Fayette Regional Health System

FINANCIAL STATEMENTS

SEPTEMBER 30, 2017 AND 2016

CPAs / ADVISORS

blue

FAYETTE REGIONAL HEALTH SYSTEM

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CPAs / ADVISORS

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REPORT OF INDEPENDENT AUDITORS

Board of Trustees
Fayette Regional Health System
Connersville, Indiana

Report on the Financial Statements

We have audited the accompanying financial statements of Fayette Regional Health System (the System), which comprise the statements of financial position as of September 30, 2017 and 2016, and the related statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

Board of Trustees
Fayette Regional Health System
Connersville, 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 financial statements referred to above present fairly, in all material respects, the financial position of the System as of September 30, 2017 and 2016 and its results of operations, changes in net assets and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Blue & Co., LLC

Indianapolis, Indiana
March 30, 2018

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF FINANCIAL POSITION
SEPTEMBER 30, 2017 AND 2016

ASSETS

	2017	2016
Current assets		
Cash and cash equivalents	$ 2,651,470	$ 4,181,455
Accounts receivable		
Patient services, net	5,173,248	4,096,742
Other	1,422,150	1,075,560
Inventories	785,209	827,601
Prepaid expenses and other current assets	369,636	280,859
Estimated third-party settlements	1,221,390	2,398,616
Investments	3,197,406	4,174,399
Total current assets	14,820,509	17,035,232
Assets limited as to use		
Trustee held funds	43	526,758
Property and equipment		
Land	1,003,725	1,094,402
Land improvements	471,366	520,578
Buildings and building equipment	51,320,484	50,749,199
Major movable equipment	22,981,870	24,531,616
Construction in progress	1,143,979	35,713
Total property and equipment	76,921,424	76,931,508
Less accumulated deprecation and amortization	(57,027,025)	(57,381,307)
Net property and equipment	19,894,399	19,550,201
Interest in net assets of foundation	1,087,778	1,116,836
Other assets	160,199	231,327
Total assets	$ 35,962,928	$ 38,460,354

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF FINANCIAL POSITION
SEPTEMBER 30, 2017 AND 2016

LIABILITIES AND NET ASSETS

	2017	2016
Current liabilities		
Current maturities of long-term debt	$ 843,062	$ 1,046,803
Current maturities of capital leases	290,360	785,895
Current maturities of deriviative liabilities	400,000	400,000
Accounts payable	4,319,206	4,393,355
Accrued salaries, wages, and payroll taxes	1,234,013	1,241,849
Other accrued liabilities	461,597	235,108
Total current liabilities	7,548,238	8,103,010
Derivative liabilities	888,593	2,228,625
Long-term debt, less current maturities	13,311,982	14,139,042
Long-term capital leases, less current maturities	612,470	186,356
Total liabilities	22,361,283	24,657,033
Net assets		
Unrestricted	12,513,867	12,686,485
Temporarily restricted - interest in foundation's net assets	1,087,778	1,116,836
Total net assets	13,601,645	13,803,321
Total liabilities and net assets	$ 35,962,928	$ 38,460,354

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF OPERATIONS
YEARS ENDED SEPTEMBER 30, 2017 AND 2016

	2017	2016
Net revenues		
Net patient service revenue	$ 43,548,139	$ 47,985,407
Provision for bad debts	(1,748,688)	(3,980,236)
Net patient service revenue less provision for bad debts	41,799,451	44,005,171
Other revenue	6,305,087	5,827,098
Total operating revenue	48,104,538	49,832,269
Expenses		
Salaries and wages	18,985,446	20,262,923
Fringe benefits	4,198,002	3,920,432
Supplies and drugs	5,358,195	6,077,488
Purchased services and professional fees	13,425,718	14,248,746
Utilities	1,437,508	1,503,519
Depreciation	2,471,299	2,715,429
Interest	1,386,108	1,563,611
Hospital assessment fee	1,070,700	910,701
Other	1,043,850	1,201,395
Total expenses	49,376,826	52,404,244
Operating loss	(1,272,288)	(2,571,975)
Non-operating revenues (expenses)		
Investment income (loss)	12,522	(720,547)
Loss on disposal of assets	149,151	(538,142)
Unrealized gain (loss) on derivatives	940,032	(66,704)
Total non-operating revenues	1,101,705	(1,325,393)
Excess expenses over revenues	(170,583)	(3,897,368)
Other changes in unrestricted net assets		
Net unrealized gain (loss) on investments	(2,035)	88,802
Change in unrestricted net assets	$ (172,618)	$ (3,808,566)

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

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

	2017	2016
Unrestricted net assets		
Excess revenues under expenses	$ (170,583)	$ (3,897,368)
Net unrealized gain (loss) on investments	(2,035)	88,802
Change in unrestricted net assets	(172,618)	(3,808,566)
Temporarily restricted net assets		
Change in interest in net assets of foundation	(29,058)	244,149
Change in net assets	(201,676)	(3,564,417)
Net assets		
Beginning of year	13,803,321	17,367,738
End of year	$ 13,601,645	$ 13,803,321

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

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

	2017	2016
Operating activities		
Change in net assets	$ (201,676)	$ (3,564,417)
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Change in interest in net assets of the Foundation	29,058	(244,149)
Unrealized loss (gain) on derivatives	(940,032)	66,704
Depreciation	2,471,299	2,715,429
Amortization of bond issue costs	14,760	14,760
Bad debts	1,748,688	3,980,236
Net realized and unrealized (gain) loss on investments	(8,146)	556,435
Loss (gain) on disposal of property and equipment	(149,151)	538,142
Changes in operating assets and liabilities:		
Accounts receivable	(3,171,784)	(668,588)
Inventories, prepaid expenses and other current assets	(46,385)	70,120
Accounts payable and other current liabilities	144,504	(671,280)
Estimated third-party settlements	1,177,226	(965,209)
Payment on derivative liability	(400,000)	(250,000)
Net cash flows from operating activities	668,361	1,578,183
Investing activities		
Purchases of property and equipment	(2,353,273)	(611,469)
Proceeds from disposal of property and equipment	392,270	3,208,000
Purchase of investments and trustee held assets	-0-	(2,210,146)
Proceeds from sale of investments and trustee held assets	1,511,854	14,940,192
Change in other assets, net	71,128	(160,199)
Net cash flows from investing activities	(378,021)	15,166,378
Financing activities		
Payments on long-term debt	(1,045,561)	(5,112,385)
Payments on capital leases	(774,764)	(974,813)
Payments on line-of-credit	-0-	(6,991,723)
Net cash flows from financing activities	(1,820,325)	(13,078,921)
Net change in cash and cash equivalents	(1,529,985)	3,665,640
Cash and cash equivalents		
Beginning of year	4,181,455	515,815
End of year	$ 2,651,470	$ 4,181,455
Supplemental disclosures of cash flow information		
Cash paid for interest	$ 1,400,868	$ 1,578,371
Non-cash investing activities		
Property acquired through capital leases	$ 705,343	$ 73,220

See accompanying notes to financial statements.

1. SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES

Organization

Fayette Memorial Hospital Association, Inc. d/b/a Fayette Regional Health System (the System) is located in Connersville, Indiana, and includes a not-for-profit acute care hospital. The System provides inpatient, outpatient, emergency and other ancillary services for residents of east central Indiana.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including the allowance for estimated uncollectable accounts and estimated third-party payor settlements, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits and investments in highly liquid debt instruments with maturities of three months or less from the date of purchase. The System maintains its cash in bank deposit accounts, which, at times, may exceed the federally insured limits. The System has not experienced any losses in such accounts. The System believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Patient Accounts Receivable and Net Patient Service Revenue

Patient accounts receivable and net patient service revenue are reported at the estimated net realizable amounts due from patients, third-party payors, and others for services rendered. Net patient service revenue includes estimated retroactive adjustments under reimbursement agreements with certain third-party payors (principally for the Medicare program). Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered, adjusted in future periods as final settlements are determined, and are included with estimated receivables from third-party payors.

Allowance for Doubtful Accounts

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the System analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor 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 System 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 payor has not yet paid, or for payors 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 System 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) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

During 2017, the System’s allowance for uncollectible accounts for patient and physician services decreased approximately $2,235,000 from approximately $5,337,000 to approximately $3,102,000. This decrease is due to decreases in gross accounts receivable as well as changes in the underlying associated write off activity. As of September 30, 2017, the allowance for uncollectible accounts of $3,102,000 was comprised of approximately $2,591,000 reserved for self-pay balances and approximately $511,000 reserved for third-party payor balances. As of September 30, 2016, the allowance for uncollectible accounts of $5,337,000 was comprised of approximately $4,246,000 reserved for self-pay balances and approximately $1,091,000 reserved for third-party payor balances.

The System grants credit to patients, substantially all of whom are local residents of the communities served. The System does not generally require credit or other collateral or other security in extending credit to patients; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients’ benefits payable under their health insurance programs, plans, or policies (e.g., Medicare, Medicaid, Health Maintenance Organizations, and commercial insurance policies). The System has not changed its charity care or uninsured discount policies during 2017 or 2016.

Accounts Receivable Other

Other receivables consist primarily of amounts due from physicians, scholarships, and other miscellaneous receivables.

Inventories

Inventories consist mainly of medical supplies and are valued at the lower of cost (first-in, first-out method) or market value.

Investments

Investments consist primarily of money market deposit accounts, common stocks, mutual funds, and hedge funds. Investments are carried at fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenue 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 as the investments are not considered trading securities and the System demonstrates the ability and intent to hold the securities until they recover.

Assets Limited as to Use

Assets limited as to use include assets held by trustees under indenture agreements and are classified as current assets to the extent they are to be used to pay for current liabilities.

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Useful lives are 3 to 40 years for property and equipment.

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

Construction in progress as of September 30, 2017 primarily relates to construction of the detoxification unit. The estimated cost to complete the project as of September 30, 2017 is approximately $6,100,000, of which all has been contractually committed.

Other Assets

The System has an equity interest in a joint venture. This investment is recorded on the equity method of accounting in the System's financial statements. The total equity interest in this joint venture was approximately $160,000 and $160,000 as of September 30, 2017 and 2016, respectively. This balance is included within other assets on the statements of financial position and is immaterial to the financial statements as a whole.

Net Assets

The financial statements have been prepared in accordance with the Not-for-Profit Entities topic of the Financial Accounting Standards Board Accounting Standards Codification (FASB ASC). This topic requires, among other things, that the financial statements report the changes in, and totals of each net asset class based on the existence of donor restrictions, as applicable. Net assets are classified as unrestricted, temporarily restricted, or permanently restricted and are detailed as follows:

- Unrestricted net assets represent the part of the net assets of the System that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

- Temporarily restricted net assets represent the part of the net assets of the System resulting from contributions and other inflows of assets whose use by the System is limited by donor-imposed stipulations that either expire by the passage of time or by actions of the System. The System's temporarily restricted net assets reflect the beneficial interest in the net assets of Fayette Regional Health System Foundation as of September 30, 2017 and 2016.

- Permanently restricted net assets represent the part of the net assets of the System resulting from contributions and other inflows of assets whose use by the System is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions for the System. There were no permanently restricted net assets as of September 30, 2017 and 2016.

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received and are included in other revenue if the promise to give is unrestricted. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. The System holds a beneficial interest in the net assets of Fayette Regional Health System Foundation that is adjusted to reflect that activity of the Foundation. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Indiana Hospital Assessment Fee Program

During 2012, the Indiana Hospital Assessment Fee (HAF) Program for the period July 1, 2011 through June 30, 2013 was approved by the Centers for Medicare & Medicaid Services (CMS) retroactive to July 1, 2011. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share (DSH) payments for Indiana hospitals. Previously, the State share was funded by governmental entities through intergovernmental transfers. The Medicaid enhanced payments relate to both fee for service and managed care claims. Under the HAF Program, the enhanced Medicaid payments follow the patients and are realized through increased Medicaid rates.

During 2017 and 2016, the System recognized HAF assessment fee expense of approximately $1,071,000 and $911,000, respectively, which resulted in increased Medicaid reimbursement.

The HAF Program was approved for extension by CMS through June 30, 2019.

Charity Care and Community Benefit

The System provides charity care on a case-by-case basis for those patients who meet certain criteria of financial need. This care is provided without charge or at amounts less than established rates. Because the System does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The System maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services and supplies furnished under its charity care policy.

Of the System's total expenses reported, an estimated $473,000 and $502,000 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 System's total expenses (less bad debt expense) divided by gross patient service revenue.

Advertising Costs

The System's policy is to expense advertising costs when the advertising first takes place. Advertising expenses were approximately $131,000 and $217,000 in 2017 and 2016, respectively.

Pension Plans

The System maintains a defined contribution pension plan (the Plan) covering substantially all employees. The System made no discretionary profit sharing contributions or discretionary mating contributions to the Plan during 2017 and 2016.

The System also maintains a 457(b) deferred compensation plan that provides for non-elective employer deferrals covering a select group of management or highly compensated individuals.

It is the System's policy to fund pension costs as accrued. Pension expense was approximately ($11,000) and $9,000 in 2017 and 2016, respectively.

Operating Indicator

The statements of operations include an operating indicator, operating income. Operating income includes transactions that are pursuant to and used in the operations of the System.

Performance Indicator

The statements of operations include a performance indicator, excess revenues over expenses. Changes in unrestricted net assets, which are excluded from excess revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments that are considered to be other than trading securities and contributions of long-lived assets.

Medical Malpractice Claims

The System participates in the Indiana Medical Malpractice Act, which limits the maximum recovery to $1,250,000 per occurrence, the first $250,000 of which would be the responsibility of the System, with the balance paid by the State of Indiana Patient Compensation Fund. The System carries an occurrence basis insurance policy covering the System's $250,000 of exposure per claim. Accordingly, the System has not recorded any provision for self-insured medical malpractice claims.

Federal and State Income Taxes

The System is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code. Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the System and recognize a tax liability if the System has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the System, and has concluded that as of September 30, 2017 and 2016, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements.

As such, the System is generally exempt from income taxes. However, the System is required to file Federal Form 990 – Return of Organization Exempt from Income Tax, which is an informational return only. The System has filed its federal and state income tax returns for September 30, 2016.

The System is subject to routine audits by taxing jurisdictions; however, as of the date the financial statements were issued, there were no audits for any tax periods in progress.

Going Concern Evaluation

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

Reclassifications

Certain 2016 balances were reclassified to agree with the current year presentation. There were no changes to net assets or changes in net assets, as previously reported.

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 System is not required to adopt until its year ending September 30, 2020, deal with the timing of reporting revenues from contracts with customers, and disclosures related thereto.

On January 5, 2016, the FASB issued ASU No. 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This new standard, which the System is not required to adopt until its year ending September 30, 2020, is intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The primary impact on the System will be that changes in the fair value of equity investments will be included in excess revenues over expenses.

On February 25, 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This new standard, which the System is not required to adopt until its 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 an Accounting Standards Update (ASU) No. 2016-14 Presentation of Financial Statements of Not-for-Profit Entities (Topic 958) that amends how a not-for-profit 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 System 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.

On November 17, 2016, the FASB issued an ASU No. 2016-18 Statement of Cash (Topic 230) – Restricted Cash. This new standard intends to eliminate diversity in practice by requiring the statement of cash flows to present the change in the total cash and cash equivalents, which will include restricted cash and cash equivalents. The System will be required to adopt this new standard in the year ending September 30, 2020.

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

Subsequent Events

The System has evaluated events or transactions occurring subsequent to the statement of financial position date for recognition and disclosure in the accompanying financial statements through the date the financial statements are available to be issued which is March 30, 2018.

2. CHANGE IN ACCOUNTING PRINCIPLES

During 2017, the System 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 entity's ability to continue as a going concern for a period of one year from the date the financial statements are available to be issued. When conditions or events that raise substantial doubt exist, additional disclosures will be required to enable 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. Note 15 to the financial statements has been updated to comply with the new disclosure requirements of ASU 2014-15.

3. INVESTMENTS AND ASSETS LIMITED AS TO USE

The composition of investments and assets limited as to use at September 30, 2017 and 2016 follows:

	2017	2016
Money market deposit accounts	$ 3,001,036	$ 4,184,663
Money market mutual funds	196,413	195,849
Hedge funds	-0-	320,645
	$ 3,197,449	$ 4,701,157

Investment return for 2017 and 2016 is as follows:

	2017	2016
Investment income		
Interest and dividend income	$ 2,341	$ 132,807
Net realized gain (loss) on investments	10,181	(645,237)
	12,522	(512,430)
Net unrealized gain (loss) on investments	(2,035)	88,802
Investment return, net	$ 10,487	$ (423,628)

Investment fees for 2017 and 2016 were approximately $-0- and $208,000, respectively. The fees are offset against investment income (loss) included within non-operating revenue (expenses) on the statements of operations.

There were no investments in an unrealized loss position as of September 30, 2017 and 2016.

Assets limited as to use include funds held by trustees subject to indenture agreements. All investments are considered other-than-trading securities by management. Assets limited as to use that are required for certain obligations classified as current liabilities are reported in current assets.

The funds held by trustee subject to indentures (investments are comprised of cash and cash equivalents) consist of the following as of September 30, 2017 and 2016:

	2017	2016
Indiana Finance Authority		
Health Facility Revenue and Refunding Bonds,		
Series 2013, Sinking Fund	$ 43	$ 526,758
	$ 43	$ 526,758

4. 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 System 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.

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

- *Money market mutual funds:* Generally, transact subscription and redemption activity at a $1 stable net asset value (NAV) however, on a daily basis the funds are valued at their daily NAV calculated using the amortized cost of the securities held in the fund.

- *Hedge funds:* Valued at the net asset value (NAV) of units of the fund. The NAV, as provided by the investment manager, is used as a practical expedient to estimate fair value. The hedge funds consist of investments in a variety of domestic and foreign equity and debt securities, managed accounts and other investment vehicles that employ diversified styles and strategies. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. Due to the nature of the investments held by the fund, changes in market conditions and the economic environment may significantly impact the net asset value of the fund and, consequently, the fair value of the System's interests in the funds. Although a secondary market exists for these investments, it is not active and individual transactions are typically not observable. When transactions do occur in this limited secondary market, they may occur at discounts to the reported net asset value. It is therefore reasonably possible that if the System were to sell these investments in the secondary market, a buyer may require a discount to the reported net asset value, and the discount could be significant.

- *Derivative liability:* The derivative liability is an interest rate swap agreement that is 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.

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

	September 30, 2017			
	Total	Level 1	Level 2	Level 3
Investments				
Money market mutual funds	$ 196,413	$ -0-	$ 196,413	$ -0-
Total investments in the fair value hierarchy	196,413	$ -0-	$ 196,413	$ -0-
Money market deposit accounts	3,001,036			
Total investments and assets limited as to use	$ 3,197,449			
Long-term liabilities				
Derivative liability	$ 1,288,593	$ -0-	$ 1,288,593	$ -0-

	September 30, 2016			
	Total	Level 1	Level 2	Level 3
Investments				
Money market mutual funds	$ 195,849	$ -0-	$ 195,849	$ -0-
Total investments in the fair value hierarchy	195,849	$ -0-	$ 195,849	$ -0-
Hedge funds (a)	320,645			
Money market deposit accounts	4,184,663			
Total investments and assets limited as to use	$ 4,701,157			
Long-term liabilities				
Derivative liability	$ 2,628,625	$ -0-	$ 2,628,625	$ -0-

(a) In accordance with Subtopic 820-10, certain investments that were measured at NAV per share or its equivalent have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the line items presented at fair value in the statements of financial position.

The System's policy is to recognize transfers between levels as of the end of the reporting period. There were no transfers during 2017 and 2016.

Realized gains and losses are reported in the statements of operations as a component of investment income.

The System 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.

Fair Value of Investments in Entities that Use Net Asset Value

The following table summarizes investments measured at fair value based on net asset value per share as of September 30, 2016. There were no investments measured at fair value based on net asset value per share as of September 30, 2017.

September 30, 2016				
Investment	Fair Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Hedge funds - multi-strategy	$ 320,645	None	Quarterly	1 Year
	$ 320,645			

5. RELATED PARTIES

The Fayette Memorial Hospital Foundation, Inc., d/b/a Fayette Regional Health System Foundation (the Foundation), which is a financially interrelated organization with Fayette Regional Health System was established to solicit contributions from the general public and to support the System activities. Funds are distributed to the System as determined by the Foundation's Board of Trustees and therefore all net assets are classified as temporarily restricted within the System's statement of financial position.

A summary of the Foundation assets, liabilities, and net assets for September 30, 2017 and 2016, follows.

	2017	2016
Financial position		
Assets, principally cash, investments and property	$ 1,166,249	$ 1,244,235
Liabilities	$ 78,471	$ 127,399
Net assets	1,087,778	1,116,836
Total liabilities and net assets	$ 1,166,249	$ 1,244,235

Below is a summary of the Foundation results of operations and changes in net assets for the years ended September 30, 2017 and 2016:

	2017	2016
Statement of activities		
Support, revenue and income	$ 98,787	$ 447,363
Expenses		
Contributions to Fayette Regional Health System	9,604	56,233
Other	155,466	235,943
Total expenses	165,070	292,176
Excess revenue over (under) expenses	(66,283)	155,187
Net unrealized gains (losses) on investments	42,557	70,693
Unrestricted net assets, beginning of year	734,598	508,718
Unrestricted net assets, end of year	710,872	734,598
Temporarily restricted net assets	376,906	382,238
Net assets, end of year	$ 1,087,778	$ 1,116,836
Change in temporarily restricted net assets	$ (5,332)	$ 18,269
Change in interest in Foundation	$ (29,058)	$ 244,149

The System provided accounting and financial management services to the Foundation of approximately $114,000 and $141,000 during 2017 and 2016, respectively.

The System purchased services from organizations that employ board members related primarily to credit bureau services for 2017 and 2016 in the amount of approximately $342,000 and $321,000, respectively.

6. DERIVATIVE LIABILITIES

The System makes limited use of derivative financial instruments for the purpose of managing interest rate risk. In particular, interest rate swaps (which are designed as cash flow hedges) are used to manage risk associated with interest rates on variable-rate borrowings and to lower its overall borrowing costs.

At September 30, 2017, the System had outstanding two interest rate swap agreements with a commercial bank, having a total principal amount of $15,730,000. Those agreements effectively change the System’s interest rate exposure on its variable rate revenue bonds, series 2002A, due 2024 to a fixed 3.47% and its variable rate revenue bonds, series 2002B, due 2022 to a fixed 4.13%. The related bonds have been retired as of September 30, 2013, but the interest rate swap agreements remained in place. During 2014, a novation transaction served to replace the interest rate swap agreement on the series 2002B with a new agreement at a different commercial bank. The terms of the new agreement remained substantially unchanged from the old agreement. The interest rate swap on the series 2002A remained with the existing commercial bank. During August 2016, the series 2002A swap agreement was amended, which accelerated the maturity date of the swap to May 1, 2024 from May 1, 2027 and required the System to pay $250,000 towards the swap liability in August 2016. In addition, the amendment required that the System pay a minimum of $200,000 towards the swap liability every June 1 and December 1 until the associated balance is $-0-. As of September 30, 2017, the notational amount of the 2002A swap was $9,775,000 and the notational amount of the 2002B swap was $4,835,000.

These derivatives are not designated as hedging instruments, and are marked-to-market on the statement of financial position at fair value at the end of each period. The related gains and loss are included in excess of revenues over expenses, the performance indicator, for the reporting period. Cash flows from interest rate swap contracts are classified as an operating activity on the statement of cash flows.

The derivatives are reported as derivative liabilities. At September 30, 2017 and 2016, the fair values of derivatives recorded in the statement of financial position are as follows:

	2017	2016
Interest rate swap agreements	$ 1,288,593	$ 2,628,625

During 2017 and 2016, the amounts of gain or loss recognized in the statement of operations are as follows:

2017

Financial instrument	Loss		Location
Interest rate swap agreements	$	940,032	Unrealized gain (loss) on derivatives

2016

Financial instrument	Loss		Location
Interest rate swap agreements	$	(66,704)	Unrealized gain (loss) on derivatives

Additional information regarding fair value measurements of the interest rate swap agreements is disclosed in Note 4.

7. LONG-TERM DEBT AND LINE-OF-CREDIT

A summary of long-term debt at September 30, 2017 and 2016 follows:

	2017	2016
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 1998, Adjustable interest rate every 5 years, based on the then current 5 year treasury rate, 0.66% at September 30, 2017 with principal maturing in varying monthly amounts of approximately $3,800 to $4,100 through 2018.	$ 25,062	$ 70,624
Indiana Finance Authority Health Facility Revenue and Refunding Bonds, Series 2013, variable interest rate, based on the LIBOR rate, 5.385% at September 30, 2017 with with principal maturing in varying annual amounts of $818,000 to $1,714,000 through 2032.	14,381,000	15,381,000
	14,406,062	15,451,624
Less unamortized bond issue costs	251,018	265,779
Less current maturities	843,062	1,046,803
	$ 13,311,982	$ 14,139,042

On May 18, 1999, the System issued $1,400,000 of Revenue bonds, Series 1998 through the Indiana Health Facility Financing Authority for the purchase of computer equipment and the construction of a new facility.

On August 21, 2013, the System issued $21,106,000 of Revenue and Refunding Bonds, Series 2013 (Series 2013 bonds) through the Indiana Finance Authority Health Facility (the Authority) to refinance the 2002 Series A and B bonds and fund the construction of an addition to the System facilities. The bonds were a private placement with Comerica Bank (Comerica) and are not actively traded on the market.

On October 16, 2014, March 23, 2015, and May 27, 2016, the Series 2013 bonds were re-issued through the Authority to amend certain borrower covenants, the basis for the interest rate and to shorten the period of time between calls on the bonds. Pursuant thereto, Comerica agreed to hold the bonds until at least June 30, 2017 (Initial Purchase Date) in accordance with the related terms and conditions of the Trust Indenture. The Initial Purchase Date was extended until December 31, 2018 with the amendment to the debt forbearance agreement, as discussed below.

Principal repayments on long-term debt are as follows:

Year ending September 30,		
2018	$	843,062
2019		863,000
2020		910,000
2021		959,000
2022		1,011,000
Thereafter		9,820,000
	$	14,406,062

The debt instruments are secured by substantially all assets and require the System to comply with certain restrictive financial covenants. However, the System and Comerica entered into a forbearance agreement, as further discussed in note 8.

8. DEBT FORBEARANCE AGREEMENT

As of September 30, 2015, the System was in default under the loan documents related to the Series 2013 Bonds for failure to pay all accrued interest when due (Interest default), and for noncompliance with certain financial covenants.

On June 30, 2016, the System entered into a forbearance agreement (the Agreement) with Comerica. The Agreement required the System to pay off the line of credit (approximately $7,000,000 with interest), fund a sinking account totaling the amount owed to pay the next 12 months of interest on the Series 2013 Bonds, pay in full all past interest due, and to pay any applicable transaction fees. Funds utilized for these payments were provided from the System’s cash and investment accounts. As part of the agreement, Comerica agreed it would not take further action to collect liabilities owed by the System, until the occurrence of a Forbearance Termination Event, as stipulated by the Agreement. The Agreement constituted a waiver of the Interest default by the System, but did not waive any defaults related to noncompliance with the various financial covenants.

Prior to the execution of the Agreement but as a precondition to the Agreement, the System optionally redeemed $4,363,000 of the Series 2013 Bonds.

During 2016, the System corrected the Interest Default. As of and subsequent to September 30, 2016, the System was in default under the loan documents related to the Series 2013 Bonds for noncompliance with certain financial covenants.

During August 2017, Comerica amended the Agreement, which extended the termination date until December 31, 2018. Prior to the execution of the amendment of the Agreement but as a precondition to the amendment of the Agreement, the System optionally redeemed $1,000,000 of the Series 2013 Bonds. The amendment also imposed various additional financial covenants on the System. During November 2017, Comerica amended the Agreement, which amended various financial covenants on the System, of which management believes they were in compliance.

9. LEASE OBLIGATIONS

Operating Leases

The System leases equipment under non-cancelable operating leases expiring in various years through 2022. Total rental expense amounted to approximately $648,000 and $722,000 for 2017 and 2016, respectively.

Future minimum payments under the operating leases with initial terms in excess of one year are as follows:

Year ending September 30,		
2018	$	82,357
2019		16,056
2020		16,056
2021		16,056
2022		6,690
	$	137,215

Capital Leases

The System has various capital lease arrangements for medical equipment expiring through 2022. Interest rates range from approximately 0% to 12% with monthly payments ranging from approximately $350 to $29,700. The leases are secured by property and equipment.

The following is the cost and accumulated depreciation on capital lease assets as of September 30, 2017 and 2016:

	2017	2016
Equipment	$ 4,569,500	$ 4,388,562
Accumulated depreciation	3,535,372	3,313,483
	$ 1,034,128	$ 1,075,079

Future payments under all capital lease obligations are as follows:

Year ending September 30,	
2018	$ 322,424
2019	183,059
2020	183,059
2021	181,825
2022	109,401
	979,768
Less interest	76,938
	$ 902,830

10. NET PATIENT SERVICE REVENUE

The System has agreements with third-party payors that provide for reimbursement to the System at amounts different from its established rates. Estimated contractual adjustments under third-party reimbursement programs represent the difference between the System's billings at standard rates and amounts reimbursed by third-party payors. They also include any differences between estimated third-party reimbursement settlements for prior years and subsequent final settlements. A summary of the reimbursement arrangements with major third-party payors is as follows:

Medicare and Medicaid

Medicare inpatient services are reimbursed based on a predetermined amount for each case based on the diagnosis associated with the patient (Prospective Payment System). 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. The System's classification of patients under the Prospective Payment System and the appropriateness of patient admissions are subject to validation reviews by the Medicare peer review organization, which is under contract with the System to perform such reviews. Medicare outpatient services are primarily reimbursed on predetermined rates based on the services provided. Medicare cost reports have been settled through 2015.

The System is reimbursed for Medicaid inpatient services under a prospectively determined rate-per-discharge and is not subject to retroactive adjustment. The differences between standard charges and reimbursement from these programs are recorded as contractual adjustments. Reimbursement for Medicaid outpatient services is based on predetermined rates, and is not subject to retroactive cost based settlements.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The System believes that it is in compliance with all applicable laws and regulations and has provided for settlement of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Other Payors

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

A summary of net patient service revenue, contractual adjustments and charity care for the years ended September 30, 2017 and 2016 follows:

	2017	2016
Patient service revenue		
Inpatient		
Routine services	$ 14,706,997	$ 13,797,007
Ancillary services	9,372,250	9,068,451
Outpatient		
Ancillary services	70,134,206	73,594,906
Physician services	11,935,404	17,740,831
Patient service revenue	106,148,857	114,201,195
Deductions		
Charity care	(1,017,605)	(1,095,020)
Contractual adjustments	(61,583,113)	(65,120,768)
Provisions for bad debts	(1,748,688)	(3,980,236)
Deductions	(64,349,406)	(70,196,024)
Net patient service revenue	$ 41,799,451	$ 44,005,171

11. ELECTRONIC HEALTH RECORDS (EHR) INCENTIVE PAYMENTS

The System receives EHR incentive payments under the Medicare and Medicaid programs. To qualify for these payments, the System must meet "meaningful use" criteria that become more stringent over time. The System periodically submits and attests to its use of certified EHR technology, satisfaction of meaningful use objectives, and various patient data. These submissions generally include performance measures for each annual EHR reporting period (ending on September 30th). The related EHR incentive payments are paid out over a four-year transition schedule and are based upon data that is captured in the System's cost reports. The payment calculation is based upon an initial amount as adjusted for discharges, Medicare utilization using inpatient days multiplied by a factor of total charges excluding charity care to total charges, and a transitional factor that ranges from 100% in first payment year and thereby decreasing by 25% each payment year until it is completely phased out in the fifth year.

The System recognizes EHR incentive payments as grant income when there is reasonable assurance that the System will comply with the conditions of the meaningful use objectives and any other specific grant requirements. In addition, the financial statement effects of the grants must be both recognizable and measurable. During 2017 and 2016, the System recognized approximately $-0- and $308,000 respectively, in EHR incentive payments as grant income using the cliff recognition method. Under the cliff recognition method, the System records income at the end of EHR reporting period in which compliance is achieved.

EHR incentive income is included in other revenue in the statement of operations. EHR incentive income recognized is based on management's estimate and amounts are subject to change, with such changes impacting operations in the period the changes occur.

Receipt of these funds is subject to the fulfillment of certain obligations by the System as prescribed by the program, subject to future audits and may be subject to repayment upon a determination of noncompliance.

12. CONCENTRATIONS OF CREDIT RISK

The System grants credit without collateral to its patients, most of who are local residents and are generally insured under third-party payor agreements. Accounts receivable as of September 30, 2017 and 2016 and gross patient service revenue from patients and third party payors for 2017 and 2016 is as follows:

	Receivable		Revenue	
	2017	2016	2017	2016
Medicare	29%	31%	39%	39%
Medicaid	33%	21%	32%	31%
Blue Cross	6%	6%	11%	11%
Commercial insurance	8%	12%	13%	15%
Patients	24%	30%	5%	4%
	100%	100%	100%	100%

13. FUNCTIONAL EXPENSES

The System is an acute care facility providing inpatient, outpatient, emergency and other ancillary services to residents within its geographical location. Expenses related to providing these services approximate the following:

	2017	2016
Health care services	$ 43,275,315	$ 45,928,634
Administrative and general	6,101,511	6,475,610
	$ 49,376,826	$ 52,404,244

14. COMMITMENTS AND CONTINGENCIES

Self-Funded Health Plan

The System is committed to pay for employees' health care costs. A third-party administrator has been retained to process and present all benefit claims to the System for payment. The System has purchased excess loss insurance from United States Fire Insurance Company. The System is responsible for the funding of all claims and related administrative costs up to $150,000 per individual per policy year. The United States Fire Insurance Company's liability under the policy is limited to $1,000,000 per policy year on the group as a whole as of September 30, 2017. Group health insurance expense for 2017 and 2016 totaled approximately $2,941,000 and $2,734,000, respectively.

<u>Litigation</u>

The System is involved in litigation and regulatory investigations arising in the normal course of business. After consultation with legal counsel, the effect if any on the Systems future position, results from operations, and cash flows for certain regulatory investigations is not determinable at this time.

15. MANAGEMENT'S PLAN

As shown in the accompanying financial statements, the System experienced net losses as noted in the excess of revenues over (under) expenses of approximately ($171,000) and ($3,897,000) in 2017 and 2016, respectively. During 2017, cash and investments decreased by approximately ($2,507,000). The net days cash on hand decreased from 61 to 46 during 2017. In addition, the System has experienced substantial decreases in volumes and net patient service revenues over the last few years. Due to the losses, the System defaulted on certain debt covenants for 2016 and as a result obtained a forbearance from the bank. Furthermore, as discussed in Note 8, the forbearance agreement was amended in 2017.

During 2017, the Hospital obtained a grant commitment of approximately $9,200,000 from the Indiana State Department of Health (passed through from the Department of Health and Human Services) to help create and fund a residential substance abuse treatment program. Management believes this program will enhance revenue growth from increased volumes, as there is substantial demand for these services within the Hospital's geographic catchment area.

Certain operational improvement initiatives to enhance revenue, streamline operations and reduce costs are being implemented by management. Management is analyzing strategies to improve/stabilize volumes. Management is concurrently pursuing opportunities to enhance liquidity. As part of these initiatives, management is strategically analyzing service lines to curtail and contain costs. Management has reduced full-time equivalents in efforts to streamline and reduce operating costs. As part of the revenue enhancements management is reviewing various reimbursement/payment options and working to improve revenue cycle operations. Management has instituted a detail cash flow budgeting process to monitor the results of the ongoing changes.

Management expects the combination of cost reductions, operational and service line changes, and revenue and liquidity enhancements to stabilize cash flow and the bottom line.