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FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidated Financial Statements

September 30, 2017 and 2016

(With Independent Auditors' Report Thereon)

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

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KPMG LLP
Suite 500
501 Riverside Avenue
Jacksonville, FL 32202

Independent Auditors' Report

The Board of Trustees
Flagler Hospital, Inc.:

We have audited the accompanying consolidated financial statements of Flagler Hospital, Inc. and subsidiaries (the System), which comprise the consolidated balance sheets as of September 30, 2017 and 2016, and the related consolidated statements of operations and changes in unrestricted net assets, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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 consolidated financial position of Flagler Hospital, Inc. and subsidiaries as of September 30, 2017 and 2016, and the changes in their net assets and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

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Other Matters

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information in schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

Jacksonville, Florida
January 29, 2018
Certified Public Accountants

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

September 30, 2017 and 2016

Assets		2017	2016
Current assets:			
Cash and cash equivalents	$	4,152,448	990,681
Net patient accounts receivable:			
Patient accounts receivable		39,709,436	44,262,219
Medicare interim payments		4,663,196	4,743,768
		44,372,632	49,005,987
Less allowances for estimated uncollectible accounts		17,224,666	17,807,404
Net patient accounts receivable		27,147,966	31,198,583
Supplies		6,719,765	6,386,550
Estimated third-party payor settlements (note 2)		10,491	—
Prepaid expenses and other current assets		5,032,621	6,018,031
Total current assets		43,063,291	44,593,845
Investments (note 3)		29,845,126	28,081,686
Assets whose use is limited or restricted (note 3)		145,828,192	106,095,957
Property and equipment, net (note 4)		148,112,829	146,135,127
Goodwill (note 15)		10,019,271	10,019,271
Other assets		5,774,816	9,029,878
Total assets	$	382,643,525	343,955,764
Liabilities and Net Assets			
Current liabilities:			
Current maturities of long-term debt (note 5)	$	6,675,000	7,715,000
Accounts payable		12,328,284	15,731,768
Estimated third-party payor settlements (note 2)		—	1,381
Accrued expenses and other current liabilities		21,787,112	15,865,484
Total current liabilities		40,790,396	39,313,633
Derivative financial instrument (note 6)		—	5,218,068
Deferred rent		3,719,080	3,850,341
Other long-term liabilities		2,525,108	4,107,527
Long-term debt, excluding current maturities (note 5)		130,148,303	82,194,854
Total liabilities		177,182,887	134,684,423
Net assets:			
Unrestricted		199,292,843	203,751,144
Temporarily restricted (note 7)		1,776,451	1,510,570
Permanently restricted (note 7)		4,391,344	4,009,627
Total net assets		205,460,638	209,271,341
Commitments and contingencies (notes 5, 9, 10, and 13)			
Total liabilities and net assets	$	382,643,525	343,955,764

See accompanying notes to consolidated financial statements.

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidated Statements of Operations and Changes in Unrestricted Net Assets

Years ended September 30, 2017 and 2016

	2017	2016
Unrestricted revenues:		
Net patient service revenue	$ 237,913,336	238,884,104
Provision for uncollectible accounts	(19,152,192)	(13,913,415)
Net patient service revenue less provision for uncollectible accounts (note 2)	218,761,144	224,970,689
Other operating revenue	7,493,802	8,609,972
Net assets released from restrictions	301,381	406,382
Total revenues	226,556,327	233,987,043
Expenses:		
Salaries	89,222,127	85,337,572
Employee benefits	21,577,235	22,149,486
Supplies	51,864,145	51,614,665
Purchased services	30,776,789	31,492,093
Utilities	2,695,571	2,732,779
Insurance	3,938,841	4,414,134
Lease and rental	1,313,080	941,881
Professional fees	13,452,949	10,065,103
Interest expense	3,186,166	3,384,643
Depreciation and amortization	19,509,959	19,703,818
Indigent tax	3,226,032	3,038,046
Other expenses	2,432,236	2,452,801
Total expenses	243,195,130	237,327,021
Loss from operations	(16,638,803)	(3,339,978)
Nonoperating gains (losses):		
Investment income (loss) (note 3)	12,528,261	12,663,021
Change in fair value of derivative financial instrument (note 6)	—	(72,558)
Other nonoperating gains (losses), net (note 5)	(424,627)	(233,753)
Total nonoperating gains (losses), net	12,103,634	12,356,710
(Deficiency) excess of revenues and gains over expenses	(4,535,169)	9,016,732
Net assets released from restrictions for capital purchases	76,868	191,012
(Decrease) increase in unrestricted net assets	$ (4,458,301)	9,207,744

See accompanying notes to consolidated financial statements.

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Net Assets

Years ended September 30, 2017 and 2016

		2017	2016
Unrestricted net assets:			
(Deficiency) excess of revenues and gains over expenses	$	(4,535,169)	9,016,732
Net assets released from restriction for capital purchases		76,868	191,012
(Decrease) increase in unrestricted net assets		(4,458,301)	9,207,744
Temporarily restricted net assets:			
Temporarily restricted contributions received		644,130	162,291
Net assets released from restrictions		(378,249)	(597,394)
Increase (decrease) in temporarily restricted net assets		265,881	(435,103)
Permanently restricted net assets:			
Permanently restricted contributions received		—	225,328
Net realized (losses) gains on investments		148,738	(20,008)
Net unrealized gains (losses) on investments		232,979	223,161
Increase in permanently restricted net assets		381,717	428,481
(Decrease) increase in net assets		(3,810,703)	9,201,122
Net assets, beginning of year		209,271,341	200,070,219
Net assets, end of year	$	205,460,638	209,271,341

See accompanying notes to consolidated financial statements.

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended September 30, 2017 and 2016

		2017	2016
Cash flows from operating activities:			
(Decrease) increase in net assets	$	(3,810,703)	9,201,122
Adjustments to reconcile (decrease) increase in net assets to net cash provided by operating activities:			
Provision for uncollectible accounts		19,152,192	13,913,415
Depreciation and amortization		19,509,959	19,703,818
Loss on disposition of fixed assets		77,246	87,534
Amortization of deferred rent		(131,261)	(131,262)
Net realized and unrealized (gains) losses on investments and assets limited as to use		(9,299,188)	(6,016,869)
Temporarily restricted contributions received		(644,130)	(162,291)
Permanently restricted contributions received		—	(225,328)
Loss on joint ventures		1,204,329	(852,196)
Net realized and unrealized (gains) losses on permanently restricted investments		(381,717)	(203,153)
Change in fair value of derivative financial instrument		(1,675,137)	72,558
Changes in operating assets and liabilities:			
Change in accounts receivable		(15,101,575)	(10,609,397)
Change in supplies		(333,215)	(445,890)
Change in prepaid expenses and other current assets and other assets		2,571,754	(4,925,311)
Change in estimated third-party payor settlements		(11,872)	(411,003)
Change in accounts payable, accrued expenses, other current liabilities, and other		—	
long-term liabilities		3,648,988	(2,330,446)
Net cash provided by operating activities		14,775,670	16,665,301
Cash flows from investing activities:			
Capital expenditures		(24,130,247)	(18,402,364)
Other assets		229,687	188,015
Distributions from joint ventures		186,848	157,194
Capital contributions to joint ventures		(34,000)	(32,000)
Sales of assets whose use is limited and investments		34,980,503	17,700,000
Purchases of assets whose use is limited and investments		(67,176,990)	(18,712,704)
Net cash used in investing activities		(55,944,199)	(19,101,859)
Cash flows from financing activities:			
Proceeds from the issuance of long-term debt		107,858,228	—
Repayment of long-term debt		(59,815,000)	(6,265,000)
Payment of debt issue costs		(1,129,779)	(1,872)
Payment of derivative financial instrument		(3,609,000)	—
Temporarily restricted contributions received		644,130	162,291
Permanently restricted contributions received		—	225,328
Net realized and unrealized gains (losses) on permanently restricted investments		381,717	203,153
Net cash provided by (used in) financing activities		44,330,296	(5,676,100)
Net increase (decrease) in cash and cash equivalents		3,161,767	(8,112,658)
Cash and cash equivalents, beginning of year		990,681	9,103,339
Cash and cash equivalents, end of year	$	4,152,448	990,681
Supplemental cash flow information:			
Cash paid during the year for interest	$	3,127,826	3,503,965
Noncash investing activity:			
Increase (decrease) in construction in progress accrual	$	(2,713,263)	(670,590)

See accompanying notes to consolidated financial statements.

(1) Summary of Significant Accounting Policies

(a) Organization

Flagler Health Care System, Inc. (FHCS) and Flagler Health Care Foundation (the Foundation) were established pursuant to a corporate reorganization of Flagler Hospital, Inc. (the Hospital) during 1984. Flagler Health Services, Inc. (FHS) and Health Park Owners Association (HPOA) were formed in 1985. FHCS, the Hospital, the Foundation, FHS, and HPOA are collectively referred to as “the System.” FHCS served as the sole member and Parent Corporation of the Hospital, the Foundation, FHS, and HPOA.

On May 1, 2014, FHCS merged with and into the Hospital, with the Hospital being the surviving corporation. The Hospital operates a 335-bed acute care general hospital from an 80-acre site just south of the city limits of St. Augustine, Florida. The Foundation serves as a support organization for the Hospital and is the developer of the Hospital campus. FHS and HPOA own and operate real property on and around the Hospital campus including four medical office buildings. All intercompany transactions and balances have been eliminated in the consolidated financial statements.

On September 1, 2015, Flagler Hospital, Inc. entered into an affiliation agreement with Baptist Health System, Inc. (Baptist), a Florida nonprofit corporation, and Southeast Georgia Health System, Inc. (SGHS), a Georgia nonprofit corporation, to form Coastal Community Health, a new Florida nonprofit corporation (Coastal). As a result of the agreement, Coastal is the sole member of Flagler Hospital, Inc. The agreement provides for indefinite six-month withdrawal windows after each three-year period from the agreement closing date. If the Hospital withdraws after the first three-year withdrawal period, the Hospital must pay $3,000,000 as liquidated damages, and for a period of 12 months following its withdrawal and is prohibited from affiliating with any other health system.

These consolidated financial statements, which are presented on the accrual basis of accounting, have been prepared to focus on the Hospital and related entities, collectively referred to as “the System,” as a whole and to present balances and transactions according to the existence or absence of donor-imposed restrictions. This has been accomplished by classification of net assets and transactions as unrestricted, temporarily restricted, and permanently restricted as follows:

- Unrestricted net assets represent resources generated from operations, unrestricted donations, and lapses of temporary restrictions and are not subject to donor-imposed stipulations.
- Temporarily restricted net assets are those whose use by the System has been limited by donors to a specific time period or purpose.
- Permanently restricted net assets are subject to donor-imposed stipulations that they be maintained in perpetuity by the System. Generally, the donor of these assets permits the System to use all or part of the income earned on related investments for general or specific purposes.

(b) Use of Estimates

The preparation of the consolidated financial statements, in accordance with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and the accompanying notes. Significant items subject to such estimates and assumptions include the carrying amount of property and equipment; valuation allowances for receivables; third-party payor settlements;

valuation of derivative instruments; self-insurance reserves; and obligations related to employee benefits. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash and cash equivalents consist of cash in depository accounts, investments in money market accounts, and other securities with maturities at the date of purchase of three months or less.

(d) Patient Accounts Receivable

Patient accounts receivable are reported at net realizable value. Accounts are written off when they are determined to be uncollectible based upon management's assessment of individual accounts. In evaluating the collectability of patient accounts receivable, the System analyzes its past history, current contractual rates, and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowances for contractual obligations and doubtful accounts.

On October 1, 2015, the System implemented a new self-pay discount policy for patients who do not have insurance coverage. Under the new policy, eligible patients will be given an automatic discount of fifty percent of the patient's total billed charges. The discount is recorded as a deduction from revenue at the time the patient is billed and was previously recorded as provision for uncollectible accounts. The discount recorded in fiscal years 2017 and 2016 were approximately $16,291,000 and $18,778,000, respectively.

For receivables associated with self-pay patients, the System records a significant allowance for estimated uncollectible accounts 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 bills for which they are financially responsible. The difference between the billed rates, after the fifty percent discount, and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for estimated uncollectible accounts.

The provision for uncollectible accounts was approximately $19,152,000 and $13,913,000 for the years ended September 30, 2017 and 2016, respectively. The increase in fiscal year 2017 was the result of an increase in self pay accounts receivable.

(e) Supplies

Supplies consist primarily of medical and surgical supplies and pharmaceuticals and are reported at the lower of cost or market, determined on a first-in, first-out basis.

(f) Assets Whose Use is Limited or Restricted and Investments

The System classifies its mutual funds, partnerships, and debt and equity securities as trading. All debt and equity securities are required to be reported at fair value, principally based on quoted market prices, in the consolidated balance sheets. The fair value of partnerships is determined by the general partner using the latest available information at the valuation date. Investment income (including realized gains and losses on investments, unrealized gains and losses on trading securities, interest, and dividends) is included in (deficiency)/excess of revenues and gains over expenses unless such earnings are subject to donor-imposed restrictions.

Assets whose use is limited include (i) assets set aside by the Board of Trustees (the Board) for future payments of bond principal and capital expenditures, and (ii) assets held from donors, which are temporarily or permanently restricted, and (iii) funds held by the bond trustee.

(g) Property and Equipment

Property and equipment are recorded at cost at the date of acquisition or fair value at the date of donation.

Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized using the straight-line method over the lesser of the period of the lease term or the estimated useful life of the equipment. The estimated useful lives of the major classes of property and equipment are assigned based on the American Hospital Association’s Estimated Useful Lives of Depreciable System Assets as follows:

	Range of useful lives
Land improvements	5 to 25 years
Buildings and fixed equipment	10 to 40 years
Major movable equipment	3 to 15 years

(h) Impairment of Long-Lived Assets

Management regularly evaluates whether events or changes in circumstances have occurred that could indicate impairment in the value of long-lived assets. If there is an indication that the carrying amount of an asset is not recoverable, the System estimates the projected undiscounted cash flows from the use and eventual disposition of the asset, excluding interest, to determine if an impairment loss should be recognized. The amount of impairment loss, if any, is determined by comparing the carrying value of the asset to its estimated fair value. There were no such impairment losses recorded during the years ended September 30, 2017 or 2016.

In addition to consideration of impairment upon the events or changes in circumstances described above, management regularly evaluates the remaining lives of its long-lived assets. If estimates are revised, the carrying value of affected assets is depreciated or amortized over the remaining lives.

(Continued)

(i) Goodwill

Goodwill is an asset representing the future economic benefits arising from assets acquired in a business combination that are not individually identified and separately recognized. Annually, or when indicators of impairment exist, the System evaluates goodwill for impairment to determine whether there are events or circumstances that indicate it is more likely than not that the fair value of a reporting unit is less than its carrying amount in accordance with the provisions of Accounting Standards Codification Topic 350, Intangibles – Goodwill and Other. The System determined that there was no goodwill impairment for the years ended September 30, 2017 or 2016.

(j) Deferred Financing Costs

On April 7, 2015, FASB published ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. The resulting impact of ASU 2015-03 is that debt issuance costs shall be treated as a direct deduction from the carrying amount of the related debt. Amortization of debt issuance costs shall be reported as interest expense. Deferred financing costs, now included as a direct deduction in long-term debt in the accompanying consolidated balance sheets, relate to the costs from the respective bond issuances and are amortized over the life of the bonds using the straight-line method, which approximates the effective-interest method. Amortization of deferred financing costs is included in interest expense in the consolidated statements of operations and changes in unrestricted net assets. The System adopted ASU 2015-03 in 2017 and reclassified the previously reported debt issue costs of approximately $480,000 from other assets to a direct deduction in long-term liabilities as of September 30, 2016 to conform to the presentation as of September 30, 2017.

(k) Other Assets

Other assets include long-term notes receivable, deposits, receivables for liability recoveries and definite-lived intangible assets. The majority of the net balance of definite-lived intangible assets include a five-year physician noncompete agreement being amortized using the straight-line method.

(l) Derivative Financial Instrument

The System accounts for its derivative financial instrument as either an asset or liability in the consolidated balance sheets and measures the instrument at fair value. The System recognizes the changes in the derivative's fair value as nonoperating gains (losses) in the consolidated statements of operations and changes in unrestricted net assets. The derivative financial instrument was settled and paid on September 28, 2017.

(m) Excess of Revenues and Gains over Expenses

The consolidated statements of operations and changes in unrestricted net assets include the (deficiency) excess of revenues and gains over expenses. Changes in unrestricted net assets that are excluded from this measure, consistent with industry practice, include contributions for property and equipment. For purposes of presentation, transactions deemed by management to be ongoing, major, or central to the provision of healthcare services are reported as operating revenues and expenses. Peripheral or incidental transactions are reported as nonoperating gains and losses.

(Continued)

(n) Net Patient Service Revenue

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates associated with these programs will change by a material amount in the near term.

The System was designated a rural provider for Medicaid on July 1, 2017. The impact of this change resulted in an increase in Net Patient Service Revenue of approximately $2,295,000 during fiscal year 2017 compared to 2016.

Patient service revenue consists of the following for the years ended September 30, 2017 and 2016:

	2017	2016
Gross patient charges	$ 1,072,680,293	1,043,922,118
Contractual adjustments	(834,766,957)	(805,038,014)
Provision for uncollectible accounts	(19,152,192)	(13,913,415)
Net patient service revenue	$ 218,761,144	224,970,689

The 2017 and 2016 gross patient charges comprise the following:

	2017	2016
Payor:		
Medicare	57 %	56 %
Medicaid	11	11
Commercial	22	23
Other	3	3
Self-pay	7	7
	100 %	100 %

(o) Charity Care and Community Benefit

The System provides care to patients who meet certain criteria under its charity care policy without charge or at amounts significantly less than its established rates. Because the System does not pursue collection of amounts determined to qualify as charity, the amounts 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. The estimated cost associated with those charity care services provided are estimated using a cost to charge ratio to the amount of gross uncompensated charges for the patients receiving charity care. The following information measures the level of charity care provided during the years ended September 30, 2017 and 2016:

		2017	2016
Charges forgone, based on established rates	$	44,784,933	39,804,314
Estimated costs and expenses incurred to provide charity care		10,166,180	9,115,188
Equivalent percentage of charity care patients to all patients		4.2 %	3.8 %

In addition to providing financial assistance, the System also provides other benefits for the community, the cost of which can exceed the revenue sources available. These other benefits include, but are not limited to, donations, education for healthcare professionals, community health improvement services, and subsidized healthcare services. The System also subsidizes the costs in excess of payments received from Medicaid.

(p) Incentive Funding for Meaningful Use of Electronic Health Records (EHR)

The System recognizes revenue under the grant accounting model for incentives earned under the Medicare and Medicaid program. Income is recognized when the System complies with the applicable EHR meaningful use grant requirements and payment is reasonably assured. Incentive payments received under the Medicare program include a discharge-related portion, which is calculated by Centers for Medicare & Medicaid Services (CMS) based on the System's most recently filed cost report. Such amounts are subject to adjustment at the time of settling the 12-month cost report for the System's fiscal year that begins after the beginning of the payment year. The System achieved compliance with the Stage 1 meaningful use requirements under the Medicare program and, accordingly, recognized other operating revenues of approximately $578,000 and $1,519,000, respectively in the accompanying consolidated statements of operations and changes in unrestricted net assets for the years ended September 30, 2017 and 2016.

(q) Donor-Restricted Contributions

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received. 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. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

(Continued)

(r) Income Taxes

The System and Foundation are not-for-profit organizations as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and are exempt from federal income taxes on related income pursuant to Section 501(a) of the Code and are also exempt from state income taxes. FHS and HPOA are for-profit subsidiaries and are subject to federal income tax on their earnings.

At September 30, 2017 and 2016, FHS had available net operating loss carryforwards for tax purposes of approximately $1,170,000 and $1,209,000, respectively, which expire through 2025, and accordingly, no provision for income taxes has been recognized. Management believes the retained deficit of HPOA is not significant.

Accounting principles generally accepted in the United States of America require the System's management to evaluate tax positions taken by the System and recognize a tax liability (or asset) if the System has taken an uncertain position that would more likely than not be sustained upon examination by the Internal Revenue Service. The System has analyzed the tax positions and has concluded that as of September 30, 2017 or 2016, there are no uncertain positions taken, or expected to be taken, that would require recognition of a liability (or asset) or disclosure in the financial statements. The System is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The System believes it is no longer subject to income tax examinations for years prior to 2013.

(s) Recently Issued Accounting Prounouncements

In May 2014, the Financial Accounting Standards (FASB) issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)* and updated through ASU 2015-14, which supersedes the revenue recognition requirements in ASC 606, *Revenue Recognition*. This ASU addresses when 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. In May 2016, the FASB issued ASU 2016-12, *Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients (Topic 606)*. This ASU adds further clarification to the revenue recognition standards issued in ASU 2014-09. The System has not evaluated all of the provisions of these updates, which are both effective for annual reporting periods beginning after December 15, 2017 for public business entities and nonprofit entities that have publicly traded debt.

In August 2014, the FASB issued ASU 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern (Topic 205)*, which requires management to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date of the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). The System adopted this ASU in 2017 and the adoption did not have a material impact on the consolidated financial statements and the accompanying footnote disclosures.

In January 2016, the FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Liabilities*. This ASU removes the requirement to disclose the fair value of financial instruments carried at amortized cost. The System adopted ASU 2016-01 and removed the fair value disclosure for its fixed rate debt in 2017.

(Continued)

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. This ASU requires lessees to record a lease liability that represents the lessee's future lease payments obligation and right-of-use asset that represents the lessee's right to use or control of a specified asset for the lease term. The System has not evaluated the impact of this ASU, which is effective for fiscal years beginning after December 15, 2018 for public business entities and not-for-profit entities that have issued publicly traded debt.

In August 2016, The FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)*. This ASU requires not-for-profit entities to report two classes of net assets, as well enhances disclosures on board designated funds, liquidity and functional expenses. The System has not evaluated all of the provisions, which are effective for fiscal years beginning after December 15, 2017.

(2) Net Patient Service Revenue

The System has agreements with third-party payors that provide for payment to the System at amounts different from its established rates. A summary of the payment arrangements with major third-party payors is as follows:

Medicare – Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Defined capital costs related to Medicare beneficiaries are paid at prospectively determined rates per discharge. Outpatient services are paid at prospectively determined rates per case. The rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors.

The System's Medicare cost reports for all years through September 30, 2016 have been filed. The System's Medicare cost reports for all years through September 30, 2013 have been examined and final settlements have been determined by the fiscal intermediary. Estimated provisions for the years ended September 30, 2017, 2016, 2015, and 2014 have been reflected in the accompanying consolidated financial statements.

Medicaid – Inpatient acute care services rendered to Medicaid program beneficiaries are paid using an AP-DRG grouping reimbursement methodology. Outpatient services rendered to Medicaid program beneficiaries are reimbursed on a fee-for-service basis. Retroactive adjustments are made to outpatient payment amounts after the related cost report is audited by the intermediary.

Revenue from the Medicare and Medicaid programs accounted for approximately 62% and 60% of the System's net patient service revenue for the years ended September 30, 2017 and 2016, respectively. The accompanying consolidated financial statements reflect reductions to net patient service revenue of approximately $398,000 and $233,000 related to changes in prior year third-party settlement estimates and other payment issues during the years ended September 30, 2017 and September 30, 2016, respectively.

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

(3) Assets Whose Use is Limited or Restricted and Investments

The composition of assets whose use is limited, stated at fair value, at September 30, 2017 and 2016 is set forth in the following table:

		2017	2016
Board-designated:			
Cash and cash equivalents	$	49,249,978	355,471
U.S. government obligations		7,667,217	11,821,150
Corporate bonds		20,390,401	18,599,515
Mutual funds		61,707,693	61,642,625
Limited partnerships		6,679,097	13,545,957
Interest receivable		133,806	131,239
	$	145,828,192	106,095,957

Investments, stated at fair value, at September 30, 2017 and 2016 include the following:

		2017	2016
Cash and cash equivalents	$	63,810	74,534
U.S. government obligations		1,743,279	2,240,327
Corporate bonds		3,965,405	3,314,743
Mutual funds		22,718,629	19,516,498
Limited partnerships		1,326,982	2,914,198
Interest receivable		27,021	21,386
	$	29,845,126	28,081,686

Unrestricted investment income and gains (losses), net for assets whose use is limited or restricted, cash equivalents, and investments comprise the following for the years ended September 30, 2017 and 2016:

		2017	2016
Income:			
Interest income and dividends	$	3,229,073	6,646,152
Unrealized gains on trading investments		4,104,549	4,072,766
Realized gains on sales of securities		5,194,639	1,944,103
	$	12,528,261	12,663,021

(4) Property and Equipment

A summary of property and equipment at September 30, 2017 and 2016 is as follows:

		2017	2016
Land and land improvements	$	16,775,751	16,386,152
Buildings and improvements		171,889,514	167,286,221
Equipment		208,435,388	189,657,347
		397,100,653	373,329,720
Less accumulated depreciation		(253,317,558)	(233,975,682)
		143,783,095	139,354,038
Construction in progress		4,329,734	6,781,089
Net property and equipment	$	148,112,829	146,135,127

The System recorded depreciation expense of approximately $19,362,000 and $19,597,000 in the consolidated statements of operations and changes in unrestricted net assets for the year ended September 30, 2017 and 2016, respectively.

Construction in progress at September 30, 2017 and 2016 consists of System renovation projects not yet completed. The System had significant construction commitments in the amount of approximately $20,000,000 as of September 30, 2017.

(5) Long-Term Debt

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

	2017	2016
St. Johns County, Industrial Development Authority Hospital Revenue Refunding Bonds, Series 2010A, with a fixed rate of interest of 2.99%	$ —	30,000,000
St. Johns County, Industrial Development Authority Hospital Revenue Refunding Bonds, Series 2010B, with a variable interest rate determined monthly (1.68% September 30, 2016) plus certain fees	—	24,790,000
St. Johns County, Industrial Development Authority Hospital Revenue Refunding Bonds, Series 2011, with a fixed rate of interest of 2.66%	—	600,000
St. Johns County, Industrial Development Authority Hospital Revenue Bonds, Series 2012A, with a fixed interest rate of 1.869%	6,000,000	9,000,000
St. Johns County, Industrial Development Authority Hospital Revenue Bonds, Series 2012B, with a variable interest rate determined monthly through September 30, 2013 then fixed (2.97% at October 1, 2013) plus certain fees	12,000,000	12,000,000
2014 Bank Loan with a fixed interest rate of 3.42%	12,575,000	14,000,000
St. Johns County, Industrial Development Authority Hospital Revenue Bonds, Series 2017A, with a fixed rate of interest of 5.00%	32,575,000	—
St. Johns County, Industrial Development Authority Hospital Revenue and Refunding Bonds, Series 2017B, with a fixed rate of interest of 2.44%	71,400,000	—
2017C Bank Loan with fixed interest rate of 3.57%	3,630,000	—
	138,180,000	90,390,000
Less debt issue cost	(1,356,697)	(480,146)
	136,823,303	89,909,854
Less current maturities	(6,675,000)	(7,715,000)
	$ 130,148,303	82,194,854

On December 9, 2010, the St. Johns County Industrial Development Authority issued $30,000,000 of System Revenue Refunding Bonds (Series 2010A). The proceeds of the Series 2010A Bonds were applied toward the partial refunding of the St. Johns County Industrial Development Authority Hospital Revenue Bonds, Series 1996. The Series 2010A Bonds are “Bank Qualified” and carry a fixed rate of interest of 2.99% through the mandatory tender date of December 15, 2020. The final maturity is December 15, 2031.

The St. Johns County Industrial Development Authority also issued $28,275,000 of Hospital Revenue Refunding Bonds (Series 2010B). The proceeds of the Series 2010B Bonds were applied toward the full refunding of the St. Johns County Industrial Development Authority Hospital Revenue Bonds, Series 2009. The Series 2010B Bonds are "Bank Qualified" variable rate bonds. The rate shall adjust monthly based on a percentage of one-month LIBOR plus a credit spread of 1.35%. The Series 2010B mature on varying dates through 2028 and are subject to mandatory tender on December 15, 2020. Both the Series 2010A and Series 2010B Bonds were paid in full on September 28, 2017. There was an early termination penalty and loss on extinguishment of debt of approximately $1,316,000 and $194,000, respectively, on the Series 2010A and Series 2010B Bonds that is included in other nonoperating gains (losses), net in the consolidated statements of operations and changes in unrestricted net assets.

On January 19, 2011, the St. Johns County Industrial Development Authority issued $12,500,000 of Hospital Revenue Refunding Bonds (Series 2011). The proceeds of the Series 2011 Bonds were applied toward refunding the remaining outstanding portion of the St. Johns County Industrial Development Authority Hospital Revenue Bonds, Series 1996. The Series 2011 Bonds are "Nonbank Qualified" and carry a fixed rate of interest of 2.66%. The Series 2011 Bonds matured on December 15, 2016.

On April 4, 2012, the St. Johns County Industrial Development Authority issued $18,000,000 of Hospital Revenue Bonds (Series 2012A) and $12,000,000 of Hospital Revenue Bonds (Series 2012B). The proceeds of the Series 2012A and 2012B were used to reimburse the System for certain renovation projects, implementation of a new electronic medical record, clinical, and billing system and other equipment. The Series 2012A Bonds are "Nonbank Qualified" and carry a fixed rate of interest of 1.869%. The Series 2012A Bonds mature in 2019. The Series 2012B Bonds are "Nonbank Qualified" and carried a variable rate of 70% of LIBOR plus 135 basis points through September 30, 2013 and then a fixed rate of interest of 2.970%. The Series 2012B mature in 2022.

On October 29, 2014, the System borrowed $14,000,000 from a Bank in the form of a commercial loan. The proceeds of the loan were applied towards the purchase of certain assets of an ambulatory surgery center located in the System's primary service area. The loan bears a fixed interest rate of 3.42% with varying annual principal payments through final maturity on October 1, 2024.

On September 28, 2017, the St. Johns County Industrial Development Authority issued $32,575,000 of Hospital Revenue Bonds (Series 2017A) and $71,400,000 of Hospital Revenue and Refunding Bonds (Series 2017B). The proceeds of the Series 2017A Bonds will be used to reimburse the System for certain hospital facilities, improvements, renovations, equipment, fixtures, furnishings and other routine capital expenditures. They are also to be used to fund certain outpatient facilities to be developed near World Golf Village, including land, buildings, furniture, fixtures, and equipment. The purpose of the Series 2017B Bonds is financing, refinancing, and reimbursing the cost of the acquisition, renovation, construction, equipping and installation of certain health care facilities. The Series 2017A Bonds carry a fixed rate of interest of 5.00%. The Series 2017A Bonds mature in 2047, but are subject to mandatory sinking fund redemption beginning in 2033. The Series 2017B Bonds carry a fixed rate of interest of 2.44%. The Series 2017B mature in 2032, but are subject to mandatory sinking fund redemption beginning in 2018.

On September 28, 2017, the System also borrowed $3,630,000 from a Bank in the form of a commercial loan. The proceeds of the loan were applied towards the payoff of the derivative financial instrument. There was a nonoperating gain recognized of approximately $1,675,000 on extinguishment of the derivative. The loan bears a fixed interest rate of 3.57% with varying annual principal repayments from 2019 through final maturity on August 15, 2029.

Bonds issued by St. Johns County Industrial Development Authority 2014 Loan are secured by a security interest in the System's gross revenues and a mortgage on the main hospital campus. All such debt instruments are additionally secured by a security interest in certain fixtures and equipment until the maturity of the Series 2012A Bonds in 2019. The primary debt covenant for all debt instruments consists of a maximum annual debt service coverage ratio of 1.20 measured annually and a minimum of 90 unrestricted days cash and investments on hand measured semiannually, both as defined in the master indenture.

The following are scheduled maturities of long-term debt for each of the next five years and thereafter.

2018	$	6,675,000
2019		6,875,000
2020		7,060,000
2021		7,160,000
2022		7,405,000
Thereafter		103,005,000
	$	138,180,000

(6) Derivative Financial Instrument

The System entered into an agreement dated October 24, 2003 and effective December 10, 2003 to exchange floating-rate interest payments on a notional amount of $35,000,000 for fixed-rate interest payments without the exchange of any underlying amount. The agreement expires December 15, 2028. The notional amount of the agreement changes according to an amortizing schedule ending on the agreement expiration date. The notional amount was $27,735,000 at September 30, 2016. The floating-rate interest payments subject to the swap agreement are based on 70% of USB-LIBOR-BBA and the fixed-rate interest payments are at a rate of 3.79%. Amounts paid or received as a result of the differences between the respective interest rates are recognized as adjustments to interest expense. Approximately $868,000 and $981,000 of interest expense in the consolidated statements of operations and changes in unrestricted net assets related to net payments for the System’s interest rate swap agreement for the years ended September 30, 2017 and 2016, respectively. The fair value of the derivative instrument was a liability of approximately $5,218,000 at September 30, 2016. An increase in the liability of approximately $72,000 has been reflected in other nonoperating gains (losses), net in the accompanying consolidated statements of operations and changes in unrestricted net assets for the year ended September 30, 2016. The derivative financial instrument was terminated on September 28, 2017 for $3,609,000.

(7) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets consist of amounts held for future capital acquisitions and designated healthcare services.

Permanently restricted net assets at September 30, 2017 and 2016 are restricted to the following:

		2017	2016
Investments to be held in perpetuity, annually 6% of the value of the corpus is to be expended toward employee scholarships	$	248,269	208,531
Investments to be held in perpetuity		4,143,075	3,801,096
	$	4,391,344	4,009,627

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 958-205, *Not-for-Profit Entities – Presentation of Financial Statements*, provides guidance on the net asset classification of donor-restricted endowment funds for not-for-profit organizations that are subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and also requires enhanced disclosures about an organization's endowment funds, and donor-restricted and board-designated endowment funds.

Pursuant to ASC 958-205, the System has interpreted UPMIFA, as adopted by Florida July 1, 2012, as requiring the preservation of fair value of donor-restricted endowment gifts as of the gift date, absent explicit donor stipulations to the contrary. The System's endowment consists of three individual funds established for a variety of purposes. The endowments are all donor-restricted and internally controlled. The System has no board-designated endowments. As required by relevant accounting literature, net assets associated with endowment funds are classified and reported based on the existence of donor-imposed restrictions. There are restrictions on the use of the related income of all endowments. The endowment investments have a target allocation of approximately 47.5% domestic equity, 12.5% international equity, 10% other assets, and 30.0% fixed-income investments.

The System classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund, and (d) unrealized gains and losses not to fall below the original corpus. The remaining portion of the donor-restricted endowment fund that is not classified as permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the System in a manner consistent with the donor designation, if any.

Endowment funds consist of the following at September 30, 2017 and 2016:

		2017	2016
Donor-restricted endowment funds:			
Permanently restricted	$	4,391,344	4,009,627
Total donor-restricted endowment funds	$	4,391,344	4,009,627

Changes in the endowment funds for the years ended September 30, 2017 and 2016 are as follows:

		2017	2016
Endowment funds, beginning of year	$	4,009,627	3,581,146
Contributions received		—	225,328
Investment return, net of fees (includes realized and unrealized gains that are permanently restricted)		381,717	203,153
Endowment funds, end of year	$	4,391,344	4,009,627

(8) Concentrations of Credit Risk

The System grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of patient accounts receivable from patients and third-party payors net of contractual adjustments and allowances for estimated uncollectible accounts at September 30, 2017 and 2016 is as follows:

	2017	2016
Medicare	39 %	37 %
Medicaid	10	6
Commercial	31	45
Other third-party payors	8	5
Self-pay	12	7
	100 %	100 %

(9) Commitments and Contingencies

(a) Professional Liability

The System is involved in litigation arising from the ordinary course of business. Claims alleging malpractice have been asserted against the System and are currently in various stages of litigation. The System has maintained coverage during 2017 and 2016 with a self-insured retention and an aggregate limit eroded at the amount of the indemnity payment and has no inner aggregate deductible as follows:

		October 15		
		2016–2017	2015–2016	2014–2015
Self-insured retention per occurrence (SIR)	$	2,000,000	1,500,000	1,500,000
Aggregate limit		6,000,000	6,000,000	5,000,000

The System also has secured excess liability coverage for these periods with limits of $20,000,000 per occurrence and $20,000,000 in the aggregate per policy period. Coverage under this, as well as the System's previous policies, is on a claims-made basis. The System has established a liability to estimate losses from reported claims and other incidents not reported during the current coverage period not covered by insurance. In the opinion of management, after consultation with legal counsel, these matters will be resolved within its insurance coverage and accruals without a material adverse effect to the System's financial position.

The estimated accrual for self-insured professional liability risks was approximately $8,681,000 and $8,944,000 at September 30, 2017 and 2016, respectively. These amounts are included in accrued expenses and other long-term liabilities in the accompanying consolidated balance sheets. Operating expenses for malpractice insurance premiums and other professional liability expenses for the years ended September 30, 2017 and 2016 were approximately $3,059,000 and $3,677,000, respectively.

The System maintains a line-of-credit agreement in the amount of $2,000,000, which is restricted to the System's self-insurance program pursuant to Section 766.105(2)(c) of the Florida Statutes. There were no draws on the line of credit as of September 30, 2017 or 2016.

(b) Workers' Compensation

The System is self-insured with respect to employee workers' compensation claims at $550,000 self-insured retention per claim for fiscal year 2017 and 2016 with no aggregate limit.

The System has contracted with an insurance carrier to cover those claims in excess of these limits. The System has established a liability for reported incidents and a liability related to loss development based on estimates from its claims administrator. The estimated accrual for self-insured workers' compensation included in accrued expenses and other long-term liabilities is approximately $2,531,000 and $2,357,000 as of September 30, 2017 and 2016, respectively. At September 30, 2017 and 2016, insurance recoveries in the amount of approximately $1,501,000 and $1,557,000, respectively, were recorded in other assets.

Prior to becoming self-insured for workers' compensation, the System was a member of the Florida System Workers' Compensation Self-Insurance Trust Fund (the Trust Fund), a self-insurance risk management trust fund in which members jointly and severally agree to pay the obligations of the Trust Fund. As a prior member of the Trust Fund, the System is subject to assessments in the event that the total amount of premiums for a year in which it was a member is not sufficient to satisfy claims. Assessments that have been levied against the System by the Trust Fund have been reflected in the accompanying consolidated financial statements as of September 30, 2017 and 2016. Management is not aware of any potential future assessments as of September 30, 2017.

(c) Health Insurance Claims

The System is self-insured with respect to employee health insurance claims covering up to $250,000 per claim with an $11,100,000 aggregate limit. The System has contracted with an insurance carrier to cover claims in excess of the self-insurance retention amounts. The estimated accrual for self-insured health insurance claims included in accrued expenses and other current liabilities is approximately $1,757,000 and $1,829,000 as of September 30, 2017 and 2016, respectively.

(d) Operating Leases

The System is obligated under various short-term operating leases for equipment and office space. Rental expense for all operating leases was approximately $1,960,000 and $1,273,000 for the years ended September 30, 2017 and 2016, respectively. The following are contracted payments for each of the next five years and thereafter:

2018	$	492,238
2019		241,091
2020		122,730
2021		119,991
2022		9,999
Total	$	986,049

(e) Management Services Agreement

The System entered into a management services agreement for services and resources in support of a bariatric program. The agreement requires payment of approximately $29,000 per month for a term of 6 years and is cancelable by either party with 180-day notice. The System expensed approximately $398,000 and $425,000 for the fiscal years ended September 30, 2017 and 2016, respectively, related to the agreement, which is included in purchased services in the consolidated statements of operations and changes in unrestricted net assets.

In October 2014, the System entered into a four-year management services agreement for services and resources in support of the off-campus surgery center operations. Per the initial agreement, the management company was paid monthly in the amount of 6% of the surgery center’s net revenue. As of April 2017, the agreement was amended to require a monthly management fee of 3% of the surgery center’s net revenue through the end of the agreement. The System expensed approximately $398,000 and $492,000 for the fiscal years ended September 30, 2017 and 2016, respectively.

On August 1, 2017, the System entered into a management services agreement for services related to the cardiovascular service line with an initial term of 3 years. The term will automatically renew for successive 1 year terms unless terminated. The agreement requires a monthly installment of approximately $272,000 to be paid by the 1st of the month.

(10) Retirement Plan

The System has a noncontributory retirement plan covering substantially all employees. The System contributed a percentage of the employee's total annual compensation plus an additional percentage for excess compensation as follows:

		2017[(a)]	2016[(b)]
Base contribution% of employee's eligible base annual compensation		4.0 %	4.0 %
Additional contribution% of excess compensation		3.0	3.0
Compensation excess amount for additional contribution	$	55,000	55,000

(a) Calendar year 2017.

(b) Calendar year 2016.

Total retirement expense for the years ended September 30, 2017 and 2016 was approximately $2,816,000 and $3,229,000, respectively.

(11) Transactions with Affiliated Organizations

On May 1, 2013, the System and certain community physicians formed First Coast Health Alliance, LLC (FCHA). FCHA is a physician hospital organization created to develop and operate a clinically integrated network of providers serving St. Johns County. The System owns fifty percent of FCHA and does have significant influence but not control over the partnership. The System has determined that the equity method of accounting is appropriate. The investment balance was $(72,000) and $1,410,000 as of September 30, 2017 and 2016, respectively, and is included in other assets. Effective June 4, 2013, the System committed to provide FCHA with a working capital line of credit for two years, not to exceed $1,750,000. The working capital line of credit converted to a note payable on July 1, 2015 with a repayment term of seven years with an interest rate equivalent to the System's current cost of capital. The outstanding balance on the note payable was approximately $1,154,000 and $1,384,000 as of September 30, 2017 and 2016, respectively, which is included in other assets in the consolidated balance sheets. Approximately $230,000 and $224,000 of the principal amount was repaid during fiscal years 2017 and 2016, respectively.

(12) Functional Expenses

The System provides general healthcare services to residents within its geographic location. Expenses related to providing these services at September 30, 2017 and 2016 are as follows:

		2017	2016
Healthcare services	$	198,856,860	189,861,617
General and administrative		44,338,270	47,465,404
	$	243,195,130	237,327,021

(13) Physician Net Revenue and Other Guarantee Agreements

The System has entered into net revenue guarantee agreements with physicians for the purpose of recruiting physicians to the local area to provide quality medical services. Under the agreements, the System provides financial assistance to physicians in establishing medical practices in the area. The agreement terms vary and the assistance may or may not be subject to repayment provisions. If the agreements are subject to repayment provisions, physician receivables are recorded. Amounts recorded as physician receivables may be forgiven under certain conditions. If the agreements are not subject to repayment provisions, the amounts paid to the physician practices are recorded as operating expenses. For the years ended September 30, 2017 and 2016, the System expensed approximately $277,000 and $92,000, respectively, related to physician recruitment. The significant agreements entered into by the System relate to general surgery, cardiology, otolaryngology, bariatric, neurology, and family practice physician practices. At September 30, 2017 and 2016, the System had other receivables recorded in prepaid expenses and other current assets of approximately $419,000 and $429,000, respectively, related to these guarantee agreements.

(14) Fair Value of Financial Instruments

The System considers fair value to be an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As required, the System uses a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1 – Observable inputs such as quoted prices in active markets

Level 2 – Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly

Level 3 – Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions

Assets and liabilities measured at fair value are based on the following three valuation techniques:

Market approach – Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities

Cost approach – Amount that would be required to replace the service capacity of an asset (i.e., replacement cost)

Income approach – Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing models, and lattice models)

Level 1 and Level 2 Trading Assets and Trading Liabilities

On a recurring basis, the System is required to measure trading securities and interest rate swaps at fair value. The fair value of Level 1 trading securities are determined based on quoted market prices in active markets. The System’s Level 2 fair value measures for fixed maturities are provided by a third-party pricing service. The System only relies on one price for each instrument to determine the carrying amount of the assets on its consolidated balance sheets. These valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuations for which all significant assumptions are observable or can be corroborated by observable market data. Examples would be securities with prices derived from market corroboration sources such as indices and yield curves; and matrix pricing. The fair value of the interest rate swap is determined using the estimated present value of the fixed leg and floating leg of the interest rate swap. The value of the fixed leg is the present value of the known fixed coupon payments. The value of the floating leg is the present value of the floating coupon payments determined at the agreed upon dates of each payment. Forward rates derived from the yield curve are used to approximate the floating rates. Each series of cash flows is discounted by market rates of interest.

Level 3 Trading Assets and Trading Liabilities

The fair values of the following investments have been estimated using the net asset value per share of the investments:

(a) Real estate fund (the Fund) fair values are provided by third-party appraisers. Each of the Fund's real property interests generally is appraised every quarter after the investment is made unless certain factors or economic conditions warrant an additional appraisal. Third-party debt not secured by a property is reviewed on a quarterly basis for any impact that debt may have on gross asset value. The Fund employs an independent valuation consultant to administer the Fund's valuation program, including assisting in the engagement and rotation of third-party appraisers, coordinating the quarterly appraisal process, and reviewing appraisals. The independent valuation consultant reviews the independent appraisals for reasonableness of assumptions, consistency of methodology, compliance with the engagement, and confirmation of value.

(b) Distressed asset fund values are valued on each business day using valuation methods as adopted by the investment manager. Where market quotes are readily available, fair value is generally determined on the basis of official closing prices or the last reported sales prices, or if no sales are reported, based on quotes obtained from a quotation reporting system, established market makers, or pricing services. Where market quotes are not readily available, distressed asset fund values are valued at fair value, as determined in good faith by the investment manager pursuant to adopted valuation methods.

The methods described above for Level 1, 2, and 3 investments may produce a fair value calculation that may not be indicative of net realizable value or reflective of fair values. Furthermore, while the System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The fair values of financial assets and liabilities that are measured on a recurring basis as of September 30, 2017 are as follows:

		2017 Fair value measurements at reporting date using					
		Fair value	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**	**Investments at NAV (2)**	**Valuation technique (1)**
Assets:							
Cash and cash equivalents	$	4,152,448	4,152,448	—	—	—	M
Investments and assets whose use is limited:							
Cash and cash equivalents	$	49,313,788	49,313,788	—	—	—	M
Interest receivable		160,827	160,827	—	—	—	M
U.S. government obligations		9,410,496	—	9,410,496	—	—	M
Corporate bonds		24,355,806	—	24,355,806	—	—	M
Mutual funds:							
Small/mid U.S. equity		19,478,063	19,478,063	—	—	—	M
Global equity		13,085,062	13,085,062	—	—	—	M
Global fixed income		12,452,030	12,452,030	—	—	—	M
Large U.S. equity		39,411,167	39,411,167	—	—	—	M
Limited partnerships:							
Real estate fund		8,006,079	—	—	—	8,006,079	M
	$	175,673,318	133,900,937	33,766,302	—	8,006,079	

(1) The following represents the three valuation techniques: (M) market approach, (I) income approach, and (C) cost approach

(2) The Hospital measured the real estate fund at Net Asset Value (NAV). These investments were excluded from the fair value hierarchy due to the adoption of ASU 2015–07.

		Commitment and redemption schedule			
		Fair value at September 30, 2017	**Redemption frequency**	**Redemption notice period**	**Investee strategy and other restrictions**
Category:					
Real estate fund	$	8,006,079	Quarterly	60 days	1

(1) The real estate fund's purpose is to actively manage a core portfolio of primarily equity real estate investments located in the United States.

The fair values of financial assets and liabilities that are measured on a recurring basis as of September 30, 2016 are as follows:

	2016 Fair value measurements at reporting date using					
	Fair value	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**	**Investments at NAV (2)**	**Valuation technique (1)**
Assets:						
Cash and cash equivalents	$ 990,681	—	—	—	—	M
Investments and assets whose use is limited:						
Cash and cash equivalents	$ 430,005	430,005	—	—	—	M
Interest receivable	152,625	152,625	—	—	—	M
U.S. government obligations	14,061,477	—	14,061,477	—	—	M
Corporate bonds	21,914,258	—	21,914,258	—	—	M
Mutual funds:						
Small/mid U.S. equity	14,186,526	14,186,526	—	—	—	M
Global equity	13,225,641	13,225,641	—	—	—	M
Global fixed income	12,047,317	12,047,317	—	—	—	M
Large U.S. equity	41,699,639	41,699,639	—	—	—	M
Limited partnerships:						
Real estate fund	7,683,824	—	—	—	7,683,824	M
Distressed asset	8,776,331	—	—	—	8,776,331	M
	$ 134,177,643	81,741,753	35,975,735	—	16,460,155	
Liabilities:						
Derivative financial instrument	$ 5,218,068	—	5,218,068	—	—	I

(1) The following represents the three valuation techniques: (M) market approach, (I) income approach, and (C) cost approach

	Commitment and redemption schedule				
		Fair value at September 30, 2016	Redemption frequency	Redemption notice period	Investee strategy and other restrictions
Category:					
Real estate fund	$	7,683,824	Quarterly	60 days	2
Distressed asset fund		8,776,331	Quarterly	60 days	1
	$	16,460,155			

(1) The alternative investment is for the purpose of seeking to provide investor enhanced returns principally through long-biased opportunistic investments, United States and international, in undervalued senior and super senior structured credit securities that are expected to produce attractive levels of current income and that may appreciate over time.

(2) The real estate fund's purpose is to actively manage a core portfolio of primarily equity real estate investments located in the United States.

(15) Acquisition

On October 30, 2014, the System acquired 100% of an ambulatory surgery center now referred to as the Flagler Surgery Center (FSC) located in St. Augustine, Florida from St. Augustine Surgery Center, LLC. The results of FSC's operations have been included in the System's consolidated financial statements since that date. The goodwill of approximately $10,019,000 at September 30, 2017 and 2016 arising from the acquisition relates to excess of the purchase price over the fair value of the surgery center assets and liabilities purchased.

(16) Subsequent Events

On December 4, 2017, the System acquired the remaining interests of approximately 89% of Orthopedic Associates of St. Augustine Surgery Center for approximately $24,000,000. Proceeds from the Hospital Revenue Bonds (Series 2017A) were applied toward this purchase which included substantially all assets, including real estate.

The System has evaluated events and transactions occurring subsequent to September 30, 2017 through January 29, 2018, which is the date the consolidated financial statements were issued and noted no other material events have occurred that require recognition or disclosure in the accompanying consolidated financial statements and related notes to the consolidated financial statements.

Schedule 1

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidating Balance Sheet

Year ended September 30, 2017

Assets	Foundation	Health services	Hospital	HPOA	Eliminations	Total
Current assets:						
Cash and cash equivalents	$ 698,568	883,692	2,563,467	6,721	—	4,152,448
Net patient accounts receivable:						
Patient accounts receivable	—	243,708	39,465,728	—	—	39,709,436
Medicare interim payments	—	—	4,663,196	—	—	4,663,196
	—	243,708	44,128,924	—	—	44,372,632
Less allowances for estimated uncollectible accounts	—	—	17,224,666	—	—	17,224,666
Net patient accounts receivable	—	243,708	26,904,258	—	—	27,147,966
Supplies	—	—	6,719,765	—	—	6,719,765
Estimated third-party payor settlements	—	—	10,491	—	—	10,491
Prepaid expenses and other current assets	89,735	155,345	4,920,751	261	(133,471)	5,032,621
Total current assets	788,303	1,282,745	41,118,732	6,982	(133,471)	43,063,291
Investments	29,845,126	—	—	—	—	29,845,126
Assets whose use is limited or restricted	6,167,795	—	139,660,397	—	—	145,828,192
Property and equipment, net	335,233	2,426,836	144,955,574	566,339	(171,153)	148,112,829
Goodwill	—	—	10,019,271	—	—	10,019,271
Other assets	—	18,602	5,757,214	—	(1,000)	5,774,816
Total assets	$ 37,136,457	3,728,183	341,511,188	573,321	(305,624)	382,643,525
Liabilities and Net Assets						
Current liabilities:						
Current maturities of long-term debt	$ —	—	6,675,000	—	—	6,675,000
Accounts payable	—	—	12,328,284	—	—	12,328,284
Accrued expenses and other current liabilities	200,067	208,725	21,503,686	8,105	(133,471)	21,787,112
Total current liabilities	200,067	208,725	40,506,970	8,105	(133,471)	40,790,396
Deferred rent	—	—	3,719,080	—	—	3,719,080
Other long-term liabilities	—	—	2,525,108	—	—	2,525,108
Long-term debt, excluding current maturities	—	—	130,148,303	—	—	130,148,303
Total liabilities	200,067	208,725	176,899,461	8,105	(133,471)	177,182,887
Net assets:						
Unrestricted	30,768,595	3,519,458	164,611,727	565,216	(172,153)	199,292,843
Temporarily restricted	1,776,451	—	—	—	—	1,776,451
Permanently restricted	4,391,344	—	—	—	—	4,391,344
Total net assets	36,936,390	3,519,458	164,611,727	565,216	(172,153)	205,460,638
Commitments and contingencies						
Total liabilities and net assets	$ 37,136,457	3,728,183	341,511,188	573,321	(305,624)	382,643,525

See accompanying independent auditors' report.

Schedule 2

FLAGLER HOSPITAL, INC. AND SUBSIDIARIES

Consolidating Statement of Operations and Changes in Unrestricted Net Assets

Year ended September 30, 2017

	Foundation	Health services	Hospital	HPOA	Eliminations	Total
Unrestricted revenues:						
Net patient service revenue	$ —	—	237,913,336	—	—	237,913,336
Provision for uncollectible accounts	—	—	(19,152,192)	—	—	(19,152,192)
Net patient service revenue less provision for uncollectible accounts	—	—	218,761,144	—	—	218,761,144
Other operating revenue	—	2,006,032	6,076,376	61,642	(650,248)	7,493,802
Net assets released from restrictions	—	—	301,381	—	—	301,381
Total revenues	—	2,006,032	225,138,901	61,642	(650,248)	226,556,327
Expenses:						
Salaries	—	681,532	88,540,595	—	—	89,222,127
Employee benefits	—	160,765	21,416,470	—	—	21,577,235
Supplies	—	53,037	51,811,108	—	—	51,864,145
Purchased services	—	279,300	30,441,237	56,252	—	30,776,789
Utilities	—	210,876	2,480,976	3,719	—	2,695,571
Insurance	—	94,414	3,844,427	—	—	3,938,841
Lease and rental	—	112,001	1,848,200	—	(647,121)	1,313,080
Professional fees	—	—	13,452,949	—	—	13,452,949
Interest expense	—	—	3,186,166	—	—	3,186,166
Depreciation and amortization	—	352,161	19,157,798	—	—	19,509,959
Indigent tax	—	—	3,226,032	—	—	3,226,032
Other expenses	—	72,861	2,360,685	1,817	(3,127)	2,432,236
Total expenses	—	2,016,947	241,766,643	61,788	(650,248)	243,195,130
Income (loss) from operations	—	(10,915)	(16,627,742)	(146)	—	(16,638,803)
Nonoperating gains (losses):						
Investment income	3,984,322	—	8,543,939	—	—	12,528,261
Other nonoperating gains (losses), net	(1,606,895)	—	1,182,268	—	—	(424,627)
Total nonoperating gains, net	2,377,427	—	9,726,207	—	—	12,103,634
Excess (deficiency) of revenues and gains over expenses	2,377,427	(10,915)	(6,901,535)	(146)	—	(4,535,169)
Net assets released from restrictions for capital purchases	—	—	76,868	—	—	76,868
Increase (decrease) in unrestricted net assets	$ 2,377,427	(10,915)	(6,824,667)	(146)	—	(4,458,301)

See accompanying independent auditors' report.