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Hospital has the ability to access.
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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

The Hospital's policy is to recognize transfers between levels as of the actual date of the event or change in circumstances. There were no significant transfers between levels during 2017 and 2016.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at September 30, 2017 and 2016.

- *Common stocks*: Valued at the closing price reported on the active market on which the individual securities are traded.

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- *Mutual funds:* Valued at the daily closing price as reported by the fund. Mutual funds held by the Hospital are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Hospital are deemed to be actively traded.
- *Derivative (Interest rate swap agreement):* Valued using pricing models that are derived principally from observable market data based on discounted cash flows and interest rate yield curves at quoted intervals for the full term of the swap. See the note disclosure "Derivatives Financial Instruments – Interest Rate Swaps" for additional information related to derivatives.

The following tables sets forth by level, within the hierarchy, the Hospital's assets and liabilities measured at fair value on a recurring basis as of September 30, 2017 and 2016 are as follows:

	September 30, 2017			
	Total	Level 1	Level 2	Level 3
Assets				
Assets limited as to use				
Common stocks	\$ 129,717	\$ 129,717	\$ -0-	\$ -0-
Mutual funds				
Equities				
Large Blend	4,948,188	4,948,188	-0-	-0-
Large Growth	1,725,450	1,725,450	-0-	-0-
Large Value	2,795,612	2,795,612	-0-	-0-
Mid Blend	18,892	18,892	-0-	-0-
Mid Growth	18,733	18,733	-0-	-0-
Mid Value	491,293	491,293	-0-	-0-
Small Blend	17,952	17,952	-0-	-0-
Small Growth	19,252	19,252	-0-	-0-
Small Value	1,043,704	1,043,704	-0-	-0-
Fixed income				
Inflation-protected bonds	267,888	267,888	-0-	-0-
Intermediate-term bonds	5,786,292	5,786,292	-0-	-0-
Short-Term bonds	41,545	41,545	-0-	-0-
Other	331,897	331,897	-0-	-0-
Total mutual funds	17,506,698	17,506,698	-0-	-0-
	17,636,415	<u>\$ 17,636,415</u>	<u>\$ -0-</u>	<u>\$ -0-</u>
Cash	87,215			
Total assets limited as to use	<u>\$ 17,723,630</u>			
Liabilities				
Interest rate swap agreement	<u>\$ 228,857</u>	<u>\$ -0-</u>	<u>\$ 228,857</u>	<u>\$ -0-</u>

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	September 30, 2016			
	Total	Level 1	Level 2	Level 3
Assets				
Assets limited as to use				
Common stocks	\$ 109,186	\$ 109,186	\$ -0-	\$ -0-
Mutual funds				
Equities				
Large Blend	4,621,041	4,621,041	-0-	-0-
Large Growth	1,620,344	1,620,344	-0-	-0-
Large Value	2,366,078	2,366,078	-0-	-0-
Mid Blend	15,724	15,724	-0-	-0-
Mid Growth	15,483	15,483	-0-	-0-
Mid Value	452,585	452,585	-0-	-0-
Small Blend	691,782	691,782	-0-	-0-
Small Growth	15,516	15,516	-0-	-0-
Fixed income				
Inflation-protected bonds	266,120	266,120	-0-	-0-
Intermediate-term bonds	4,864,324	4,864,324	-0-	-0-
Short-term bonds	42,237	42,237	-0-	-0-
Managed futures	425,814	425,814	-0-	-0-
Other	374,555	374,555	-0-	-0-
Total mutual funds	15,771,603	15,771,603	-0-	-0-
	15,880,789	\$ 15,880,789	\$ -0-	\$ -0-
Cash	76,975			
Total assets limited as to use	<u>\$ 15,957,764</u>			
Liabilities				
Interest rate swap agreement	<u>\$ 680,509</u>	<u>\$ -0-</u>	<u>\$ 680,509</u>	<u>\$ -0-</u>

The Hospital holds investments which are exposed to various risks such as interest rate, market, and credit. Due to the level of risk associated with these securities and the level of uncertainty related to changes in the value, it is at least reasonably possible that changes in the various risk factors will occur in the near term that could materially affect the amounts reported in the accompanying financial statements.

Long-term debt and capital leases: - Fair value is estimated based on the borrowing rates currently available to the Hospital for bank loans with similar terms and maturities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

6. PROPERTY AND EQUIPMENT

	2017	2016
Land	\$ 393,118	\$ 393,118
Land improvements	1,797,214	1,830,710
Leasehold improvements	29,213	-0-
Hospital buildings	51,253,946	51,623,465
Medical office buildings	9,474,348	9,443,718
Equipment	24,506,764	23,958,257
Medical office equipment	45,914	52,659
Construction in process	899,962	230,319
	<u>88,400,479</u>	<u>87,532,246</u>
Less accumulated depreciation	(51,728,879)	(48,840,788)
	<u>\$ 36,671,600</u>	<u>\$ 38,691,458</u>

7. MEDICAL OFFICE BUILDINGS

The Hospital owns Medical Office Buildings (MOBs) adjacent to the Hospital and leases space in these MOBs to physicians under various operating leases expiring in February 2027. Other revenue for the years ended September 30, 2017 and 2016, includes gross rental income of approximately \$748,000 and \$590,000, respectively, from cancelable and noncancelable leases of the Medical Office Building.

Future minimum lease payments to be received at September 30, 2017, were:

Year Ending September 30,	
2018	\$ 729,713
2019	589,512
2020	492,489
2021	367,224
2022	275,842
Thereafter	391,778
	<u>\$ 2,846,558</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

8. LINE OF CREDIT

The Hospital has a line of credit available with Lake City Bank with maximum amount of \$5,000,000 available through January 2023. The line of credit is at a variable rate of interest based on the financial institution's prime rate, adjusted on the same day change basis. The variable rate was 3.75% as of September 30, 2017. The Hospital had approximately \$1,146,000 and \$-0- outstanding on the line of credit as of September 30, 2017 and 2016, respectively. The line of credit is secured by inventory, accounts receivable, equipment and assets whose use is limited with a net book value of approximately \$51,032,000 and \$48,179,000 as of September 30, 2017 and 2016, respectively.

9. LONG-TERM DEBT

Long-term debt at September 30, consists of the following:

	<u>2017</u>	<u>2016</u>
Note Payable to bank, due July 15, 2024, variable rate (2.99%), monthly principal payments due in the amount of \$68,907. The note is secured by inventory, accounts receivable, equipment and assets whose use is limited with a net book value of approximately \$51,032,000 and \$48,179,000 as of September 30, 2017 and 2016, respectively.	\$ 8,406,529	\$ 9,233,415
Less current maturities	<u>(826,886)</u>	<u>(826,886)</u>
	<u>\$ 7,579,643</u>	<u>\$ 8,406,529</u>

The variable interest rate is calculated 175 basis points over the One Month London Inter-Bank Offered Rate (LIBOR) and was 2.99% at September 30, 2017.

Maturities of long-term debt for the years succeeding September 30, 2017 are as follows:

Year Ending September 30,	
2018	\$ 826,886
2019	826,886
2020	826,886
2021	826,886
2022	826,886
Thereafter	<u>4,272,099</u>
	<u>\$ 8,406,529</u>

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Capital leases as of September 30, 2017 are as follows:

	2017	2016
Computed tomography equipment capital lease; imputed interest rate of 1.37%; monthly principal payments of \$11,696; due through August 2021; secured by the financed equipment with a net book value of approximately \$475,000 and \$611,000 as of September 30, 2017 and 2016, respectively.	\$ 523,833	\$ 656,025
Various miscellaneous capital leases, maturing through January 1, 2019; annual interest rate of 3.02%; secured by the financed equipment with a total net book value of approximately \$177,000 and \$295,000 as of September 30, 2017 and 2016, respectively.	149,531	324,172
Total capital leases	673,364	980,197
Less current maturities	(257,455)	(295,899)
	\$ 415,909	\$ 684,298

Maturities of capital leases for the years succeeding September 30, 2017 are as follows:

Year Ending September 30,	
2018	\$ 266,610
2019	166,567
2020	140,352
2021	116,961
Less interest	(17,126)
Obligations under capital leases	\$ 673,364

Following is a summary of property held under capital leases:

	2017	2016
Equipment	\$ 1,275,131	\$ 1,275,131
Less: accumulated depreciation	(623,514)	(369,505)
Property held under capital leases, net	\$ 651,617	\$ 905,626

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

10. DERIVATIVE FINANCIAL INSTRUMENT – INTEREST RATE SWAP

Objectives and Strategies for Using Derivatives

The Hospital makes limited use of derivative financial instruments for the purpose of managing interest rate risk. In particular, forward interest rate swaps are used to manage the risk associated with interest rates on variable-rate borrowings and to lower its overall borrowing costs.

As of September 30, 2017 and 2016, the Hospital had an outstanding interest rate swap agreement with Lake City Bank, having a total notational amount of approximately \$8,407,000 and \$9,233,000, respectively. This interest rate swap agreement effectively changed the Hospital's interest rate exposure on a portion of its 2014 Note Payable to a fixed 4.28%. Lake City Bank pays the variable rate, 2.99%, as of September 30, 2017. The interest rate swap agreement matures in July 2024. The Hospital is exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreements. However, the Hospital does not anticipate nonperformance by counterparties.

Management designated this interest rate swap agreement as a cash flow hedging instrument. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of the change in unrestricted net assets. The interest rate swap has met the requirements of the short cut method for hedge effectiveness; therefore, the change in the fair value of the interest rate swap is included in other changes in unrestricted net assets on the consolidated statement of operations and changes in net assets. Cash flows from interest rate swap contracts are classified as an operating activity on the consolidated statements of cash flows.

The following table below presents information regarding the Hospital's interest rate swap agreement designated as a cash flow hedge, as of September 30, 2017 and 2016.

	2017	2016
Fair value of interest rate swap agreement	\$ 228,857	\$ 680,509
Balance sheet location of fair value amount	Long-term liabilities	Long-term liabilities
Unrealized gain (loss) on interest rate swap recognized in change in unrestricted net assets	\$ 451,652	\$ (115,348)
Location of unrealized gain (loss) recognized in change in unrestricted net assets	Other changes in unrestricted net assets	Other changes in unrestricted net assets

Additional information regarding fair value measurements of the interest rate swap agreements is disclosed in Note 5, Fair Value Measurements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

11. NET ASSETS

Temporarily restricted net assets are available for the following purposes:

	2017	2016
Capital asset purchases	\$ 54,110	\$ -0-

12. PENSION PLAN

The Hospital has a noncontributory defined contribution pension plan covering all eligible employees. The Hospital's cost each year is determined by the plan as a specific percentage of each participating employee's salary. It is the Hospital's policy to fund pension costs as accrued. Pension expense was approximately \$152,000 and \$118,000 in 2017 and 2016, respectively.

13. SELF-INSURED HEALTH AND DENTAL PLAN

The Hospital provides self-insured health and dental benefits to its employees. A third-party claims administrator has been retained to process all benefit claims. Claim expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported. A stop/loss policy through commercial insurance covers individual claims in excess of \$150,000 per individual per policy year with an aggregate limit of approximately \$5,296,000. Self-funded health and dental insurance and related expenses approximated \$4,220,000 and \$3,655,000 for 2017 and 2016, respectively.

14. FUNCTIONAL EXPENSES

The Hospital provides health care services to residents within its geographic location. Certain costs have been allocated among the health care services and general and administrative categories based on the actual direct expenditure and cost allocations based on measurements relevant for the expenditures. Although the methods used were appropriate, alternative methods may provide different results. Expenses related to providing these services are as follows:

	2017	2016
Health care services	\$ 58,625,562	\$ 57,243,986
General and administrative	9,553,188	8,695,147
	<u>\$ 68,178,750</u>	<u>\$ 65,939,133</u>