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DEKALB HEALTH

CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2018 AND 2017

CPAs / ADVISORS



DEKALB HEALTH

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REPORT OF INDEPENDENT AUDITORS

Board of Directors
DeKalb Memorial Hospital, Inc.
d/b/a DeKalb Health
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 sheets as of September 30, 2018 and 2017, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the 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 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 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.
d/b/a DeKalb Health
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, 2018 and 2017, and the results of its operations and its 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
November 29, 2018

DEKALB HEALTH

CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2018 AND 2017

ASSETS

	2018	2017
Current assets		
Patient accounts receivable, less allowances for uncollectible accounts of \$5,849,048 in 2018 and \$4,651,107 in 2017	\$ 8,992,192	\$ 8,238,232
Inventories	1,841,904	1,579,003
Prepaid expenses and other current assets	466,568	652,878
Estimated settlements due from third-party payors	-0-	72,689
Total current assets	11,300,664	10,542,802
Assets limited as to use		
Internally designated funds	18,826,725	17,669,520
Externally restricted by donors	-0-	54,110
Total assets limited as to use	18,826,725	17,723,630
Property and equipment, net	34,933,182	36,671,600
Other assets	524,035	120,666
Total assets	\$ 65,584,606	\$ 65,058,698

LIABILITIES AND NET ASSETS

	2018	2017
Current liabilities		
Accounts payable	\$ 4,278,367	\$ 3,531,328
Accrued salaries and related liabilities	2,791,423	2,632,760
Estimated settlements due to third-party payors	168,361	-0-
Other accrued liabilities	767,654	545,574
Line of credit	1,101,557	1,145,973
Current portion of capital leases	161,953	257,455
Current portion of long-term debt	605,586	826,886
Total current liabilities	9,874,901	8,939,976
Long-term liabilities		
Interest rate swap liability	-0-	228,857
Capital leases, less current portion	253,956	415,909
Long-term debt, less current portion	8,820,996	7,579,643
Total long-term liabilities	9,074,952	8,224,409
Total liabilities	18,949,853	17,164,385
Net assets		
Unrestricted	46,634,753	47,840,203
Temporarily restricted	-0-	54,110
Total net assets	46,634,753	47,894,313
Total liabilities and net assets	\$ 65,584,606	\$ 65,058,698

See accompanying notes to consolidated financial statements.

DEKALB HEALTH

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2018 AND 2017

	2018	2017
Unrestricted revenue and other support		
Net patient service revenue	\$ 75,103,199	\$ 67,836,343
Less provision for uncollectible accounts	9,140,470	4,633,159
Net patient service revenue net of provision for bad debts	65,962,729	63,203,184
Rental income	878,088	747,933
Contributions	63,410	6,602
Other revenue	1,515,045	1,199,690
Total unrestricted revenue and other support	68,419,272	65,157,409
Expenses		
Salaries and wages	28,683,067	28,633,652
Employee benefits	9,471,153	8,190,739
Purchased other services	6,238,984	6,627,185
Supplies and drugs	13,481,299	11,578,962
Repairs and maintenance	1,361,721	1,731,232
Utilities	1,159,450	1,159,025
Insurance	669,553	774,142
Rent	438,258	237,859
Hospital assessment fee	2,707,375	1,964,450
Depreciation	4,287,651	4,751,892
Interest	461,179	419,726
Other	1,939,194	2,109,886
Total expenses	70,898,884	68,178,750
Loss from operations	(2,479,612)	(3,021,341)
Nonoperating gains (losses)		
Interest and dividends	472,162	496,538
Net unrealized gains (losses) on investments	265,359	(189,809)
Net realized gains on investments	500,897	1,466,795
Gain (loss) on disposal of property and equipment	(18,366)	33,150
Total nonoperating gains (losses), net	1,220,052	1,806,674
Revenue and other support under expenses	(1,259,560)	(1,214,667)
Other changes in unrestricted net assets		
Net assets released from restrictions used for purchase of property and equipment	54,110	-0-
Unrealized gain on interest rate swap	-0-	451,652
Total other changes in unrestricted net assets	54,110	451,652
Changes in unrestricted net assets	(1,205,450)	(763,015)
Temporarily restricted net assets		
Contributions	-0-	54,110
Net assets released from restriction	(54,110)	-0-
Changes in temporarily restricted net assets	(54,110)	54,110
Changes in net assets	(1,259,560)	(708,905)
Net assets		
Beginning of year	47,894,313	48,603,218
End of year	\$ 46,634,753	\$ 47,894,313

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2018 AND 2017

	2018	2017
Operating activities		
Changes in net assets	\$ (1,259,560)	\$ (708,905)
Adjustments to reconcile change in net assets to net cash from operating activities:		
Depreciation	4,287,651	4,751,892
Provision for bad debts	9,140,470	4,633,159
(Gain) loss on disposal of property and equipment	18,366	(33,150)
Net realized gains on investments	(500,897)	(1,466,795)
Net unrealized (gains) losses on investments	(265,359)	189,809
Change in fair value of interest rate swap agreement	-0-	(451,652)
Contributions for long-lived assets	-0-	(54,110)
Changes in operating assets and liabilities:		
Patient accounts receivable, net	(9,894,430)	(4,804,080)
Inventories	(262,901)	(311,387)
Prepaid expenses and other current assets	186,310	16,523
Other assets	(403,369)	(52,592)
Accounts payable	747,039	1,192,549
Accrued salaries and related liabilities	158,663	(57,339)
Estimated settlements due/from to third-party payors	241,050	(547,505)
Interest rate swap liability	(228,857)	-0-
Other accrued liabilities	222,080	(224,148)
Net cash flows from operating activities	<u>2,186,256</u>	<u>2,072,269</u>
Investing activities		
Purchase of property and equipment	(2,567,599)	(2,732,034)
Purchase of investments	(6,233,956)	(7,223,777)
Proceeds from disposition of property and equipment	-0-	33,150
Proceeds from disposition of investments	5,897,117	6,734,897
Net cash flows from investing activities	<u>(2,904,438)</u>	<u>(3,187,764)</u>
Financing activities		
Principal payments on long-term debt	(9,113,984)	(1,133,719)
Proceeds from issuance of long-term debt	9,876,582	-0-
Payments on line of credit	(44,416)	-0-
Proceeds from line of credit	-0-	1,145,973
Proceeds from restricted contributions	-0-	54,110
Net cash flows from financing activities	<u>718,182</u>	<u>66,364</u>
Net change in cash and cash equivalents	-0-	(1,049,131)
Cash and cash equivalents		
Beginning of year	-0-	1,049,131
End of year	<u>\$ -0-</u>	<u>\$ -0-</u>
Supplemental cash flows information		
Cash paid for interest	\$ 461,179	\$ 419,726
Property and equipment included in accounts payable	\$ 817,174	\$ -0-

See accompanying notes to consolidated financial statements.

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

DeKalb Memorial Hospital, Inc., d/b/a DeKalb Health (the 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.

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 2018 and 2017. Of the Hospital's total expenses reported within the consolidated statements of operations and changes in net assets, an estimated \$205,000 and \$378,000 arose from providing services to charity patients during 2018 and 2017, 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.

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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, 2018 and 2017, 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 payors 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 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 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 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 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, 2018 AND 2017

During 2018, the Hospital's allowance for uncollectible accounts changed from approximately \$4,651,000 at September 30, 2017, to approximately \$5,849,000 at September 30, 2018. As of September 30, 2018, the Hospital's allowance for uncollectible accounts was comprised of approximately \$2,706,000 reserved for self-pay balances and approximately \$3,143,000 reserved for third-party payor balances. As of September 30, 2017, the 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. The increase in allowance from 2017 to 2018 was the result of trends experienced in the collection of self-pay patients in fiscal year 2018 and an electronic health records conversion.

During 2017, the Hospital's allowance for uncollectible accounts changed from approximately \$5,508,000 at September 30, 2016, to approximately \$4,651,000 at September 30, 2017. The decrease in allowance from 2016 to 2017 was the result of trends experienced in 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, 2018 and 2017 was as follows:

	Receivables		Revenue	
	2018	2017	2018	2017
Medicare	33%	28%	44%	44%
Medicaid	16%	18%	15%	16%
Commercial and other	39%	33%	36%	37%
Self-pay	12%	21%	5%	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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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.

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 net realizable value with cost being determined on the first-in, first-out 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

Advertising Costs

Advertising costs are expenses as incurred. Total advertising expense for 2018 and 2017 was approximately \$273,000 and \$338,000, respectively, and are recorded as operating expenses within the consolidated statements of operations and changes in net assets.

Estimated Malpractice Costs

The Hospital purchases professional and general liability insurance to cover medical malpractice claims. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted arising from services provided to patients.

The Indiana Medical Malpractice Act, IC 34-18 (Act) provides a maximum recovery of \$1,650,000 for an occurrence of malpractice until June 30, 2019, and \$1,800,000 thereafter. The Act requires the Hospital to maintain medical malpractice liability insurance in the amount of at least \$400,000 per occurrence (\$8,000,000 in the annual aggregate) until June 30, 2019. Starting July 1, 2019, the Act will require the Hospital to maintain medical malpractice liability insurance in the amount of at least \$500,000 per occurrence (\$10,000,000 in the annual aggregate). The Act also requires the Hospital to pay a surcharge to the State Patient's Compensation Fund (Fund). The Fund is used to pay medical malpractice claims in excess of per occurrence and the annual aggregate amounts as noted above, under certain terms and conditions. No accrual for possible losses attributable to incidents that may have occurred but that have not been identified has been made because the amount, if any, is not reasonably estimable. The Fund is on a claims-made basis and as long as this coverage is continuous or replaced with equivalent insurance, claims based on occurrences during its term but reported subsequently will be insured.

Accounting principles generally accepted in the United States of America require a health care provider to accrue the expense of its share of malpractice claim costs, if any, for any reported and unreported incidents of potential improper professional service occurring during the year by estimating the probable ultimate costs of the incidents. Based upon the Hospital's claim experience, no such accrual has been made. It is reasonably possible that this estimate could change materially in the near term.

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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 under expense. Changes in unrestricted net assets, which are excluded from revenue and other support under expense, consistent with industry practice, include net assets released from restrictions, unrealized gain on the interest rate swap 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.

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 29, 2018.

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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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 balance sheet.

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.

On June 21, 2018, FASB issued ASU 2018-08, *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. The amendments in this ASU clarify and improve current guidance about whether a transfer of assets (or the reduction, settlement, or cancellation of liabilities) is a contribution or an exchange transaction. The amendments clarify how an entity determines whether a resource provider is participating in an exchange transaction by evaluating whether the resource provider is receiving commensurate value in return for the resources transferred. Additionally, the amendments in this ASU require that an entity determine whether a contribution is conditional on the basis of whether an agreement includes a barrier that must be overcome and either a right of return of assets transferred or a right of release of a promisor's obligation to transfer assets. Finally, ASU 2018-08 amends the "simultaneous release accounting policy" to allow a not-for-profit entity to recognize a restricted contribution directly in unrestricted net assets/net assets without donor restrictions if the restriction is met in the same period that revenue is recognized. The Hospital will be required to adopt this new standard in the year ending September 30, 2020.

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

2. 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

The Hospital recognizes patient service revenue associated with services provided to patients who have third-party payor 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 payors 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:

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 \$2,707,000 and \$1,964,000 during 2018 and 2017, 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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.

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, 2018 and 2017 is as follows:

	2018	2017
Inpatient services	\$ 42,985,401	\$ 43,453,253
Outpatient services	137,436,366	126,991,045
Gross patient service revenue	<u>180,421,767</u>	<u>170,444,298</u>
Charity care	(521,474)	(944,038)
Contractual allowances	(104,797,094)	(101,663,917)
Provision for bad debts	(9,140,470)	(4,633,159)
Deductions from revenue	<u>(114,459,038)</u>	<u>(107,241,114)</u>
Net patient service revenue	<u>\$ 65,962,729</u>	<u>\$ 63,203,184</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, 2017.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

3. 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:

	2018	2017
Cash	\$ -0-	\$ 87,215
Certificates of deposit	100,000	-0-
Common stocks	141,293	129,717
Money market mutual funds	17,256	-0-
Mutual funds - equities	9,552,552	11,079,076
Mutual funds - fixed income	9,015,624	6,427,622
Total assets limited as to use	<u>\$ 18,826,725</u>	<u>\$ 17,723,630</u>

Total investment return is comprised of the following:

	2018	2017
Interest and dividend income	\$ 472,162	\$ 496,538
Realized gains on sale of investments	500,897	1,466,795
Unrealized gains (losses) on investments	265,359	(189,809)
Investment return, net	<u>\$ 1,238,418</u>	<u>\$ 1,773,524</u>

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 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.
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DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

- 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 2018 and 2017.

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, 2018 and 2017.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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, 2018 and 2017 are as follows:

	September 30, 2018			
	Total	Level 1	Level 2	Level 3
Assets				
Assets limited as to use				
Common stocks	\$ 141,293	\$ 141,293	\$ -0-	\$ -0-
Money market mutual funds	17,256	-0-	17,256	-0-
Mutual funds				
Equities				
Large blend	5,182,927	5,182,927	-0-	-0-
Large growth	529,070	529,070	-0-	-0-
Large value	1,548,410	1,548,410	-0-	-0-
Mid blend	332,716	332,716	-0-	-0-
Mid growth	12,419	12,419	-0-	-0-
Mid value	982,528	982,528	-0-	-0-
Small blend	21,878	21,878	-0-	-0-
Small growth	22,145	22,145	-0-	-0-
Small value	920,459	920,459	-0-	-0-
Fixed income				
Inflation-protected bonds	754,110	754,110	-0-	-0-
Intermediate-term bonds	3,333,507	3,333,507	-0-	-0-
Short-Term bonds	3,078,570	3,078,570	-0-	-0-
Other	1,849,437	1,849,437	-0-	-0-
Total mutual funds	18,568,176	18,568,176	-0-	-0-
	18,726,725	\$ 18,709,469	\$ 17,256	\$ -0-
Certificates of deposit	100,000			
Total assets limited as to use	\$ 18,826,725			

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

	September 30, 2017			
	Total	Level 1	Level 2	Level 3
Assets				
Assets limited as to use				
Common stocks	\$ 129,717	\$ 129,717	\$ -0-	\$ -0-
Money market mutual funds	-0-	-0-	-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	\$ 228,857	\$ -0-	\$ 228,857	\$ -0-

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: The fair value approximates carrying value based on the borrowing rates currently available to the Hospital for loans and leases with similar terms and maturities.

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

5. PROPERTY AND EQUIPMENT

	2018	2017
Land	\$ 393,118	\$ 393,118
Land improvements	1,808,464	1,797,214
Leasehold improvements	203,151	29,213
Buildings	61,162,990	60,728,294
Equipment	24,909,218	24,552,678
Construction in process	2,403,216	899,962
	<u>90,880,157</u>	<u>88,400,479</u>
Less accumulated depreciation	(55,946,975)	(51,728,879)
	<u>\$ 34,933,182</u>	<u>\$ 36,671,600</u>

As of September 30, 2018, the Hospital had commitments for various property and equipment projects through 2019 that approximated \$2,040,000.

6. 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, 2018 and 2017, includes gross rental income of approximately \$878,000 and \$748,000, respectively, from cancelable and noncancelable leases of the MOBs.

Future minimum lease payments to be received at September 30, 2018, were:

Year Ending September 30,	
2019	\$ 730,004
2020	881,983
2021	850,308
2022	857,887
2023	863,408
Thereafter	<u>2,618,886</u>
	<u>\$ 6,802,476</u>

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

7. RELATED PARTY RECEIVABLE

The Hospital has recorded a long-term receivable in the approximate amount of \$462,000 and \$-0- at September 30, 2018 and 2017, respectively, reflected in other assets on the consolidated balance sheets, from Redimed, LLC for management and clinical support provided. Redimed, which is 50% owned by the Hospital, is a joint venture with Lutheran Hospital that provides urgent care, physical therapy and business health services. The Hospital took over management responsibilities of Redimed in February 2018.

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 4.75% and 3.75% as of September 30, 2018 and 2017, respectively. The Hospital had approximately \$1,102,000 and \$1,146,000 outstanding on the line of credit as of September 30, 2018 and 2017, 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 \$53,542,000 and \$51,032,000 as of September 30, 2018 and 2017, respectively.

9. LONG-TERM DEBT

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

	2018	2017
Note Payable to bank, due December 15, 2022, fixed rate (3.68%), monthly principal and interest payments due in the amount of \$78,451. The note is secured by inventory, accounts receivable, equipment and assets whose use is limited with a net book value of approximately \$53,542,000 as of September 30, 2018.	\$ 9,426,582	\$ -0-
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 as of September 30, 2017. Note Payable was refinanced in 2018.	-0-	8,406,529
Total long-term debt	9,426,582	8,406,529
Less current maturities	(605,586)	(826,886)
	<u>\$ 8,820,996</u>	<u>\$ 7,579,643</u>

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

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

Maturities of long-term debt for the years succeeding September 30, 2018 are as follows:

Year Ending September 30,	
2019	\$ 605,586
2020	627,310
2021	650,789
2022	675,146
2023	6,867,751
	<u>\$ 9,426,582</u>

Capital leases as of September 30 are as follows:

	2018	2017
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 \$339,000 and \$475,000 as of September 30, 2018 and 2017, respectively.	\$ 389,818	\$ 523,833
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 \$58,000 and \$177,000 as of September 30, 2018 and 2017, respectively.	26,091	149,531
Total capital leases	415,909	673,364
Less current maturities	(161,953)	(257,455)
	\$ 253,956	\$ 415,909

Maturities of capital leases for the years succeeding September 30, 2018 are as follows:

Year Ending September 30,	
2019	\$ 166,567
2020	140,352
2021	116,961
	<u>423,880</u>
Less: interest element	(7,971)
Obligations under capital leases	<u>\$ 415,909</u>

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

Following is a summary of property held under capital leases:

	<u>2018</u>	<u>2017</u>
Equipment	\$ 1,275,131	\$ 1,275,131
Less: accumulated depreciation	(877,739)	(623,514)
Property held under capital leases, net	<u>\$ 397,392</u>	<u>\$ 651,617</u>

10. DERIVATIVE FINANCIAL INSTRUMENT – INTEREST RATE SWAP

Objectives and Strategies for Using Derivatives

During 2017, the Hospital made limited use of derivative financial instruments for the purpose of managing interest rate risk. In particular, forward interest rate swaps were used to manage the risk associated with interest rates on variable-rate borrowings and to lower its overall borrowing costs.

At September 30, 2017, the Hospital had an outstanding interest rate swap agreement with Lake City Bank, having a total notational amount of approximately \$8,407,000. 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 paid the variable rate, 2.99%, during 2017. The interest rate swap agreement was set to mature in July 2024. However, the interest rate swap agreement was retired in 2018 during the 2014 Note Payable refinancing.

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.

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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.

		2017
Fair value of interest rate swap agreement	\$	228,857
Balance sheet location of fair value amount		Long-term liabilities
Unrealized gain on interest rate swap recognized in change in unrestricted net assets	\$	451,652
Location of unrealized gain recognized in change 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 4, Fair Value Measurements.

11. NET ASSETS

Temporarily restricted net assets are available for the following purposes:

		2018		2017
Capital asset purchases	\$	-0-	\$	54,110

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 \$118,000 and \$152,000 in 2018 and 2017, 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 health claims in excess of \$150,000 per individual per policy year with an aggregate limit of approximately \$5,650,000. Self-funded health and dental insurance and related expenses approximated \$6,285,000 and \$4,220,000 for 2018 and 2017, respectively.

DEKALB HEALTH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2018 AND 2017

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:

	<u>2018</u>	<u>2017</u>
Health care services	\$ 60,595,999	\$ 58,625,562
General and administrative	10,302,885	9,553,188
	<u>\$ 70,898,884</u>	<u>\$ 68,178,750</u>