



Report of Independent Auditors and
Consolidated Financial Statements with
Supplementary Information for

**Sky Lakes Medical Center
and Affiliates**

September 30, 2016 and 2015

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Sky Lakes Medical Center and Affiliates

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Sky Lakes Medical Center and Affiliates (the Medical Center) which comprise the consolidated balance sheets as of September 30, 2016 and 2015, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the 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 controls 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 controls 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.

REPORT OF INDEPENDENT AUDITORS (continued)

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Medical Center as of September 30, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter – Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary consolidating balance sheet, consolidating statement of operations, consolidating changes in net assets, combining balance sheet – obligated group, combining statement of operations – obligated group, and combining statement of changes in net assets – obligated group included on pages 35 through 42 are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and has not been subjected to the auditing procedures applied in the audit of the consolidated financial statements, and, accordingly, we express no opinion on it.

Moss Adams LLP

Portland, Oregon

January 27, 2017

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SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATED BALANCE SHEETS

ASSETS

| | September 30, | |
|---|------------------------------|------------------------------|
| | 2016 | 2015 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 33,410,000 | \$ 13,647,000 |
| Certificates of deposit | 5,577,000 | 12,718,000 |
| Patient accounts receivable, net | 36,322,000 | 32,780,000 |
| Other receivables | 5,209,000 | 5,839,000 |
| Risk pool withhold receivable | 1,662,000 | 3,797,000 |
| Supplies inventories | 3,940,000 | 2,229,000 |
| Prepaid expenses | 2,541,000 | 2,775,000 |
| Promises to give, current portion | 785,000 | 219,000 |
| | <u>89,446,000</u> | <u>74,004,000</u> |
| ASSETS LIMITED AS TO USE | 26,805,000 | 5,057,000 |
| PROPERTY AND EQUIPMENT, net | 95,775,000 | 99,475,000 |
| OTHER ASSETS | | |
| Investments | 113,578,000 | 101,647,000 |
| Deferred financing costs, net of amortization | 1,219,000 | 1,610,000 |
| Promises to give, net of current portion | - | 566,000 |
| Other | 1,348,000 | 1,414,000 |
| | <u>116,145,000</u> | <u>105,237,000</u> |
| Total other assets | <u>116,145,000</u> | <u>105,237,000</u> |
| Total assets | <u><u>\$ 328,171,000</u></u> | <u><u>\$ 283,773,000</u></u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATED BALANCE SHEETS

LIABILITIES AND NET ASSETS

| | September 30, | |
|---|------------------------------|------------------------------|
| | 2016 | 2015 |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 5,309,000 | \$ 10,759,000 |
| Accrued payroll | 6,816,000 | 5,573,000 |
| Accrued compensated absences | 4,550,000 | 4,294,000 |
| Accrued interest payable | 265,000 | 230,000 |
| Other accrued expenses | 9,971,000 | 11,187,000 |
| Estimated third-party payor settlements | 1,775,000 | 2,014,000 |
| Capital lease obligations, current portion | 1,165,000 | 980,000 |
| Long-term debt, current portion | 2,030,000 | 1,945,000 |
| | <u>31,881,000</u> | <u>36,982,000</u> |
| LONG-TERM LIABILITIES | | |
| Capital lease obligations, net of current portion | 6,142,000 | 5,061,000 |
| Long-term debt, net of current portion | 71,582,000 | 50,951,000 |
| Other long-term liabilities | 6,352,000 | 5,793,000 |
| | <u>84,076,000</u> | <u>61,805,000</u> |
| Total liabilities | <u>115,957,000</u> | <u>98,787,000</u> |
| NET ASSETS | | |
| Unrestricted net assets | | |
| Sky Lakes Medical Center | 205,860,000 | 179,619,000 |
| Non-Controlling Interest | 756,000 | 679,000 |
| | <u>206,616,000</u> | <u>180,298,000</u> |
| Temporarily restricted | <u>5,598,000</u> | <u>4,688,000</u> |
| Total net assets | <u>212,214,000</u> | <u>184,986,000</u> |
| Total liabilities and net assets | <u><u>\$ 328,171,000</u></u> | <u><u>\$ 283,773,000</u></u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATED STATEMENTS OF OPERATIONS

| | Years Ended September 30, | |
|--|---------------------------|----------------|
| | 2016 | 2015 |
| REVENUES | | |
| Patient service revenue, net contractual adjustments | \$ 236,920,000 | \$ 215,498,000 |
| Provision for bad debts | (15,136,000) | (12,646,000) |
| Net patient service revenue | 221,784,000 | 202,852,000 |
| Contributions | 23,000 | 62,000 |
| Other revenue | 24,306,000 | 17,028,000 |
| Net assets released from restrictions | 373,000 | 328,000 |
| Total revenues | 246,486,000 | 220,270,000 |
| EXPENSES | | |
| Salaries and benefits | 103,083,000 | 95,594,000 |
| Purchased services | 27,122,000 | 20,319,000 |
| Supplies | 17,563,000 | 16,116,000 |
| Drugs | 17,193,000 | 15,698,000 |
| Depreciation and amortization | 13,759,000 | 10,844,000 |
| Provider tax | 11,165,000 | 10,773,000 |
| Building and maintenance | 12,268,000 | 10,279,000 |
| Physician fees | 7,827,000 | 7,154,000 |
| Interest expense | 3,113,000 | 2,844,000 |
| Insurance | 2,008,000 | 2,195,000 |
| Rentals and lease expense | 1,431,000 | 1,168,000 |
| Professional fees | 3,257,000 | 1,131,000 |
| Minor equipment | 803,000 | 700,000 |
| Other | 4,825,000 | 5,548,000 |
| Total expenses | 225,417,000 | 200,363,000 |
| OPERATING INCOME | 21,069,000 | 19,907,000 |
| OTHER INCOME | | |
| Investment income | 5,188,000 | 6,510,000 |
| Other non-operating (expense) income | (1,351,000) | 462,000 |
| Total other income | 3,837,000 | 6,972,000 |
| EXCESS OF REVENUES OVER EXPENSES | \$ 24,906,000 | \$ 26,879,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

| | Years Ended September 30, | |
|---|---------------------------|----------------|
| | 2016 | 2015 |
| UNRESTRICTED NET ASSETS | | |
| Excess of revenues over expenses | \$ 24,906,000 | \$ 26,879,000 |
| Contributions | - | 56,000 |
| Net change in unrealized gains and losses on other-than-trading securities | 1,412,000 | (3,217,000) |
| Increase in unrestricted net assets | 26,318,000 | 23,718,000 |
| TEMPORARILY RESTRICTED NET ASSETS | | |
| Contributions | 1,054,000 | 444,000 |
| Net change in unrealized gains and losses on other-than-trading securities | 223,000 | (443,000) |
| Investment income | 6,000 | 469,000 |
| Net assets released from restrictions | (373,000) | (328,000) |
| Increase in temporarily restricted net assets | 910,000 | 142,000 |
| CHANGE IN NET ASSETS | 27,228,000 | 23,860,000 |
| NET ASSETS, beginning of year | 184,986,000 | 161,126,000 |
| NET ASSETS, end of year | \$ 212,214,000 | \$ 184,986,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Years Ended September 30, | |
|---|---------------------------|---------------|
| | 2016 | 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Change in net assets | \$ 27,228,000 | \$ 23,860,000 |
| Adjustments to reconcile change in net assets to net cash from operating activities: | | |
| Depreciation and amortization | 13,759,000 | 10,844,000 |
| Net amortization of premiums and accretion of discounts on investments held-to-maturity | 352,000 | 889,000 |
| Net amortization of premiums and accretion of discounts on bonds | (381,000) | (87,000) |
| Net change in unrealized gains and losses on other-than-trading securities | (1,635,000) | 3,217,000 |
| Loss (gain) on sale of investments | (71,000) | (853,000) |
| Other than temporary impairment on investment securities | - | 266,000 |
| Loss on sale of fixed assets | 186,000 | 17,000 |
| (Increase) decrease in the cash surrender value of corporate owned life insurance | (992,000) | 959,690 |
| (Increase) decrease in: | | |
| Patient accounts receivable, net | (3,542,000) | (8,429,000) |
| Other receivables | 630,000 | (1,304,000) |
| Risk pool withhold receivable | 2,135,000 | (1,053,000) |
| Supplies inventories | (1,711,000) | (47,000) |
| Prepaid expenses | 234,000 | (78,000) |
| Promises to give | - | 53,000 |
| Deferred financing costs, net | 391,000 | 83,000 |
| Other assets | 66,000 | 47,000 |
| Increase (decrease) in: | | |
| Accounts payable | (5,450,000) | 4,630,000 |
| Accrued payroll | 1,243,000 | 377,000 |
| Accrued compensated absences | 256,000 | 384,000 |
| Accrued interest payable | 35,000 | (9,000) |
| Other accrued expenses | (1,216,000) | 1,505,000 |
| Estimated third-party payor settlements | (239,000) | (710,000) |
| Other long-term liabilities | 559,000 | 151,000 |
| Net cash from operations | 31,837,000 | 34,712,690 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Years Ended September 30, | |
|---|---------------------------|----------------------|
| | 2016 | 2015 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from sale/redemption of investments | \$ 13,305,000 | \$ 26,446,000 |
| Purchase of investments | (36,718,000) | (37,301,090) |
| Purchase of corporate owned life insurance | (7,920,000) | (21,518,600) |
| Purchase of certificates of deposit | - | (5,000,000) |
| Redemption of certificates of deposit | 7,141,000 | 13,157,000 |
| Purchase of property and equipment | (7,895,000) | (17,258,000) |
| Net cash flows from investing activities | (32,087,000) | (41,474,690) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Issued bonds | 59,146,000 | - |
| Payments on long-term debt | (38,050,000) | (1,604,000) |
| Payment on capital lease obligations | (1,083,000) | (1,281,000) |
| Net cash flows from financing activities | 20,013,000 | (2,885,000) |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | 19,763,000 | (9,647,000) |
| CASH AND CASH EQUIVALENTS, beginning of year | 13,647,000 | 23,294,000 |
| CASH AND CASH EQUIVALENTS, end of year | <u>\$ 33,410,000</u> | <u>\$ 13,647,000</u> |

The Medical Center entered into capital lease obligations in the amount \$2,350,000 and \$75,000 for new property and equipment for the years ended September 30, 2016 and 2015, respectively.

Cash paid for interest, as of September 30, 2016 and 2015, was approximately \$1,973,000 and \$2,853,000, respectively.

During the year ended September 30, 2015, the Foundation received stock with a fair market value of \$600,000. The stock was received to satisfy a previous pledge outstanding.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies

Organization – Sky Lakes Medical Center (the Medical Center) is a not-for-profit hospital located in south-central Oregon. The Medical Center provides inpatient, outpatient, and emergency care services to the residents of Southern Oregon and Northern California. The Medical Center was incorporated in Oregon in 1963.

Principles of consolidation – The consolidated financial statements include the accounts of the Medical Center and all of its wholly-owned and majority-owned subsidiaries. There are four other entities included in these consolidated financial statements:

West Physician Services, LLC dba Sky Lakes Physician Services (WPS)

West Physician Services, LLC dba Sky Lakes Physician Services was established by the Medical Center in 2003 to provide specialty care to patients. The Medical Center is the sole member of WPS.

Sky Lakes Medical Center Foundation, Inc. (the Foundation)

Sky Lakes Medical Center Foundation is a not-for-profit corporation formed to advance the work of the Medical Center through philanthropy. The Foundation is led by a board of directors who serve voluntarily and are elected by the Medical Center.

Klamath Medical Business Center, LLC (KMBC)

In 2004, the Medical Center, together with Cascade Comprehensive Care, Inc. (CCC), formed Klamath Medical Business Center, LLC. The Medical Center directly owns 50% of KMBC. In addition, they indirectly own approximately 18% through their ownership in CCC (Note 5). In addition, the Medical Center performs management functions for KMBC. KMBC exists for the purpose of leasing building facilities to the Medical Center and CCC.

KW Campus, LLC (KW)

In 2015 the Medical Center, together with an unrelated limited liability entity formed KW Campus, LLC. KW was formed to develop a central campus in Klamath Falls, Oregon that is home to a variety of organizations whose purpose is to deliver health care, wellness and safety services, and provide opportunities for those served to improve their lives through effort and reward as part of their journey to self-sufficiency. The Medical Center directly owns 50% of KW and performs all management functions for KW.

All significant intercompany transactions have been eliminated.

Use of estimates – The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

Significant estimates are necessary in determining the fair value of investments, the recorded value of the contractual and bad debt allowance, amount due to or from third parties, risk pool withhold receivable and useful lives of fixed assets. Management believes the assumptions used in arriving at these estimates are reasonable.

Fair value measurements – Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. Market participants are buyers and sellers, who are independent, knowledgeable, and willing and able to transact in the principal (or most advantageous) market for the asset or liability being measured.

Fair value is based on quoted market prices, when available, for identical or similar assets or liabilities. In the absence of quoted market prices, management determines the fair value of the Medical Center's assets and liabilities using valuation models or third-party pricing services, both of which rely on market-based parameters when available, such as interest rate yield curves, option volatilities, and credit spreads. The valuation techniques used are based on observable and unobservable inputs.

The following methods and assumptions were used by the Medical Center in estimating fair values of each class of financial instruments for which it is practicable to estimate that value:

Cash and cash equivalents – The carrying amount approximates the fair value because of the short maturity of those instruments.

Long-term debt – Long-term debt is estimated by discounting future cash flows at rates currently available for debt with similar terms and remaining maturities. The carrying amount approximates the fair value.

Cash and cash equivalents – Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less. Financial instruments potentially subjecting the Medical Center to concentrations of credit risk consist primarily of bank demand deposits in excess of FDIC insured limits. The Medical Center has not experienced any losses in such accounts.

Certificates of deposit – Certificates of deposit are held at various financial institutions and range in maturity through August 2018 and have interest rates ranging from .25% to 1.05%. Certificates of deposit are not subject to withdrawal limitations and are classified as current assets. Early withdrawal may result in a forfeiture of interest earned.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

Patient accounts receivable – In the normal course of business, the Medical Center provides credit terms to its patients, including billing to third-party insurance carriers, most of whom are local residents and are insured under third-party payor agreements. In evaluating the collectability of receivables, the Medical Center 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. Patient accounts receivables are reduced by an allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party coverage, the Medical Center 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, the Medical Center records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible.

The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. The Medical Center's allowance for contractual adjustments was approximately \$40,838,000 and \$57,446,000 at September 30, 2016 and 2015, respectively. The Medical Center's bad debt provision was \$35,309,000 and \$21,523,000 at September 30, 2016 and 2015, respectively. There was no change in the methodology used by the Medical Center to estimate the allowance for contractual adjustments and bad debt provision in the current year.

The mix of gross receivables from patients and third-party payors was as follows at September 30:

| | 2016 | 2015 |
|--------------------------|------|------|
| Medicare | 34% | 41% |
| Medicaid | 23% | 27% |
| Other third-party payors | 32% | 26% |
| Self-pay | 11% | 6% |
| Total | 100% | 100% |

Other receivables – Other receivables consist mainly of provider tax receivable, employee loan receivables, physician loan receivables, and other miscellaneous receivables. These receivables are reduced by an allowance for doubtful accounts determined on a specific reserve basis.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

Risk pool withhold receivable – The risk pool withhold receivable represents funds withheld from claims paid to the providers. Based upon insurance carrier's performance, the funds are either retained by the insurer or paid to the Medical Center.

Supplies inventories – Supplies inventories consist mainly of patient supplies and pharmaceuticals and are carried at the lower of cost (primarily average cost) or market.

Promises to give – Unconditional promises to give are recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received. Conditional promises to give are recognized only when the conditions on which they depend are substantially met and the promise becomes unconditional.

Assets limited as to use – Assets limited as to use include assets held by trustees under indenture agreements (Note 10).

Property and equipment – Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

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

Investments – Investments in equity securities with readily determinable fair values and all investments that are available-for-sale are measured at fair value on the balance sheet. Investment securities that management has the positive intent and ability to hold until maturity are classified as held-to-maturity and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts. Premiums are amortized and discounts are accreted using the interest method over the period remaining until maturity. Investment income or loss (including realized gains and losses on investments, interest, and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

The Medical Center has purchased various cash surrender value life insurance policies on key management. The policies are recorded at the estimated cash-surrender value of the policies. Increases in the cash-surrender value are recorded as investment income.

The Medical Center also has various investments in health-related organizations. Generally, when the ownership interest in health-related activities is more than 50%, the activities are consolidated, and a minority interest is recorded if appropriate. When the ownership interest is at least 20%, but not more than 50%, it is typically accounted for on the equity method, and the income or loss is reflected in net revenue. Activities with less than 20% ownership or lacking significant influence over the operations of the related entity are carried at the lower of cost or estimated net realizable value.

Deferred financing costs – Deferred financing costs incurred and bond premium received in connection with the issuance of the refunding gross revenue bonds are being amortized over the term of the bond issue by the straight line method, which approximates the effective interest rate method.

Health insurance – The Medical Center offers health insurance (the Employee Benefit Plan) to its active employees and families. The Medical Center pays approximately 80% of the premium and employees contribute the remaining 20% through bi-weekly payroll deductions. The Employee Benefit Plan provides medical, dental, vision, and prescription coverage. The Employee Benefit Plan is self-funded, but is reinsured through HM Life Insurance Company with a specific attachment point of \$270,000 per covered individual annually plus a \$60,000 aggregating specific with an unlimited lifetime maximum. The Medical Center has established reserve amounts based upon information as to the status of claims plus development factors for incurred but not yet reported claims and anticipated future changes in underlying case reserves. Such reserve amounts are only estimates and there can be no assurance that the Medical Center's future Employee Benefit Plan obligations will not exceed the amount of its reserves. The Medical Center's reserve for health insurance was approximately \$1,959,000 and \$1,754,000 at September 30, 2016 and 2015, respectively, and is included in accrued payroll on the consolidated balance sheet.

Worker's compensation – The Medical Center is self-funded for worker's compensation insurance, but is reinsured through Safety National Casualty Corporation with a specific attachment point of \$500,000 per claim. The Medical Center has contracted with Empire Pacific Risk Management to act as the third party administrator to process and pay claims. The Medical Center has established reserve amounts based upon information as to the status of claims plus development factors for incurred but not yet reported claims and anticipated future changes in underlying case reserves. Such reserve amounts are only estimates and there can be no assurance that the Medical Center's future workers' compensation obligations will not exceed the amount of its reserves. The Medical Center's reserve for workers' compensation was \$705,000 and \$656,000 at September 30, 2016 and 2015, respectively, and is included in accrued payroll on the consolidated balance sheet. Further, the Department of Consumer and Business Services Workers' Compensation Division requires a security deposit be maintained to support expected future claims and processing costs. As of September 30, 2016, the security deposit requirement was \$568,000. To fulfill the security deposit requirement, the Medical Center has a standby letter of credit with US Bank for the full amount with an expiration date of July 31, 2017.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

Estimated malpractice costs – The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. Estimated malpractice costs are included in other accrued expenses on the consolidated balance sheets and were approximately \$957,000 and \$523,000 as of September 30, 2016 and 2015, respectively. The estimated receivable was approximately \$588,000 and \$251,000 as of September 30, 2016 and 2015, respectively and is included in other receivables on the consolidated balance sheet.

Net patient service revenue – The Medical Center has agreements with third-party payors that provide for payments to the Medical Center at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. For uninsured patients that do not qualify for charity care, the Medical Center recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of the Medical Center's uninsured patients will be unable or unwilling to pay for the services provided.

Thus, the Medical Center records a significant provision for bad debts related to uninsured patients in the period the services are provided. Net patient service revenue is reported at 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.

Other operating revenues – During the 2016 and 2015 fiscal year, the Medical Center received approximately \$7,500,000 and \$2,967,000, respectively from the Oregon Health Authority for the Hospital Transformation Performance Program (HTPP). HTPP established funds from a quality pool which were awarded to hospitals based on their performance on eleven outcome and quality measures. During the 2016 and 2015 fiscal years, approximately \$826,000 and \$1,221,000, respectively, was received from Centers for Medicare & Medicaid (CMS), pursuant to the Health Information Technology for Economic and Clinical Health Act (HITECH Act), for reimbursement of Electronic Health Records (EHR) capital expenditures made by the Medical Center, also known as Meaningful Use funds. The Medical Center recognizes income associated with these funds when its requirements for reimbursement have been met and application for reimbursement has been submitted to CMS.

The Medical Center has contracted with several pharmacies to provide contracted 340b pharmacy services for eligible patients of the Medical Center. Revenue from these pharmacy contracts is included in other operating revenue on the consolidated statement of operations and was approximately \$2,788,000 and \$3,566,000 for the years ending September 30, 2016 and 2015, respectively.

The Medical center operates a retail pharmacy within the hospital. Revenue from the retail pharmacy is included in other operating revenue on the consolidated statement of operations and was approximately \$3,816,000 and \$1,776,000 for the years ending September 30, 2016 and 2015, respectively.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

Charity care – The Medical Center provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Medical Center does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The policy of the Medical Center for charity care includes providing non-elective services to patients whose household income falls at or below 200% of the Federal Poverty Level at no cost. For those patients who fall between 200% and 400% of the Federal Poverty Level and who are unable to pay their bills, patients are eligible for either a partial write-off of their account, annual maximum out of pocket, or both. The policy applies to both insured patients as well as uninsured patients provided the patient meets the eligibility criteria. Total cost of charity care provided by the Medical Center was approximately \$3,202,000 and \$2,685,000 for the years ending September 30, 2016 and 2015, respectively.

Donated restricted gifts – Unconditional promises to give cash and other assets to the Medical Center 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. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Temporarily and permanently restricted net assets – Temporarily restricted net assets are those whose use by the Medical Center has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Medical Center in perpetuity. The Medical Center does not have any permanently restricted net assets at September 30, 2016 and 2015.

Excess of revenues over expenses – The consolidated statement of operations includes excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include the net change in unrealized gains and losses on investments other-than-trading securities, contributions, and distributions.

Volunteers – A significant portion of the Medical Center's gift shop operations and patient relations functions are conducted by unpaid volunteers. The value of this contributed time is not reflected in the accompanying consolidated financial statements since the volunteers' time does not meet the criteria for recognition.

Income taxes – The Medical Center and Foundation are tax-exempt organizations and are not subject to state or federal income taxes, except on unrelated business income, in accordance with Section 501(c)(3) of the Internal Revenue Code.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

The Medical Center and Foundation had no unrecognized tax benefits at September 30, 2016 or 2015. The Medical Center and Foundation recognize interest accrued and penalties related to unrecognized tax benefits as an administrative expense. During the years ended September 30, 2016 and 2015, the Medical Center and Foundation recognized no interest and penalties.

The Medical Center files an exempt organization information return and an unrelated business income tax return in the U.S. federal jurisdiction and an unrelated business income tax return with the Oregon Department of Revenue.

The Foundation files an exempt organization information return in the U.S. federal jurisdiction.

WPS, the Medical Center's for-profit corporate subsidiary, accounts for income taxes in accordance with Accounting Standards Codification ("ASC") 740-10, whereby, income taxes are provided for the tax effects of transactions reported in the consolidated financial statements and consist of taxes currently due plus deferred taxes. Deferred taxes are recognized for differences between the basis of assets and liabilities for financial statement and income tax purposes.

KMBC and KW have elected to be taxed under the provisions of the Oregon Limited Liability Company Act. Under those provisions, the LLC's do not pay federal income tax on their taxable income. Instead, the members are liable for income taxes on each LLC's taxable income.

The Klamath Falls Intercommunity Hospital Authority (the Authority) is a municipal corporation under Oregon state law and is not subject to federal income tax.

Recent accounting pronouncements – In April 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. ASU 2015-03 requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability. This ASU is effective for annual periods ending December 31, 2017 and interim and annual periods thereafter, with early adoption permitted. Management is currently evaluating the impact of the provisions of ASU No. 2015-03 on the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, which increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements in the financial statements of lessees. This update is effective for fiscal years beginning after December 15, 2019, with early adoption permitted. Management is currently evaluating the impact of the provisions of ASU No. 2016-02 on the consolidated financial statements.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Organization and Summary of Significant Accounting Policies (continued)

In August 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)*, which improves the current net asset classification requirements and the information presented in financial statements and notes about an entity's liquidity, financial performance, and cash flows. The update removes the requirement to present three classes of net assets with two classes, net assets with donor restrictions and net assets without donor restrictions. The update also removes the requirement to present or disclose the indirect method (reconciliation) if using the direct method for the statement of cash flows as well as added several additional enhanced disclosures to the notes. The amendments in this update are effective for fiscal years beginning after December 15, 2017 and interim periods beginning after December 15, 2018, with application to interim financial statements permitted but not required in the initial year of application. Management is currently evaluating the impact of the provisions of ASU No. 2016-14 on the consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230)*, which requires the statement of cash flows to explain the change during the period in the total cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The amendments in this update are effective for fiscal years beginning after December 15, 2018 and interim periods beginning after December 15, 2019, with early adoption permitted. Management is currently evaluating the impact of the provisions of ASU No. 2016-18 on the consolidated financial statements.

Subsequent events – Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. The Medical Center recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Medical Center's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before financial statements are issued.

The Medical Center has evaluated subsequent events through January 27, 2017, which is the date the financial statements were issued.

Reclassifications – Certain reclassifications have been made to the 2015 consolidated financial statements to conform to current-year presentations. These reclassifications did not affect previously reported excess of revenues over expenses or net assets.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Net Patient Service Revenue

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

- *Medicare* – Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to patient classification systems that are based on clinical, diagnostic, and other factors. Medical education costs and uncollected bad debts on patient accounts related to Medicare beneficiaries are paid based on a modified cost reimbursement methodology. Additional payments for the Medicare disproportionate share are made to the Medical Center based on the ratio of Title XIX inpatient recipients to total inpatients. The Medical Center is reimbursed for outpatient cost reimbursable items at a tentative rate with final settlement determined after submission of the annual cost report by the Medical Center and audit thereof by the Medicare fiscal intermediary.
- Atrio Health Plans, Inc. is a for-profit Oregon health care service, of which CCC owns 36% interest (Note 14). Atrio Health Plans, Inc. provides Medicare Advantage Plans to residents primarily of Douglas, Klamath, Marion, and Polk counties.
- *Medicaid* – Inpatient services rendered to Medicaid program beneficiaries are reimbursed at prospectively determined rates and outpatient services rendered to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology. The Medical Center is reimbursed at a tentative rate with final settlement determined after submission of the annual cost report by the Medical Center and finalization of the cost report by the Oregon Division of Medical Assistance Programs (DMAP).
- CCC is a local Medicaid claims administrator of which the Medical Center owns 48% (Note 5 and 14). The Medical Center is paid on an interim basis based upon prospectively determined rates. The Medical Center also participates in a risk pool arrangement that encourages cost containment.

Entities doing business with governmental payors, including Medicare and Medicaid, are subject to risks unique to the government-contracting environment that are difficult to anticipate and quantify. Revenues are subject to adjustment as a result of examination by government agencies as well as auditors, contractors, and intermediaries retained by the federal, state, or local governments (collectively “Government Agents”). Resolution of such audits or reviews often extends (and in some cases does not even commence until) several years beyond the year in which services were rendered and/or fees received.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 – Net Patient Service Revenue (continued)

Moreover, different Government Agents frequently interpret government regulations or other requirements differently. For example, Government Agents might disagree on a patient's principal medical diagnosis, the appropriate code for a clinical procedure, or many other matters. Such disagreements might have a significant effect on the ultimate payout due from the government to fully recoup sums already paid. Governmental agencies may make changes in program interpretations, requirements, or "conditions of participation," some of which may have implications for amounts previously estimated. In addition to varying interpretation and evolving codification of the regulations, standards of supporting documentation and required data are subject to wide variation.

In accordance with generally accepted accounting principles, to account for the uncertainty around Medicare and Medicaid revenues, the client estimates the amount of revenue that will ultimately be received under the Medicare and Medicaid programs. Amounts ultimately received or paid may vary significantly from these estimates.

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

Patient service revenue, net of contractual allowances of approximately \$328,478,000 and \$302,673,000 for the years ending September 30, 2016 and 2015, respectively, recognized in the period from major payor sources is as follows:

| | <u>2016</u> | <u>2015</u> |
|-----------------------------------|-----------------------|-----------------------|
| Medicare | \$ 80,831,000 | \$ 81,320,000 |
| Other third-party payors | 106,127,000 | 83,782,000 |
| Medicaid | 48,554,000 | 48,008,000 |
| Self-pay | 1,408,000 | 2,388,000 |
| Provision for bad debts | <u>(15,136,000)</u> | <u>(12,646,000)</u> |
| Total net patient service revenue | <u>\$ 221,784,000</u> | <u>\$ 202,852,000</u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3 – Promises to Give

Unconditional promises to give at September 30 are as follows:

| | <u>2016</u> | <u>2015</u> |
|---------------------------------------|--------------------------|--------------------------|
| Receivable in less than one year, net | \$ 785,000 | \$ 219,000 |
| Receivable in one to five years, net | <u>-</u> | <u>566,000</u> |
| | <u><u>\$ 785,000</u></u> | <u><u>\$ 785,000</u></u> |

At September 30, 2016 and 2015, substantially all unconditional promises to give were from one donor.

Note 4 – Assets Limited as to Use

Assets held by trustees under indenture agreements for the bonds outstanding at September 30 include:

| | <u>2016</u> | <u>2015</u> |
|---------------------------------|-----------------------------|----------------------------|
| Guaranteed investment contracts | \$ - | \$ 4,793,000 |
| Money market | <u>26,805,000</u> | <u>264,000</u> |
| | <u><u>\$ 26,805,000</u></u> | <u><u>\$ 5,057,000</u></u> |

In 2016, The Authority issued \$53,325,000 in Series 2016 Bonds (Note 10) with an initial \$25,000,000 of the sale proceeds being set aside for various capital expenditures by the Medical Center. The remaining sales proceeds, for which expenditures have yet to occur, is recorded within the assets limited as to use as of September 30, 2016.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 – Investments

Investments at September 30 include:

| | 2016 | 2015 |
|--------------------------------------|-----------------------|-----------------------|
| Corporate bonds, held-to-maturity | \$ 45,539,000 | \$ 46,552,000 |
| Life insurance | 36,471,000 | 27,559,000 |
| Money market | 26,805,000 | 264,000 |
| Common stocks | 20,093,000 | 17,213,000 |
| Certificates of deposit | 5,577,000 | 12,718,000 |
| Cascade Comprehensive Care, Inc. | 5,435,000 | 4,900,000 |
| Mutual funds | 4,358,000 | 4,058,000 |
| Population Health Alliance, LLC | 1,290,000 | 1,000,000 |
| Southern Oregon Linen Services, Inc. | 392,000 | 362,000 |
| Guaranteed investment contracts | - | 4,793,000 |
| Mt. States Healthcare RRG | - | 3,000 |
| | <u>\$ 145,960,000</u> | <u>\$ 119,422,000</u> |

The reconciliation between investments on the consolidated financial statements and the above table is as follows as of September 30:

| | 2016 | 2015 |
|--|-----------------------|-----------------------|
| Investments on the consolidated balance sheet | \$ 113,578,000 | \$ 101,647,000 |
| Assets limited as to use on the consolidated balance sheet | 26,805,000 | 5,057,000 |
| Certificates of deposit on the consolidated balance sheet | 5,577,000 | 12,718,000 |
| | <u>\$ 145,960,000</u> | <u>\$ 119,422,000</u> |

Southern Oregon Linen Service, Inc.

The Medical Center owns 13.2% of the common stock in Southern Oregon Linen Service (SOLS). SOLS was established in 1996 as a central cooperative laundry to service several regional hospitals. The Medical Center concluded that it could not exert influence over SOLS' operations and financial activities; therefore, the Medical Center is accounting for the investment on the cost method.

Population Health Alliance of Oregon, LLC

The Medical Center has 7% ownership in Population Health Alliance of Oregon, LLC (PHA). PHA was created with other public benefit non-profit organizations to promote coordinated health care interventions and communication for populations with conditions in which self-care efforts are significant. The Medical Center concluded that it could not exert influence over PHA's operations and financial activities; therefore, the Medical Center is accounting for the investment on the cost method.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 – Investments (continued)

Cascade Comprehensive Care, Inc.

The Medical Center owns 48% of the common stock in CCC, which is accounted for using the equity method. CCC is a managed health care company that currently manages a Medicaid contract under the Oregon Health Plan. CCC handles quality assurance, utilization management, claims adjudication, pharmacy management, encounter reporting, financial and solvency reporting, physician and provider contracting, reinsurance/stoploss issues, risk model management etc. for the local community.

The following represents the unaudited summary financial information for CCC for the years ended September 30:

| | 2016 (unaudited) | 2015 (unaudited) |
|------------------------------|----------------------|----------------------|
| Current assets | \$ 19,803,000 | \$ 21,669,000 |
| Noncurrent assets | 17,646,000 | 12,035,000 |
| | <u>\$ 37,449,000</u> | <u>\$ 33,704,000</u> |
| Total assets | | |
| Current liabilities | \$ 24,504,000 | \$ 21,236,000 |
| Noncurrent liabilities | 1,716,000 | 47,000 |
| Equity | 11,229,000 | 12,421,000 |
| | <u>\$ 37,449,000</u> | <u>\$ 33,704,000</u> |
| Total liabilities and equity | | |
| Operating revenue | \$ 88,330,000 | \$ 49,726,000 |
| Operating expenses | 85,626,000 | 45,642,000 |
| | <u>\$ 2,704,000</u> | <u>\$ 4,084,000</u> |
| Operating income | | |

Note 6 – Fair Value Measurements

Financial Accounting Standards Board ASC 820, *Fair Value Measurements and Disclosures*, provides the framework for measuring fair value. That framework 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 measurement) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described as follows:

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6 – Fair Value Measurements (continued)

Basis of fair value measurement –

Level 1 – Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Medical Center has the ability to access.

Level 2 – Inputs to the valuation methodology are quoted prices in markets that are not considered to be active or financial instruments without quoted market prices, but for which all significant inputs are observable, either directly or indirectly.

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 used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at September 30, 2016 and 2015.

Corporate bonds, available-for-sale– Valued at the closing price reported on the major market on which the individual securities are traded or have reported broker trades which may be considered indicative of an active market. Where quoted prices are available in an active market, the investments are classified within level 1 of the valuation hierarchy. If quoted market prices are not available for the specific security, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, discounted cash flows, and other observable inputs.

Life insurance – Valued at the estimated cash-surrender value of the policies. The carrying amount approximates fair value.

Mutual funds – Valued at the net asset value of shares held by the Medical Center at year end using prices quoted by the relevant pricing agent.

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

Certificates of deposit – Valued at fair value by discounting the related cash flows based on current yields of similar instruments with comparable durations considering the credit-worthiness of the issuer.

Guaranteed investment contracts –Valued by discounting the related cash flows based on current yields of similar instruments with comparable durations considering the credit-worthiness of the issuer.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6 – Fair Value Measurements (continued)

The following tables disclose by level, the fair value hierarchy, of the Medical Center's assets at fair value at September 30, 2016:

| | Fair Value Measurements | | | |
|-------------------------|-------------------------|----------------------|----------------------|-------------|
| | Total Fair Value | Level One | Level Two | Level Three |
| Common stock | | | | |
| Consumer goods | \$ 7,066,000 | \$ 3,897,000 | \$ 3,169,000 | \$ - |
| Other | 92,000 | 92,000 | - | - |
| Healthcare | 997,000 | 997,000 | - | - |
| Utilities | 1,034,000 | 1,034,000 | - | - |
| Industrial goods | 1,326,000 | 1,326,000 | - | - |
| Services | 1,447,000 | 1,447,000 | - | - |
| Basic materials | 1,452,000 | 1,452,000 | - | - |
| Financial | 3,270,000 | 3,270,000 | - | - |
| Technology | 3,409,000 | 3,409,000 | - | - |
| Life insurance | 36,471,000 | - | 36,471,000 | - |
| Mutual funds | | | | |
| Equity funds | 2,000,000 | - | 2,000,000 | - |
| Hybrid funds | 1,315,000 | - | 1,315,000 | - |
| Bond funds | 456,000 | - | 456,000 | - |
| Value funds | 272,000 | - | 272,000 | - |
| Money market funds | 27,105,000 | - | 27,105,000 | - |
| Other funds | 15,000 | - | 15,000 | - |
| Certificates of deposit | 5,577,000 | - | 5,577,000 | - |
| | <u>\$ 93,304,000</u> | <u>\$ 16,924,000</u> | <u>\$ 76,380,000</u> | <u>\$ -</u> |

Investment securities that management has the positive intent and ability to hold until maturity are classified as held-to-maturity and are carried at their remaining unpaid principal balance, net of unamortized premiums or unaccreted discounts and therefore excluded from the fair value tables. Total investments held-to-maturity, valued at cost, and investments in other healthcare entities accounted for at cost or equity as of September 30, 2016 were approximately \$52,656,000.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6 – Fair Value Measurements (continued)

The following tables disclose by level, the fair value hierarchy, of the Medical Center's assets at fair value at September 30, 2015:

| | Fair Value Measurements | | | |
|---------------------------------|-------------------------|----------------------|----------------------|-------------|
| | Total Fair Value | Level One | Level Two | Level Three |
| Common stock | | | | |
| Consumer goods | \$ 5,945,000 | \$ 2,874,000 | \$ 3,071,000 | \$ - |
| Technology | 2,664,000 | 2,664,000 | - | - |
| Financial | 3,336,000 | 3,336,000 | - | - |
| Services | 1,606,000 | 1,606,000 | - | - |
| Basic materials | 1,165,000 | 1,165,000 | - | - |
| Healthcare | 960,000 | 960,000 | - | - |
| Industrial goods | 859,000 | 859,000 | - | - |
| Other | 393,000 | 393,000 | - | - |
| Utilities | 285,000 | 285,000 | - | - |
| Life insurance | 27,559,000 | - | 27,559,000 | - |
| Guaranteed investment contracts | 4,793,000 | - | 4,793,000 | - |
| Mutual funds | | | | |
| Equity funds | 2,412,000 | - | 2,412,000 | - |
| Hybrid funds | 1,084,000 | - | 1,084,000 | - |
| Bond funds | 294,000 | - | 294,000 | - |
| Value funds | 292,000 | - | 292,000 | - |
| Money market funds | 228,000 | - | 228,000 | - |
| Other funds | 12,000 | - | 12,000 | - |
| Certificates of deposit | 12,718,000 | - | 12,718,000 | - |
| | <u>\$ 66,605,000</u> | <u>\$ 14,142,000</u> | <u>\$ 52,463,000</u> | <u>\$ -</u> |

Total investments held-to-maturity, valued at cost, and investments in other healthcare entities accounted for at cost or equity as of September 30, 2015 were \$52,817,000.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 – Property and Equipment

A summary of property and equipment at September 30 follows:

| | 2016 | 2015 |
|---|----------------|----------------|
| Buildings and fixed equipment | \$ 120,066,000 | \$ 121,942,000 |
| Moveable equipment | 63,907,000 | 57,873,000 |
| Equipment under capital lease obligations | 13,921,000 | 12,326,000 |
| Land improvements | 4,231,000 | 4,078,000 |
| Land | 3,310,000 | 3,094,000 |
| Leasehold improvements | 184,000 | 184,000 |
| | 205,619,000 | 199,497,000 |
| Less: Accumulated depreciation and amortization | (111,619,000) | (101,992,000) |
| | 94,000,000 | 97,505,000 |
| Construction in progress | 1,775,000 | 1,970,000 |
| Property and equipment, net | \$ 95,775,000 | \$ 99,475,000 |

Depreciation expense from operations for the years ended September 30, 2016 and 2015 was \$12,598,000 and \$9,672,000, respectively. Amortization expense for the years ended September 30, 2016 and 2015 was \$1,161,000 and \$1,172,000, respectively. Accumulated amortization for equipment under capital lease obligations was \$6,745,000 and \$6,391,000 at September 30, 2016 and 2015, respectively.

Note 8 – Plum Ridge Care Center

Lease value of Plum Ridge Care Center – In 2001, Klamath County, Oregon deeded the Plum Ridge Care Center to the Authority. The Medical Center entered into a long-term lease agreement for a period of 89 years for the sum of \$1 per year. In addition, the Medical Center has the option of purchasing the property at any time for the sum of \$1. The Medical Center recognized the fair value of the lease at the time the agreement with the Authority was entered into. The Medical Center is amortizing the lease value over the life of the lease. The lease value of Plum Ridge Care Center at September 30, 2016 and 2015 was approximately \$1,348,000 and \$1,404,000, respectively, and is included in other assets in the consolidated balance sheet.

Deferred rental revenue – In 2001, the Medical Center subleased the Plum Ridge Care Center to Plum Ridge Care Community, LLC, an unrelated third party, on equivalent lease terms as to the Medical Center's lease with the Authority, except the Medical Center did not grant the right to purchase the property to Plum Ridge Care Community, LLC. The Medical Center recognized a liability to Plum Ridge Care Community, LLC, for the lease value of the remaining term of the lease. The revenue is being amortized over the lease term. The deferred rental revenue of Plum Ridge Care Center was approximately \$2,441,000 and \$2,474,000 at September 30, 2016 and 2015, respectively, and is included in other long-term liabilities in the consolidated balance sheet.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 – Capital Leases

Capital leases as of September 30 are as follows:

| | 2016 | 2015 |
|--|--------------|--------------|
| Facility lease with a private party with monthly payments of \$36,274 at 8.90% through September 2037. | \$ 4,131,000 | \$ 4,194,000 |
| Equipment lease-purchase agreement with Toshiba America Medical Credit with monthly payments of \$34,809 at 1.18% through September 2017. | 380,000 | 791,000 |
| Equipment lease-purchase agreement with Phillips Medical Capital, LLC with monthly payments of \$17,153 at 2.11% through April 2018. | 305,000 | 502,000 |
| Equipment lease-purchase agreement with CareFusion Solutions, LLC with monthly payments of \$14,685 at 2.64% through May 2017. | 877,000 | 290,000 |
| Equipment lease-purchase agreement with Phillips Medical Capital, LLC with monthly payments of \$9,347 at 2.52% through October 2017. | 126,000 | 234,000 |
| Equipment lease-purchase agreement with GE Healthcare Financial Services with monthly payments of \$5,574 at 6.73% through March 2021. | 338,000 | 30,000 |
| Equipment lease-purchase agreement with GE Healthcare Financial Services with monthly payments of \$2,022 at 1.50% through May 2021. | 107,000 | - |
| Equipment lease-purchase agreement with GE Healthcare Financial Services with monthly payments of \$7,778 at 1.50% through May 2021. | 420,000 | - |
| Equipment lease-purchase agreement with GE Healthcare Financial Services with monthly payments of \$9,632 at 1.50% through May 2021. | 521,000 | - |
| Equipment lease-purchase agreement with GE Healthcare Financial Services with monthly payments of \$1,707 at 1.50% through September 2021. | 102,000 | - |
| Total capital lease obligations | 7,307,000 | 6,041,000 |
| Less current portion | (1,165,000) | (980,000) |
| Capital lease obligations, net of current portion | \$ 6,142,000 | \$ 5,061,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 – Capital Leases (continued)

Scheduled payments on capital lease obligations for the years ending September 30 are as follows:

| | |
|---|----------------------------|
| 2017 | \$ 1,645,000 |
| 2018 | 1,062,000 |
| 2019 | 942,000 |
| 2020 | 942,000 |
| 2021 | 998,000 |
| Thereafter | <u>6,964,000</u> |
| Total minimum lease payments | 12,553,000 |
| Less: Amount representing interest | <u>(5,246,000)</u> |
| Present value of net minimum lease payments | <u><u>\$ 7,307,000</u></u> |

Note 10 – Long-Term Debt

Long term debt consisted of the following as of September 30:

| | <u>2016</u> | <u>2015</u> |
|--|-----------------------------|-----------------------------|
| Series 2016 Bonds with interest rates from 2% to 5% and mature in varying amounts through 2046, net of premiums of \$5,773,275 at September 30, 2016. | \$ 58,163,000 | \$ - |
| Series 2012 Bonds with interest rates from 3.5% to 5% and mature in varying amounts through 2031, net of premiums of \$1,114,115 and \$1,188,390 at September 30, 2016 and 2015, respectively. | 15,449,000 | 16,588,000 |
| Series 2006 Bonds with interest rates from 4% to 5% and were paid in full during fiscal year 2016, net of premiums of \$257,455 at September 30, 2015. | <u>-</u> | <u>36,308,000</u> |
| Total long-term debt | 73,612,000 | 52,896,000 |
| Less current portion | <u>(2,030,000)</u> | <u>(1,945,000)</u> |
| Long-term debt, net of current portion | <u><u>\$ 71,582,000</u></u> | <u><u>\$ 50,951,000</u></u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 – Long-Term Debt (continued)

2016 Bonds

During the year ended September 30, 2016, The Authority issued \$53,325,000 in Series 2016 Bonds to defease the remaining 2006 Bonds, to pay or to reimburse the Medical Center for capital expenditures, to fund a Reserve Fund for the 2016 Bonds, and to pay costs of issuing the 2016 Bonds. The issuance was structured as a legal defeasance. Adequate amounts of the 2016 Bond issuance were used to purchase U.S. Treasury Securities to fully pay the debt service requirements of the 2006 Bonds. The securities have been placed in an escrow account and the Escrow Agent for the account will pay the debt service requirements as they become due. As the debt for the 2006 Series has been legally defeased, the Medical Center is no longer required to report the liability in the consolidated balance sheet.

The 2016 Bonds are secured by a Deed of Trust on a portion of the Medical Center campus, including the main hospital facility.

2012 Bonds

In 2013, The Authority issued \$17,000,000 in Series 2012 Bonds to defease the remaining 2002 Bonds, to pay or to reimburse the Medical Center for the payment of new equipment, to fund a Reserve Fund for the 2012 Bonds, and to pay costs of issuing the 2012 Bonds. The issuance was structured as a legal defeasance. Adequate amounts of the 2012 Bond issuance were used to purchase U.S. Treasury Securities to fully pay the debt service requirements of the 2002 Bonds. The securities have been placed in an escrow account and the Escrow Agent for the account will pay the debt service requirements as they become due. As the debt for the 2002 Series has been legally defeased, the Medical Center is no longer required to report the liability in the consolidated balance sheet.

The 2012 Bonds are secured by a Deed of Trust on a portion of the Medical Center campus, including the main hospital facility. They are further secured by a Reserve Fund, created by the terms of the Bond Indenture to be held by the Bond Trustee (Note 4) to prevent a payment default on the Bonds. The Reserve Fund is required to maintain a balance equal to the lesser of the maximum annual debt service, 125% of the average annual debt service, or 10% of the bond proceeds. They are also secured by a pledge of the gross revenues.

2006 Bonds

In 2006, the Authority issued Series 2006 Bonds to defease \$19,265,000 of the 2002 Bonds, to finance costs of improving, expanding, and equipping the existing hospital and related facilities, and to fund a Reserve Fund on behalf of the Medical Center. The issuance was structured as a legal defeasance. Adequate amounts of the 2006 Bond issuance were used to purchase U.S. Treasury Securities to fully pay the debt service requirements of the 2002 Bonds. The securities have been placed in an escrow account and the Escrow Agent for the account will pay the debt service requirements as they become due. Because it is legally defeased, the Medical Center is no longer required to report the liability in the consolidated balance sheet.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 – Long-Term Debt (continued)

The 2006 Bonds are secured by a Deed of Trust on a portion of the Medical Center campus, including the main hospital facility. They are further secured by a Reserve Fund, created by the terms of the Bond Indenture to be held by the Bond Trustee (Note 4) to prevent a payment default on the Bonds. The Reserve Fund is required to maintain a balance equal to the lesser of the maximum annual debt service, 125% of the average annual debt service, or 10% of the bond proceeds. They are also secured by a pledge of the gross revenues.

The Medical Center must satisfy certain covenants as long as the 2006 Bonds are outstanding. At September 30, 2016, management is not aware of any violation of the covenants.

Scheduled future principal payments and amortization of premiums for all long-term debt for the years ending September 30 are as follows:

| | |
|------------|-----------------------------|
| 2017 | \$ 2,030,000 |
| 2018 | 2,366,000 |
| 2019 | 2,452,000 |
| 2020 | 2,552,000 |
| 2021 | 2,657,000 |
| Thereafter | <u>61,555,000</u> |
| | <u><u>\$ 73,612,000</u></u> |

Note 11 – Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at September 30:

| | <u>2016</u> | <u>2015</u> |
|---|----------------------------|----------------------------|
| Cancer Endowment Fund | \$ 1,944,000 | \$ 1,749,000 |
| Capital Campaign | 1,405,000 | 1,405,000 |
| Cancer Discretionary Fund | 409,500 | 480,000 |
| Other Funds | <u>1,839,500</u> | <u>1,054,000</u> |
| Total temporarily restricted net assets | <u><u>\$ 5,598,000</u></u> | <u><u>\$ 4,688,000</u></u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 – Income Taxes

WPS has \$26,900,000 available of unused operating loss carry forwards available at September 30, 2016, that may be applied against future taxable income, which expire in years 2024 through 2036.

Utilization of any deferred tax assets for the operating loss carry forwards disclosed above is dependent on future taxable profits. Because WPS has no history of sustained profitability and the asset will not be realized within one year of the balance sheet date, deferred tax assets of \$10,400,000 and \$8,700,000, including the unused operating loss carry forwards, have been fully reserved for at September 30, 2016 and 2015, respectively.

Note 13 – Commitments and Contingencies

Operating Leases

Lessee Leases

The Medical Center leases equipment and facilities under operating leases which expire through May 2018. Total rental expense for all operating leases in the fiscal years ending September 30, 2016 and 2015 was approximately \$689,000 and \$786,000, respectively.

Minimum future payments on non-cancelable leases as of September 30 are:

| | |
|------|-------------------|
| 2017 | \$ 460,000 |
| 2018 | <u>203,000</u> |
| | <u>\$ 663,000</u> |

Lessor Leases

The Medical Center is the lessor of the office space to various entities under operating leases expiring in various years through September 2057.

Following is a summary of property on or held for lease at September 30:

| | <u>2016</u> | <u>2015</u> |
|-------------------------------|---------------------|---------------------|
| Buildings and improvements | \$ 9,688,000 | \$ 8,928,000 |
| Less accumulated depreciation | <u>(5,551,000)</u> | <u>(4,707,000)</u> |
| | <u>\$ 4,137,000</u> | <u>\$ 4,221,000</u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 – Commitments and Contingencies (continued)

Minimum future rentals to be received on non-cancelable leases as of September 30 are:

| | |
|------------|----------------------------|
| 2017 | \$ 761,000 |
| 2018 | 660,000 |
| 2019 | 490,000 |
| 2020 | 358,000 |
| 2021 | 281,000 |
| Thereafter | <u>245,000</u> |
| | <u><u>\$ 2,795,000</u></u> |

Litigation

The Medical Center is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Medical Center's future financial position or results from operations.

Note 14 – Related-Party Transactions

The following is a summary of transactions between the Medical Center and related parties:

Atrio Health Plans

The Medical Center received \$13,991,000 and \$13,051,000 in Medicare reimbursement from Atrio Health Plans, Inc. in fiscal year 2016 and 2015, respectively.

Southern Oregon Linen Services

The Medical Center purchased laundry services of approximately \$417,000 and \$380,000 from Southern Oregon Linen Services in fiscal years 2016 and 2015, respectively.

Cascade Comprehensive Care, Inc.

The Medical Center received approximately \$34,242,000 and \$21,934,000 in Medicaid reimbursements from CCC in fiscal years 2016 and 2015, respectively.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 15 – Functional Expenses

The Medical Center provides general health care services to residents within its geographic location. Expenses related to providing these services for the Medical Center as of September 30 are as follows:

| | 2016 | 2015 |
|----------------------------|-----------------------|-----------------------|
| Healthcare services | \$ 191,604,450 | \$ 168,289,000 |
| General and administrative | 33,812,550 | 32,074,000 |
| Total | <u>\$ 225,417,000</u> | <u>\$ 200,363,000</u> |

Note 16 – Retirement Plans

401(a) – Money Purchase Pension Plan

The Medical Center has established a defined contribution retirement plan for all employees who have at least one year of service, are age twenty-one or older, and have completed 1,000 hours of service in the plan year. The Medical Center is required to contribute 5% of an employee's eligible compensation to the plan each plan year. The Medical Center accrued \$3,007,000 and \$2,685,000 to the plan on behalf of employees for fiscal years ended September 30, 2016 and 2015, respectively, which was included in other accrued expenses in the consolidated balance sheets.

403(b) – Elective Deferral Plan

The Medical Center has established a 403(b) retirement plan covering substantially all employees under the guidelines of Internal Revenue Code 403(b) Tax Deferred Annuity Plan. The employees may elect to contribute, according to a salary reduction agreement, a percentage of their annual compensation and are eligible for the plan on the first day of employment with the Medical Center. The Plan is a 'Custodial Account Plan' invested in mutual funds.

401(k) Plan

WPS established the West Physician Services 401(k) Retirement Plan, which is a qualified retirement plan under Section 401(k) of the Internal Revenue Code. All employees over 21 years of age are eligible to participate in the plan. There are no employer contributions made to the plan.

409(a) – Retirement Plan

WPS established the West Physician Services Nonqualified Retirement Plan, for the purposes of providing nonqualified retirement benefits to a select group of its employees. The Medical Center is required to contribute 15% of an employee's compensation to the plan each plan year. In addition, the plan permits eligible employees to defer a portion of their compensation. The participant balances are distributable in cash after retirement or termination of employment. The Medical Center contributed \$341,000 and \$463,000 to the plan on behalf of employees for fiscal years ended September 30, 2016 and 2015, respectively.

SKY LAKES MEDICAL CENTER AND AFFILIATES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 16 – Retirement Plans (continued)

457(b) – Deferred Compensation Plan

The Medical Center established the Sky Lakes Medical Center 457(b) Plan. The Plan is a 457(b) qualified deferred compensation plan that permits eligible employees to defer a portion of their compensation. The participant balances are distributable in cash after retirement, unforeseeable emergencies, or termination of employment. Employer contributions to the plan approximated \$60,000 and \$49,000 for the years ended September 30, 2016 and 2015, respectively. The Medical Center may hold the participant balances in cash or invest it in assets selected by the Plan Administrator. The Plan Administrator has elected to invest the participant balances in mutual funds.

SUPPLEMENTARY INFORMATION

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SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATING BALANCE SHEET
SEPTEMBER 30, 2016

| | ASSETS | | | | | | |
|---|-----------------------------|---|--|--------------|----------------|------------------------|----------------|
| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Klamath Medical Business Center | KW Campus | Total | Eliminating Entries | Consolidated |
| CURRENT ASSETS | | | | | | | |
| Cash and cash equivalents | \$ 32,207,000 | \$ 759,000 | \$ 414,000 | \$ 30,000 | \$ 33,410,000 | \$ - | \$ 33,410,000 |
| Certificates of deposit | 5,577,000 | - | - | - | 5,577,000 | - | 5,577,000 |
| Patient accounts receivable, net | 36,322,000 | - | - | - | 36,322,000 | - | 36,322,000 |
| Other receivables | 8,166,000 | - | - | - | 8,166,000 | (2,957,000) | 5,209,000 |
| Risk pool withhold receivable | 1,662,000 | - | - | - | 1,662,000 | - | 1,662,000 |
| Supplies inventories | 3,940,000 | - | - | - | 3,940,000 | - | 3,940,000 |
| Prepaid expenses | 2,541,000 | - | - | - | 2,541,000 | - | 2,541,000 |
| Promises to give, current portion | - | 785,000 | - | - | 785,000 | - | 785,000 |
| Total current assets | 90,415,000 | 1,544,000 | 414,000 | 30,000 | 92,403,000 | (2,957,000) | 89,446,000 |
| ASSETS LIMITED AS TO USE | 26,805,000 | - | - | - | 26,805,000 | - | 26,805,000 |
| PROPERTY AND EQUIPMENT, net | 94,294,000 | - | 821,000 | 660,000 | 95,775,000 | - | 95,775,000 |
| OTHER ASSETS | | | | | | | |
| Investments | 96,381,000 | 17,972,000 | - | - | 114,353,000 | (775,000) | 113,578,000 |
| Deferred financing costs, net of amortization | 1,219,000 | - | - | - | 1,219,000 | - | 1,219,000 |
| Other | 1,358,000 | - | - | - | 1,358,000 | (10,000) | 1,348,000 |
| Total other assets | 98,958,000 | 17,972,000 | - | - | 116,930,000 | (785,000) | 116,145,000 |
| Total assets | \$ 310,472,000 | \$ 19,516,000 | \$ 1,235,000 | \$ 690,000 | \$ 331,913,000 | \$ (3,742,000) | \$ 328,171,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATING BALANCE SHEET
SEPTEMBER 30, 2016

| | LIABILITIES AND NET ASSETS | | | | | | |
|---|-----------------------------------|---|--|--------------|----------------|------------------------|----------------|
| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Klamath Medical Business Center | KW Campus | Total | Eliminating Entries | Consolidated |
| CURRENT LIABILITIES | | | | | | | |
| Accounts payable | \$ 4,549,000 | \$ 760,000 | \$ - | \$ 413,000 | \$ 5,722,000 | \$ (413,000) | \$ 5,309,000 |
| Accrued payroll | 6,816,000 | - | - | - | 6,816,000 | - | 6,816,000 |
| Accrued compensated absences | 4,550,000 | - | - | - | 4,550,000 | - | 4,550,000 |
| Accrued interest payable | 265,000 | - | - | - | 265,000 | - | 265,000 |
| Other accrued expenses | 12,516,000 | - | - | - | 12,516,000 | (2,545,000) | 9,971,000 |
| Estimated third-party payor settlements | 1,775,000 | - | - | - | 1,775,000 | - | 1,775,000 |
| Capital lease obligations, current portion | 1,165,000 | - | - | - | 1,165,000 | - | 1,165,000 |
| Long-term debt, current portion | 2,030,000 | - | - | - | 2,030,000 | - | 2,030,000 |
| Total current liabilities | 33,666,000 | 760,000 | - | 413,000 | 34,839,000 | (2,958,000) | 31,881,000 |
| LONG-TERM LIABILITIES | | | | | | | |
| Capital lease obligations, net of current portion | 6,142,000 | - | - | - | 6,142,000 | - | 6,142,000 |
| Long-term debt, net of current portion | 71,582,000 | - | - | - | 71,582,000 | - | 71,582,000 |
| Other long-term liabilities | 6,352,000 | - | - | - | 6,352,000 | - | 6,352,000 |
| Total long-term liabilities | 84,076,000 | - | - | - | 84,076,000 | - | 84,076,000 |
| Total liabilities | 117,742,000 | 760,000 | - | 413,000 | 118,915,000 | (2,958,000) | 115,957,000 |
| NET ASSETS | | | | | | | |
| Unrestricted - Sky Lakes Medical Center | 192,730,000 | 13,158,000 | 1,235,000 | 277,000 | 207,400,000 | (1,540,000) | 205,860,000 |
| Unrestricted - Non-Controlling Interest | - | - | - | - | - | 756,000 | 756,000 |
| Temporarily restricted | - | 5,598,000 | - | - | 5,598,000 | - | 5,598,000 |
| Total net assets | 192,730,000 | 18,756,000 | 1,235,000 | 277,000 | 212,998,000 | (784,000) | 212,214,000 |
| Total liabilities and net assets | \$ 310,472,000 | \$ 19,516,000 | \$ 1,235,000 | \$ 690,000 | \$ 331,913,000 | \$ (3,742,000) | \$ 328,171,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATING STATEMENT OF OPERATIONS
FOR THE YEAR ENDED SEPTEMBER 30, 2016

| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Klamath Medical Business Center | KW Campus | Total | Eliminating Entries | Consolidated |
|--|-----------------------------|---|--|--------------|----------------|------------------------|----------------|
| REVENUES | | | | | | | |
| Patient service revenue, net contractual adjustments | \$ 236,920,000 | \$ - | \$ - | \$ - | \$ 236,920,000 | \$ - | \$ 236,920,000 |
| Provision for bad debts | (15,136,000) | - | - | - | (15,136,000) | - | (15,136,000) |
| Net patient service revenue | 221,784,000 | - | - | - | 221,784,000 | - | 221,784,000 |
| Contributions | - | 23,000 | - | - | 23,000 | - | 23,000 |
| Other revenue | 25,449,000 | - | 306,000 | - | 25,755,000 | (1,449,000) | 24,306,000 |
| Net assets released from restrictions | - | 373,000 | - | - | 373,000 | - | 373,000 |
| Total revenues | 247,233,000 | 396,000 | 306,000 | - | 247,935,000 | (1,449,000) | 246,486,000 |
| EXPENSES | | | | | | | |
| Salaries and benefits | 102,922,000 | 161,000 | - | - | 103,083,000 | - | 103,083,000 |
| Purchased services | 27,462,000 | - | 6,000 | - | 27,468,000 | (346,000) | 27,122,000 |
| Supplies | 17,563,000 | - | - | - | 17,563,000 | - | 17,563,000 |
| Drugs | 17,193,000 | - | - | - | 17,193,000 | - | 17,193,000 |
| Depreciation and amortization | 13,720,000 | - | 39,000 | - | 13,759,000 | - | 13,759,000 |
| Provider tax | 11,165,000 | - | - | - | 11,165,000 | - | 11,165,000 |
| Building and maintenance | 12,188,000 | - | 92,000 | - | 12,280,000 | (12,000) | 12,268,000 |
| Physician fees | 7,849,000 | - | - | - | 7,849,000 | (22,000) | 7,827,000 |
| Interest expense | 3,113,000 | - | - | - | 3,113,000 | - | 3,113,000 |
| Insurance | 2,004,000 | - | 4,000 | - | 2,008,000 | - | 2,008,000 |
| Rentals and lease expense | 2,262,000 | - | - | - | 2,262,000 | (831,000) | 1,431,000 |
| Professional fees | 3,346,000 | - | 9,000 | 8,000 | 3,363,000 | (106,000) | 3,257,000 |
| Minor equipment | 825,000 | - | - | - | 825,000 | (22,000) | 803,000 |
| Other | 4,452,000 | 1,118,000 | - | 7,000 | 5,577,000 | (752,000) | 4,825,000 |
| Total expenses | 226,064,000 | 1,279,000 | 150,000 | 15,000 | 227,508,000 | (2,091,000) | 225,417,000 |
| OPERATING INCOME (LOSS) | 21,169,000 | (883,000) | 156,000 | (15,000) | 20,427,000 | 642,000 | 21,069,000 |
| OTHER INCOME | | | | | | | |
| Investment income | 5,188,000 | - | - | - | 5,188,000 | - | 5,188,000 |
| Other non-operating expense | (617,000) | - | - | - | (617,000) | (734,000) | (1,351,000) |
| Total other income | 4,571,000 | - | - | - | 4,571,000 | (734,000) | 3,837,000 |
| EXCESS OF REVENUES OVER EXPENSES | \$ 25,740,000 | \$ (883,000) | \$ 156,000 | \$ (15,000) | \$ 24,998,000 | \$ (92,000) | \$ 24,906,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES
CONSOLIDATING STATEMENT OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED SEPTEMBER 30, 2016

| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Klamath Medical Business Center | KW Campus | Total | Eliminating Entries | Consolidated |
|---|-----------------------------|---|--|-------------------|-----------------------|------------------------|-----------------------|
| UNRESTRICTED NET ASSETS | | | | | | | |
| Excess of revenues over expenses | \$ 25,740,000 | \$ (883,000) | \$ 156,000 | \$ (15,000) | \$ 24,998,000 | \$ (92,000) | \$ 24,906,000 |
| Contributions | - | - | 14,000 | - | 14,000 | (14,000) | - |
| Net change in unrealized gains and losses on other-than-trading securities | - | 1,412,000 | - | - | 1,412,000 | | 1,412,000 |
| Increase (decrease) in unrestricted net assets | 25,740,000 | 529,000 | 170,000 | (15,000) | 26,424,000 | (106,000) | 26,318,000 |
| TEMPORARILY RESTRICTED NET ASSETS | | | | | | | |
| Contributions | - | 1,054,000 | - | - | 1,054,000 | - | 1,054,000 |
| Net change in unrealized gains and losses on other-than-trading securities | - | 223,000 | - | - | 223,000 | - | 223,000 |
| Investment income | - | 6,000 | - | - | 6,000 | - | 6,000 |
| Net assets released from restrictions | - | (373,000) | - | - | (373,000) | - | (373,000) |
| Increase in temporarily restricted net assets | - | 910,000 | - | - | 910,000 | - | 910,000 |
| CHANGE IN NET ASSETS | 25,740,000 | 1,439,000 | 170,000 | (15,000) | 27,334,000 | (106,000) | 27,228,000 |
| NET ASSETS, beginning of year | 166,990,000 | 17,317,000 | 1,065,000 | 292,000 | 185,664,000 | (678,000) | 184,986,000 |
| NET ASSETS, end of year | <u>\$ 192,730,000</u> | <u>\$ 18,756,000</u> | <u>\$ 1,235,000</u> | <u>\$ 277,000</u> | <u>\$ 212,998,000</u> | <u>\$ (784,000)</u> | <u>\$ 212,214,000</u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES – OBLIGATED GROUP
COMBINING BALANCE SHEET
SEPTEMBER 30, 2016

| | ASSETS | | | | |
|---|-----------------------------|---|----------------|------------------------|-----------------------------|
| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Total | Eliminating Entries | Total Obligated Group |
| CURRENT ASSETS | | | | | |
| Cash and cash equivalents | \$ 32,207,000 | \$ 759,000 | \$ 32,966,000 | \$ - | \$ 32,966,000 |
| Certificates of deposit | 5,577,000 | - | 5,577,000 | - | 5,577,000 |
| Patient accounts receivable, net | 36,322,000 | - | 36,322,000 | - | 36,322,000 |
| Other receivables | 8,166,000 | - | 8,166,000 | (2,545,000) | 5,621,000 |
| Risk pool withhold receivable | 1,662,000 | - | 1,662,000 | - | 1,662,000 |
| Supplies inventories | 3,940,000 | - | 3,940,000 | - | 3,940,000 |
| Prepaid expenses | 2,541,000 | - | 2,541,000 | - | 2,541,000 |
| Promises to give, current portion | - | 785,000 | 785,000 | - | 785,000 |
| Total current assets | 90,415,000 | 1,544,000 | 91,959,000 | (2,545,000) | 89,414,000 |
| ASSETS LIMITED AS TO USE | 26,805,000 | - | 26,805,000 | - | 26,805,000 |
| PROPERTY AND EQUIPMENT, net | 94,294,000 | - | 94,294,000 | - | 94,294,000 |
| OTHER ASSETS | | | | | |
| Investments | 96,381,000 | 17,972,000 | 114,353,000 | (96,000) | 114,257,000 |
| Deferred financing costs, net of amortization | 1,219,000 | - | 1,219,000 | - | 1,219,000 |
| Other | 1,358,000 | - | 1,358,000 | - | 1,358,000 |
| Total other assets | 98,958,000 | 17,972,000 | 116,930,000 | (96,000) | 116,834,000 |
| Total assets | \$ 310,472,000 | \$ 19,516,000 | \$ 329,988,000 | \$ (2,641,000) | \$ 327,347,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES – OBLIGATED GROUP
COMBINING BALANCE SHEET
SEPTEMBER 30, 2016

| | LIABILITIES AND NET ASSETS | | | | |
|---|-------------------------------------|--|-----------------------|--------------------------------|--------------------------------------|
| | <u>Sky Lakes Medical Center</u> | <u>Sky Lakes Medical Center Foundation</u> | <u>Total</u> | <u>Eliminating Entries</u> | <u>Total Obligated Group</u> |
| CURRENT LIABILITIES | | | | | |
| Accounts payable | \$ 4,549,000 | \$ 760,000 | \$ 5,309,000 | \$ - | \$ 5,309,000 |
| Accrued payroll | 6,816,000 | - | 6,816,000 | - | 6,816,000 |
| Accrued compensated absences | 4,550,000 | - | 4,550,000 | - | 4,550,000 |
| Accrued interest payable | 265,000 | - | 265,000 | - | 265,000 |
| Other accrued expenses | 12,516,000 | - | 12,516,000 | (2,545,000) | 9,971,000 |
| Estimated third-party payor settlements | 1,775,000 | - | 1,775,000 | - | 1,775,000 |
| Capital lease obligations, current portion | 1,165,000 | - | 1,165,000 | - | 1,165,000 |
| Long-term debt, current portion | 2,030,000 | - | 2,030,000 | - | 2,030,000 |
| Total current liabilities | <u>33,666,000</u> | <u>760,000</u> | <u>34,426,000</u> | <u>(2,545,000)</u> | <u>31,881,000</u> |
| LONG-TERM LIABILITIES | | | | | |
| Capital lease obligations, net of current portion | 6,142,000 | - | 6,142,000 | - | 6,142,000 |
| Long-term debt, net of current portion | 71,582,000 | - | 71,582,000 | - | 71,582,000 |
| Other long-term liabilities | 6,352,000 | - | 6,352,000 | - | 6,352,000 |
| Total long-term liabilities | <u>84,076,000</u> | <u>-</u> | <u>84,076,000</u> | <u>-</u> | <u>84,076,000</u> |
| Total liabilities | <u>117,742,000</u> | <u>760,000</u> | <u>118,502,000</u> | <u>(2,545,000)</u> | <u>115,957,000</u> |
| NET ASSETS | | | | | |
| Unrestricted | 192,730,000 | 13,158,000 | 205,888,000 | (96,000) | 205,792,000 |
| Temporarily restricted | - | 5,598,000 | 5,598,000 | - | 5,598,000 |
| Total net assets | <u>192,730,000</u> | <u>18,756,000</u> | <u>211,486,000</u> | <u>(96,000)</u> | <u>211,390,000</u> |
| Total liabilities and net assets | <u>\$ 310,472,000</u> | <u>\$ 19,516,000</u> | <u>\$ 329,988,000</u> | <u>\$ (2,641,000)</u> | <u>\$ 327,347,000</u> |

SKY LAKES MEDICAL CENTER AND AFFILIATES – OBLIGATED GROUP
COMBINING STATEMENT OF OPERATIONS
SEPTEMBER 30, 2016

| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Total | Eliminating Entries | Total Obligated Group |
|--|-----------------------------|---|----------------|------------------------|-----------------------------|
| REVENUES | | | | | |
| Patient service revenue, net contractual adjustments | \$ 236,920,000 | \$ - | \$ 236,920,000 | \$ - | \$ 236,920,000 |
| Provision for bad debts | (15,136,000) | - | (15,136,000) | - | (15,136,000) |
| Net patient service revenue | 221,784,000 | - | 221,784,000 | - | 221,784,000 |
| Contributions | - | 23,000 | 23,000 | - | 23,000 |
| Other revenue | 25,449,000 | - | 25,449,000 | (1,441,000) | 24,008,000 |
| Net assets released from restrictions | - | 373,000 | 373,000 | - | 373,000 |
| Total revenues | 247,233,000 | 396,000 | 247,629,000 | (1,441,000) | 246,188,000 |
| EXPENSES | | | | | |
| Salaries and benefits | 102,922,000 | 161,000 | 103,083,000 | - | 103,083,000 |
| Purchased services | 27,462,000 | - | 27,462,000 | (325,000) | 27,137,000 |
| Supplies | 17,563,000 | - | 17,563,000 | - | 17,563,000 |
| Drugs | 17,193,000 | - | 17,193,000 | - | 17,193,000 |
| Depreciation and amortization | 13,720,000 | - | 13,720,000 | - | 13,720,000 |
| Provider tax | 11,165,000 | - | 11,165,000 | - | 11,165,000 |
| Building and maintenance | 12,188,000 | - | 12,188,000 | (12,000) | 12,176,000 |
| Physician fees | 7,849,000 | - | 7,849,000 | (22,000) | 7,827,000 |
| Interest expense | 3,113,000 | - | 3,113,000 | - | 3,113,000 |
| Insurance | 2,004,000 | - | 2,004,000 | - | 2,004,000 |
| Rentals and lease expense | 2,262,000 | - | 2,262,000 | (831,000) | 1,431,000 |
| Professional fees | 3,346,000 | - | 3,346,000 | (98,000) | 3,248,000 |
| Minor equipment | 825,000 | - | 825,000 | (22,000) | 803,000 |
| Other | 4,452,000 | 1,118,000 | 5,570,000 | (754,000) | 4,816,000 |
| Total expenses | 226,064,000 | 1,279,000 | 227,343,000 | (2,064,000) | 225,279,000 |
| OPERATING INCOME (LOSS) | 21,169,000 | (883,000) | 20,286,000 | 623,000 | 20,909,000 |
| OTHER INCOME | | | | | |
| Investment income | 5,188,000 | - | 5,188,000 | - | 5,188,000 |
| Other non-operating income | (617,000) | - | (617,000) | (645,000) | (1,262,000) |
| Total other income | 4,571,000 | - | 4,571,000 | (645,000) | 3,926,000 |
| EXCESS OF REVENUE OVER EXPENSES | \$ 25,740,000 | \$ (883,000) | \$ 24,857,000 | \$ (22,000) | \$ 24,835,000 |

SKY LAKES MEDICAL CENTER AND AFFILIATES – OBLIGATED GROUP
COMBINING STATEMENT OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED SEPTEMBER 30, 2016

| | Sky Lakes Medical Center | Sky Lakes Medical Center Foundation | Total | Eliminating Entries | Total Obligated Group |
|---|-----------------------------|---|----------------|------------------------|-----------------------------|
| UNRESTRICTED NET ASSETS | | | | | |
| Excess of revenues over expenses | \$ 25,740,000 | \$ (883,000) | \$ 24,857,000 | \$ (22,000) | \$ 24,835,000 |
| Net change in unrealized gains and losses on other-than-trading securities | - | 1,412,000 | 1,412,000 | - | 1,412,000 |
| Increase in unrestricted net assets | 25,740,000 | 529,000 | 26,269,000 | (22,000) | 26,247,000 |
| TEMPORARILY RESTRICTED NET ASSETS | | | | | |
| Contributions | - | 1,054,000 | 1,054,000 | - | 1,054,000 |
| Net change in unrealized gains and losses on other-than-trading securities | - | 223,000 | 223,000 | - | 223,000 |
| Investment income | - | 6,000 | 6,000 | - | 6,000 |
| Net assets released from restrictions | - | (373,000) | (373,000) | - | (373,000) |
| Increase in temporarily restricted net assets net assets | - | 910,000 | 910,000 | - | 910,000 |
| CHANGE IN NET ASSETS | 25,740,000 | 1,439,000 | 27,179,000 | (22,000) | 27,157,000 |
| NET ASSETS, beginning of year | 166,990,000 | 17,317,000 | 184,307,000 | - | 184,307,000 |
| NET ASSETS, end of year | \$ 192,730,000 | \$ 18,756,000 | \$ 211,486,000 | \$ (22,000) | \$ 211,464,000 |