



Baylor Scott & White

HEALTH

Baylor Scott & White Holdings and Its Controlled Affiliates

Combined Financial Statements and Supplementary Information

For the Years Ended June 30, 2017 and 2016



**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

*Combined Financial Statements and Supplementary Information
For the Years Ended June 30, 2017 and 2016*

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AND ITS CONTROLLED AFFILIATES**

Combined Financial Statements and Supplementary Information

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Report of Independent Auditors

To the Board of Trustees:
Baylor Scott & White Holdings:

We have audited the accompanying combined financial statements of Baylor Scott & White Holdings and its controlled affiliates, which comprise the combined balance sheets as of June 30, 2017 and 2016 and the related combined statements of operations and changes in net assets, and of cash flows for the years then ended.

Management's Responsibility for the Combined Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the combined 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 Company'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 combined financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Baylor Scott & White Holdings and its controlled affiliates as of June 30, 2017 and 2016, and the results of their operations, their changes in net assets and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.



Other Matter

Our audit was conducted for the purpose of forming an opinion on the combined financial statements taken as a whole. The other community benefits information is presented for purposes of additional analysis and is not a required part of the combined financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the combined financial statements and accordingly, we do not express an opinion or provide any assurance on it.

PricewaterhouseCoopers LLP

November 3, 2017

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

COMBINED BALANCE SHEETS - JUNE 30, 2017 and 2016
(In thousands)

ASSETS	<u>2017</u>	<u>2016</u>	LIABILITIES AND NET ASSETS	<u>2017</u>	<u>2016</u>
CURRENT ASSETS:			CURRENT LIABILITIES:		
Cash and cash equivalents	\$ 1,189,606	\$ 1,527,749	Current maturities of long-term debt and capital lease obligations	\$ 126,644	\$ 63,416
Short-term investments	192,269	101,170	Long-term debt subject to short-term remarketing arrangements	95,000	95,000
THVG funds due from United Surgical Partners, Inc.	85,888	70,264	Trade accounts payable	303,893	266,636
Accounts receivable:			Accrued liabilities:		
Patient, net of allowance for uncollectibles of \$580,488 in 2017 and \$479,170 in 2016	816,598	793,910	Payroll related	373,398	466,195
Premiums	116,182	59,871	Third-party programs	87,195	87,865
Other	185,862	190,389	Medical claims payable	37,354	34,950
Other current assets	<u>254,466</u>	<u>225,644</u>	Other	<u>398,896</u>	<u>332,868</u>
Total current assets	<u>2,840,871</u>	<u>2,968,997</u>	Total current liabilities	<u>1,422,380</u>	<u>1,346,930</u>
LONG-TERM INVESTMENTS:			LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current maturities	3,171,837	3,219,130
Unrestricted	3,091,185	2,714,623	OTHER LONG-TERM LIABILITIES:		
Restricted	<u>471,075</u>	<u>455,141</u>	Self insurance and other insurance liabilities	99,208	96,549
Total long-term investments	<u>3,562,260</u>	<u>3,169,764</u>	Interest rate swap liabilities, net	265,129	357,006
ASSETS WHOSE USE IS LIMITED:			Other	<u>305,964</u>	<u>267,674</u>
Other designated assets	165,128	83,396	Total other long-term liabilities	<u>670,301</u>	<u>721,229</u>
Self insurance reserves	98,272	94,125	Total liabilities	<u>5,264,518</u>	<u>5,287,289</u>
Funds held by bond trustee	<u>61,126</u>	<u>98,449</u>	COMMITMENTS AND CONTINGENCIES		
Total assets whose use is limited	<u>324,526</u>	<u>275,970</u>	NONCONTROLLING INTERESTS – REDEEMABLE	443,128	471,566
ASSETS HELD FOR SALE	16,354	-	NET ASSETS:		
PROPERTY AND EQUIPMENT, net	3,525,384	3,555,627	Unrestricted - attributable to BSWH	4,695,399	4,311,163
CONTRIBUTIONS RECEIVABLE, net	61,014	60,211	Unrestricted - noncontrolling interests-nonredeemable	<u>202,603</u>	<u>195,693</u>
INTEREST IN NET ASSETS OF RELATED FOUNDATION	4,048	3,740	Total unrestricted net assets	4,898,002	4,506,856
OTHER LONG-TERM ASSETS:			Temporarily restricted	276,585	261,321
Equity investments in unconsolidated entities	57,548	65,582	Permanently restricted	<u>264,373</u>	<u>261,854</u>
Goodwill and intangible assets, net	734,291	673,525	Total net assets	<u>5,438,960</u>	<u>5,030,031</u>
Other	<u>20,310</u>	<u>15,470</u>	Total liabilities and net assets	<u>\$11,146,606</u>	<u>\$10,788,886</u>
Total other long-term assets	<u>812,149</u>	<u>754,577</u>			
Total assets	<u>\$11,146,606</u>	<u>\$10,788,886</u>			

The accompanying notes are an integral part of these financial statements.

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

COMBINED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

FOR THE YEARS ENDED JUNE 30, 2017 AND 2016

(In thousands)

	<u>2017</u>	<u>2016</u>
OPERATING REVENUE:		
Net patient care revenue	\$ 8,664,811	\$ 7,907,699
Less patient related bad debt expense	<u>927,168</u>	<u>773,501</u>
Net patient care revenue, net of patient related bad debt expense	7,737,643	7,134,198
Premium revenue	903,261	867,510
Other operating revenue	378,332	303,167
Net assets released from restrictions for operations	<u>65,240</u>	<u>61,340</u>
Total operating revenue	<u>9,084,476</u>	<u>8,366,215</u>
OPERATING EXPENSES:		
Salaries, wages, and employee benefits	4,367,194	4,028,300
Supplies	1,582,408	1,442,096
Other operating expenses	1,893,278	1,636,765
Medical claims	357,860	303,670
Losses (gains) on fixed asset sales and disposals, net	2,649	(2,690)
Impairment losses	87,943	-
Depreciation and amortization	385,528	365,738
Interest	<u>115,743</u>	<u>98,188</u>
Total operating expenses	<u>8,792,603</u>	<u>7,872,067</u>
INCOME FROM OPERATIONS	<u>291,873</u>	<u>494,148</u>
NONOPERATING GAINS (LOSSES):		
Gains (losses) on investments, net	271,331	(7,106)
Interest rate swap activity	82,624	(167,386)
Contributions	779	1,012
Equity in losses in unconsolidated entities	(9,515)	(2,365)
Loss from extinguishment of debt	-	(53,253)
Other	<u>378</u>	<u>(348)</u>
Total nonoperating gains (losses)	<u>345,597</u>	<u>(229,446)</u>
REVENUE AND GAINS IN EXCESS OF EXPENSES AND LOSSES BEFORE INCOME TAXES	637,470	264,702
LESS INCOME TAX EXPENSE	<u>7,015</u>	<u>11,620</u>
REVENUE AND GAINS IN EXCESS OF EXPENSES AND LOSSES	630,455	253,082

**BAYLOR SCOTT & WHITE HOLDINGS
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COMBINED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS - continued

FOR THE YEARS ENDED JUNE 30, 2017 AND 2016

(In thousands)

	2017	2016
OTHER CHANGES IN UNRESTRICTED NET ASSETS:		
Unrealized losses on investments, net	\$ (1,786)	\$ (1,390)
Net assets released from restrictions for capital expenditures	25,584	24,053
Other changes in net assets attributable to noncontrolling interests - nonredeemable	(65,871)	(9,759)
Revenue and gains in excess of expenses and losses attributable to noncontrolling interests - redeemable	(206,727)	(222,826)
Net assets acquired	185	13,001
Other	9,306	(16,999)
INCREASE IN UNRESTRICTED NET ASSETS	391,146	39,162
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS:		
Contributions	69,369	64,245
Realized gains and investment income, net	17,369	8,150
Unrealized gains (losses) on investments, net	18,562	(13,303)
Change in value of split-interest agreements	386	(1,162)
Net assets released from restrictions for operations	(65,240)	(61,340)
Net assets released from restrictions for capital expenditures	(25,584)	(24,053)
Changes in net assets of related foundation	281	(297)
Other	121	(3,563)
INCREASE (DECREASE) IN TEMPORARILY RESTRICTED NET ASSETS	15,264	(31,323)
CHANGES IN PERMANENTLY RESTRICTED NET ASSETS:		
Contributions	918	22,070
Realized gains and investment income, net	175	409
Unrealized gains (losses) on investments, net	370	(313)
Change in value of split-interest agreements	918	(1,557)
Changes in net assets of related foundation	27	2
Other	111	1,944
INCREASE IN PERMANENTLY RESTRICTED NET ASSETS	2,519	22,555
INCREASE IN NET ASSETS	408,929	30,394
NET ASSETS, beginning of period	5,030,031	4,999,637
NET ASSETS, end of period	\$ 5,438,960	\$ 5,030,031

The accompanying notes are an integral part of these financial statements. - 4 -

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

COMBINED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED JUNE 30, 2017 AND 2016

(In thousands)

	<u>2017</u>	<u>2016</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Increase in net assets	\$ 408,929	\$ 30,394
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Loss from extinguishment of debt	-	3,462
Unrealized (gains) losses on investments, net	(155,813)	75,109
Realized gains on investments, net	(105,222)	(19,634)
Unrealized (gains) losses on interest rate swap, net	(111,307)	136,936
Contributions restricted for long-term purposes	(918)	(22,070)
Patient related bad debt expense	927,168	773,501
Depreciation and amortization	385,528	365,738
Impairment losses	87,943	-
Losses (gains) on fixed asset sales and disposals, net	2,649	(2,690)
Equity in losses in unconsolidated entities	9,515	2,365
Change in value of split-interest agreements	(1,304)	2,719
Deferred rent	3,444	(3,698)
Other changes attributable to noncontrolling interests	272,598	232,585
Net assets acquired	(185)	(13,001)
Changes in operating assets and liabilities (net of acquisitions):		
Increase in net patient accounts receivable	(956,746)	(862,121)
(Increase) decrease in other accounts receivable	(43,212)	32,695
(Increase) decrease in other assets	(35,497)	15,608
Increase in trade accounts payable and accrued liabilities	8,786	142,075
Increase in other liabilities	<u>53,833</u>	<u>97,194</u>
Net cash provided by operating activities	<u>750,189</u>	<u>987,167</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(406,207)	(354,855)
Cash proceeds from sales of assets	3,088	18,397
Cash paid for acquisitions, net of cash received	(83,875)	(300,472)
Increase in THVG funds due from United Surgical Partners, Inc.	(15,624)	(11,388)
Increase in trading investments	(226,306)	(155,205)
Net payments on interest rate swaps	(6,352)	(68,911)
Purchases of other than trading investments	(99,636)	(36,961)
Sales of other than trading investments	106,915	34,504
Increase in assets whose use is limited	<u>(48,556)</u>	<u>(67,245)</u>
Net cash used in investing activities	<u>(776,553)</u>	<u>(942,136)</u>

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

COMBINED STATEMENTS OF CASH FLOWS - continued

FOR THE YEARS ENDED JUNE 30, 2017 AND 2016

(In thousands)

	<u>2017</u>	<u>2016</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on long-term debt	\$ (75,424)	\$ (1,045,817)
Proceeds from issuance of long-term debt	75,443	1,599,512
Distributions to noncontrolling interests owners	(320,346)	(287,041)
Purchases of noncontrolling interests	(18,565)	(20,323)
Sales of noncontrolling interests	25,956	38,436
Cash receipts restricted for long-term purposes	2,045	13,616
Annuity payments to beneficiaries	<u>(888)</u>	<u>(950)</u>
Net cash (used in) provided by financing activities	<u>(311,779)</u>	<u>297,433</u>
 NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	 <u>(338,143)</u>	 <u>342,464</u>
 CASH AND CASH EQUIVALENTS, beginning of period	 <u>1,527,749</u>	 <u>1,185,285</u>
 CASH AND CASH EQUIVALENTS, end of period	 <u>\$ 1,189,606</u>	 <u>\$ 1,527,749</u>
 SUPPLEMENTAL CASH FLOW DATA:		
Cash paid for interest	<u>\$ 122,264</u>	<u>\$ 21,756</u>
Cash paid for income tax	<u>\$ 11,136</u>	<u>\$ 11,011</u>
Property and equipment acquired under capital leases	<u>\$ 15,288</u>	<u>\$ 4,235</u>
Increase (decrease) in accounts payable due to property and equipment received but not paid	<u>\$ 2,034</u>	<u>\$ (792)</u>

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements

For the Years Ended June 30, 2017 and 2016

1. ORGANIZATION

Baylor Scott & White Holdings (BSW Holdings), a Texas nonprofit corporation exempt from federal income taxation under Section 501(c)(3) of the Internal Revenue Code, and its controlled affiliates (collectively, the “System”) were created from the combination of two Texas healthcare systems, Baylor Health Care System (BHCS) and its affiliates, and Scott & White Healthcare (SWH) and its affiliates. BSW Holdings and Baylor Scott & White Health (BSW Health), a Texas nonprofit corporation, were created by BHCS and SWH in connection with their combination. BSW Holdings is the sole member of BHCS, SWH, and BSW Health and has control and substantial reserved powers over all BHCS and SWH material affiliates. BHCS and its material affiliates are collectively referred to as “Baylor”. SWH and its material affiliates are collectively referred to as “Scott & White”. BSW Holdings and its affiliates are collectively referred to as the “System” or “BSWH”.

The combined financial statements include the accounts of BSW Holdings, BSW Health, BHCS, SWH, Baylor University Medical Center (BUMC), Scott & White Memorial Hospital (SWMH), Scott & White Health Plan (the “Health Plan” or “SWHP”), five foundations, twenty-five community and specialty hospitals located throughout the Dallas and Fort Worth metroplex and the central Texas area, one wholly owned insurance subsidiary, Baylor Quality Health Care Alliance, LLC, an accountable care organization, four physician practice organizations (HealthTexas Provider Network, Scott & White Clinic, Hillcrest Family Health Center, and Hillcrest Physician Services), and other related entities. Investments in certain related entities with 50.0% or less ownership are accounted for using the equity method. The transactions and balances for investments in certain related entities with greater than 50.0% ownership, or where the System exercises board control, are included in the accompanying combined financial statements with related noncontrolling interests reported in the combined financial statements. These entities include nine acute and specialty hospitals referenced above, along with partnerships in: Texas Health Ventures Group, LLC (THVG), providing short stay hospital and outpatient surgery services, BIR JV, LLP, providing rehabilitation services, BTDI JV, LLP, providing imaging services, EBD JV, LLP and ESWCT, LLC, providing emergency medical services, THVG Bariatric, LLC, providing bariatric services, and HTPN Gastroenterology Services, LLP, providing endoscopic services. All significant intercompany accounts and transactions among entities included in the combined financial statements have been eliminated.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

The following summarizes significant changes in the System in 2017 and 2016:

THVG

BUMC has a majority ownership of 50.1% in THVG with USP North Texas, Inc. (USP), a Texas corporation and subsidiary of United Surgical Partners, Inc. (USPI) holding the remaining 49.9%. THVG had net patient care revenue included in the System's combined financial statements of approximately \$960,827,000 and \$881,897,000 for the years ended June 30, 2017 and 2016, respectively.

THVG completed the acquisition of one outpatient center in 2017. THVG recorded goodwill and intangible assets, net, of approximately \$19,852,000, fixed assets of approximately \$517,000, noncontrolling interests of approximately \$16,674,000, and other net liabilities of approximately \$3,695,000 in 2017.

THVG completed the acquisition of one outpatient center in 2016. THVG recorded goodwill and intangible assets, net, of approximately \$12,005,000, fixed assets of approximately \$128,000, redeemable noncontrolling interests of approximately \$3,862,000, and other net liabilities of approximately \$8,271,000 in 2016.

BT East Dallas JV, LLP and BT Garland JV, LLP

Effective January 1, 2016, two Texas limited liability partnerships were formed between the System and Healthcare Network Texas, Inc., a Delaware corporation and subsidiary of Tenet Healthcare Corporation (Tenet). BUMC has a majority ownership of 75% of BT East Dallas JV, LLP, (BT East Dallas) with Tenet holding the remaining 25%. Baylor Medical Centers at Garland and McKinney (Garland), a Texas nonprofit corporation wholly owned by BHCS, has a majority ownership of 50.1% of BT Garland JV, LLP (Garland JV) with Tenet holding the remaining 49.9%. The purpose of these partnerships is to own, operate, and manage five community hospitals focused on delivering integrated, value-based care to communities in Rockwall, Collin, and Dallas counties. The System recorded goodwill and intangible assets, net, of approximately \$256,957,000, fixed assets of approximately \$186,930,000, redeemable noncontrolling interests of approximately \$151,286,000, and other net liabilities of approximately \$292,601,000 in 2016.

Blue Star Sports Medicine and Performance Facility

In June 2016, BSWH executed lease agreements for space in the Blue Star Sports Medicine and Performance Facility to be constructed in Frisco, Texas, with an estimated completion date of February 2018. The lease agreements will be recorded as a capital lease after commencement of the agreements.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Lakeway

In September 2016, the System purchased Lakeway Regional Medical Center, a 106 bed multispecialty hospital now called Baylor Scott & White Medical Center - Lakeway, operated as a part of Scott & White Hospital - Round Rock.

Assets Held for Sale

Effective June 9, 2017, BSW Holdings approved the proposed divestiture of Baylor Scott & White Medical Center - Garland (BSWMC - Garland) and Baylor Scott & White Medical Center - White Rock (White Rock), a hospital operated by BT East Dallas JV, LLP, and classification as assets held for sale. Due to the proposed divestiture and their classification as held for sale, an impairment assessment was required for the long-lived assets of BSWMC - Garland and White Rock under the assets to be disposed of by sale model. The assessment resulted in an adjustment for impairment of approximately \$70,624,000, recorded in the accompanying combined statements of operations for the year ended June 30, 2017. The remaining book value of BSWMC - Garland and White Rock is reported in assets held for sale in the accompanying combined balance sheets, as of June 30, 2017. After impairments, the remaining net book value of land, building and improvements, and major movable equipment and other was approximately \$3,900,000, \$5,427,000, and \$7,027,000, respectively, as of June 30, 2017. The transactions are expected to close in fiscal year 2018.

2. SIGNIFICANT ACCOUNTING POLICIES

The accompanying combined financial statements of the System have been prepared in conformity with accounting principles generally accepted in the United States. The following is a summary of the significant accounting and reporting policies used in preparing the financial statements.

Adoption of New Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-15, “*Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern.*” This ASU amendment requires management to assess an entity’s ability to continue as a going concern. Management should evaluate whether conditions or events, considered in the aggregate, exist that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date that the financial statements are issued. The System applied the provisions of ASU 2014-15 in fiscal year 2017, which did not have a material impact on the combined financial statements.

In January 2015, FASB issued ASU 2015-01, “*Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.*” The amendments in ASU 2015-01

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

eliminate the concept of extraordinary items in financial statements. The System applied the provisions of ASU 2015-01 in fiscal year 2017, which did not have a material impact on the combined financial statements.

In April 2015, FASB issued ASU 2015-03, *“Interest - Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs.”* The amendments in ASU 2015-03 are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability, consistent with debt discounts. The System applied the provisions of ASU 2015-03 in fiscal year 2017, as discussed in the change in accounting principle disclosure, included in Note 14.

In April 2015, FASB issued ASU 2015-05, *“Intangibles - Goodwill and Other - Internal-Use Software: Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement.”* The amendments in ASU 2015-05 provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The System applied the provisions of ASU 2015-05 in fiscal year 2017, which did not have a material impact on the combined financial statements.

In August 2015, FASB issued ASU 2015-15, *“Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting).”* This ASU requires an entity to defer and present debt issuance costs as an asset and subsequently amortize the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The System applied the provisions of ASU 2015-15 in fiscal year 2017, which did not have a material impact on the combined financial statements.

Other Accounting Pronouncements

In May 2014, April 2016, May 2016, December 2016, and February 2017, FASB issued ASU 2014-09, *“Revenue from Contracts with Customers (Topic 606)”*; ASU 2016-10, *“Identifying Performance Obligations and Licensing”*; ASU 2016-12, *“Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients”*; ASU 2016-20, *“Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers”*; and ASU 2017-05, *“Clarifying the Scope of Asset Derecognition Guidance and*

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Accounting for Partial Sales of Nonfinancial Assets”, respectively, which supersedes the revenue recognition requirements in Accounting Standards Codification (ASC) 605, “*Revenue Recognition*.” These ASU’s address when an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. These ASU’s are effective for annual reporting periods beginning after December 15, 2017, and interim periods within those years for public business entities and not-for-profit entities that have issued publicly traded debt, and December 15, 2018 for all other entities as amended by ASU 2015-14. The System is currently evaluating the impact of the ASU’s and believes they will not have a material impact on total operating revenue.

In February 2015, FASB issued ASU 2015-02, “*Consolidation: Amendments to the Consolidation Analysis*.” The amendments in ASU 2015-02 improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). The provisions of ASU 2015-02 are effective for fiscal years beginning after December 15, 2015, and interim periods within those years for public business entities, and December 15, 2016, and interim periods thereafter for all other entities. This ASU is not expected to have a material impact on the combined financial statements.

In May 2015, FASB issued ASU 2015-07, “*Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*.” This ASU removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. The provisions of ASU 2015-07 are effective for fiscal years beginning after December 15, 2015, and interim periods within those years for public business entities, and December 15, 2016, and interim periods within those years for all other entities. This ASU is not expected to have a material impact on the combined financial statements.

In May 2015, FASB issued ASU 2015-09, “*Disclosures about Short-Duration Contracts*.” This ASU requires insurance entities to disclose, for annual reporting periods, information about the liability for unpaid claims and claim adjustment expenses. The amendments also require insurance entities to disclose information about significant changes in methodologies and assumptions used to calculate the liability for unpaid claims and claim adjustment expenses, including reasons for the change, and the effects on the financial statements. In

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

addition, the amendments require insurance entities to disclose, for annual and interim reporting periods, a roll-forward of the liability for unpaid claims and claim adjustment expenses. For health insurance claims, the amendments require the disclosure of the total of incurred-but-not-reported liabilities, and expected development on reported claims included in the liability for unpaid claims and claim adjustment expenses. The provisions of ASU 2015-09 are effective for fiscal years beginning after December 15, 2015, and interim periods thereafter for public business entities, and December 15, 2016, and interim periods thereafter for all other entities. This ASU is not expected to have a material impact on the combined financial statements.

In July 2015, FASB issued ASU 2015-11, “*Simplifying the Measurement of Inventory.*” This ASU requires an entity to measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using last-in, first-out (LIFO) or the retail inventory method. The amendments do not apply to inventory that is measured using LIFO or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out (FIFO) or average cost. The provisions of ASU 2015-11 are effective for fiscal years beginning after December 15, 2016, and interim periods within those years for public business entities, and December 15, 2016, and interim periods thereafter for all other entities. This ASU is not expected to have a material impact on the combined financial statements.

In September 2015, FASB issued ASU 2015-16, “*Simplifying the Accounting for Measurement-Period Adjustments.*” This ASU requires that an acquirer recognize adjustments to estimated amounts that are identified during the measurement period and any related income effects in the reporting period in which the adjustment amounts are determined. The ASU also requires an entity to present separately on the face of the income statement, or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the estimated amounts had been recognized as of the acquisition date. The provisions of ASU 2015-16 are effective for fiscal years beginning after December 15, 2015, and interim periods within those years for public business entities, and December 15, 2016, and interim periods thereafter for all other entities. This ASU is not expected to have a material impact on the combined financial statements.

In November 2015, FASB issued ASU 2015-17, “*Balance Sheet Classification of Deferred Taxes.*” This ASU requires that deferred tax liabilities and assets be classified as noncurrent

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in a classified statement of financial position. The provisions of ASU 2015-17 are effective for fiscal years beginning after December 15, 2016, and interim periods within those years for public business entities, and December 15, 2017, and interim periods thereafter for all other entities. This ASU is not expected to have a material impact on the combined financial statements.

In January 2016, FASB issued ASU 2016-01, “*Recognition and Measurement of Financial Assets and Financial Liabilities.*” This ASU requires equity investments to be measured at fair value with changes in fair value recognized in net income. This ASU also requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes. A reporting organization must present separately, in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk. The provisions of ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, and interim periods within those years for public business entities, and December 15, 2018 for all other entities. The System is currently evaluating the impact of this ASU.

In February 2016, FASB issued ASU 2016-02, “*Leases.*” This ASU requires lessees to record a lease liability that represents the lessee’s future lease obligation payments and a right-of-use asset that represents the lessee’s right to use or control of a specified asset for the lease term. The main difference with current practice being that lessees will be required to record an asset and liability for what is now considered an operating lease. The provisions of ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, and interim periods within those years for public business entities and not-for-profit entities that have issued publicly traded debt, and December 15, 2019 for all other entities. The System is currently evaluating the impact of this ASU and believes it will have a material impact on the combined financial statements.

In March 2016, FASB issued ASU 2016-05, “*Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships.*” This ASU clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria remain intact. The provisions of ASU 2016-05 are effective for fiscal years beginning after December 15, 2016, and interim periods within those years for public business entities, and December 15, 2017 for all other entities. The System is currently evaluating the impact of this ASU.

In March 2016, FASB issued ASU 2016-06, “*Contingent Put and Call Options in Debt Instruments.*” This ASU clarifies what steps are required when assessing whether the economic characteristics and risks of call (put) options are clearly and closely related to the economic characteristics and risks of their debt hosts, which is one of the criteria for

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bifurcating an embedded derivative. Consequently, when a call (put) option is contingently exercisable, an entity does not have to assess whether the event that triggers the ability to exercise a call (put) option is related to interest rates or credit risks. The provisions of ASU 2016-06 are effective for fiscal years beginning after December 15, 2016, and interim periods within those years for public business entities, and December 15, 2017 for all other entities. The System is currently evaluating the impact of this ASU.

In March 2016, FASB issued ASU 2016-07, “*Simplifying the Transition to the Equity Method of Accounting.*” This ASU eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Retroactive adjustment of the investment is no longer required. The provisions of ASU 2016-07 are effective for fiscal years beginning after December 15, 2016 and interim periods within those years. This ASU is not expected to have a material impact on the combined financial statements.

In August 2016, FASB issued ASU 2016-14, “*Presentation of Financial Statements of Not-for-Profit Entities.*” This ASU requires not-for-profit entities to report two classes of net assets, as well as enhances disclosures on board designated funds, liquidity, and functional expenses. The provisions of ASU 2016-14 are effective for fiscal years beginning after December 15, 2017, and interim periods thereafter. The System is currently evaluating the impact of this ASU.

In August 2016, FASB issued ASU 2016-15, “*Classification of Certain Cash Receipts and Cash Payments.*” This ASU provides cash flow statement classification guidance related to debt extinguishment costs, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, distributions made from equity method investees, separately identifiable cash flows, and application of the predominance principle. The provisions of ASU 2016-15 are effective for fiscal years beginning after December 15, 2017, and interim periods within those years for public business entities, and December 15, 2018, and interim periods thereafter for all other entities. The System is currently evaluating the impact of this ASU.

In October 2016, FASB issued ASU 2016-16, “*Intra-Entity Transfers of Assets Other Than Inventory.*” This ASU requires an entity to recognize the income tax consequences of an intra-

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entity transfer of an asset other than inventory when the transfer occurs. The provisions of ASU 2016-16 are effective for fiscal years beginning after December 15, 2017, and interim periods within those years for public business entities, and December 15, 2018, and interim periods thereafter for all other entities. The System is currently evaluating the impact of this ASU.

In November 2016, FASB issued ASU 2016-18, “*Restricted Cash: a Consensus of the FASB Emerging Issues Task Force.*” This ASU requires a statement of cash flows to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The provisions of ASU 2016-18 are effective for fiscal years beginning after December 15, 2017, and interim periods within those years for public business entities, and December 15, 2018, and interim periods thereafter for all other entities. The System is currently evaluating the impact of this ASU.

In January 2017, FASB issued ASU 2017-01, “*Clarifying the Definition of a Business.*” By clarifying the definition of a business, the amendments of this ASU affect all companies and other reporting organizations that must determine whether they have acquired or sold a business. The provisions of ASU 2017-01 are effective for fiscal years beginning after December 15, 2017, and interim periods within those years for public business entities, and December 15, 2018, and interim periods within those years for all other entities. The System is currently evaluating the impact of this ASU.

In January 2017, FASB issued ASU 2017-02, “*Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity.*” This ASU retains the consolidation guidance that was in Subtopic 810-20. Not-for-Profits that are general partners should continue to be presumed to control a for-profit limited partnership, regardless of the extent of their ownership interest, unless that presumption is overcome. The provisions of ASU 2017-02 are effective for fiscal years beginning after December 15, 2016, and interim periods thereafter. This ASU is not expected to have a material impact on the combined financial statements.

In January 2017, FASB issued ASU 2017-04, “*Simplifying the Test for Goodwill Impairment.*” This ASU eliminates Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. The provisions of ASU 2017-04 are effective for fiscal years beginning after December 15, 2019, and interim periods within those years for public business entities, and December 15, 2021, and interim periods within those years for all other entities. The System is currently evaluating the impact of this ASU.

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In March 2017, FASB issued ASU 2017-07, “*Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.*” This ASU requires that an employer report the service cost component in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The provisions of ASU 2017-07 are effective for fiscal years beginning after December 15, 2017, and interim periods within those years for public business entities, and December 15, 2018, and interim periods thereafter for all other entities. The System is currently evaluating the impact of this ASU.

In March 2017, FASB issued ASU 2017-08, “*Premium Amortization on Purchased Callable Debt Securities.*” This shortens the amortization period for certain callable debt securities held at a premium and requires the premium to be amortized to the earliest call date. However, the amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The System has not evaluated all of the provisions of ASU 2017-08, which are effective for fiscal years beginning after December 15, 2018, and interim periods within those years for public business entities, and December 15, 2019, and interim periods thereafter for all other entities. The System is currently evaluating the impact of this ASU.

Cash and Cash Equivalents

Cash equivalents are defined as investments which have original maturities of three months or less. Cash equivalents consist primarily of securities issued by the United States government or its agencies, certificates of deposit, commercial paper, and dollar denominated foreign issuer investments.

THVG Funds Due From United Surgical Partners, Inc.

THVG participates in a shared services accounts payable program with USPI, wherein USPI has custody of substantially all of THVG’s cash, paying THVG and its facilities interest income on the net balance at prevailing market rates. Amounts held by USPI on behalf of THVG totaled approximately \$85,888,000 and \$70,264,000 at June 30, 2017 and 2016, respectively. The funds due from USPI are available on demand.

Investments

The System has designated all of its investments as trading except for those investments held at Highground Advisors (HA) for the benefit of the BHCS Foundation, the investments of All Saints Health Foundation and the investments of the Health Plan. For all trading investments,

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the interest and dividends, realized gains (losses), and unrealized gains (losses) are included in gains (losses) on investments, net, in the accompanying combined statements of operations and changes in net assets. For other than trading investments, interest and dividends and realized gains (losses) are included in gains (losses) on investments, net, unless restricted by donor. Unrealized gains (losses) on other than trading investments are included in other changes in unrestricted net assets, unless restricted by donor.

Interest and dividends, realized gains (losses) and unrealized gains (losses) for the years ended June 30, 2017 and 2016 consisted of the following (in thousands):

	2017			
	Interest and Dividends	Realized Gains	Unrealized Gains (Losses)	Total
Nonoperating gains	\$ 37,371	\$ 95,293	\$ 138,667	\$ 271,331
Other changes in unrestricted net assets	-	-	(1,786)	(1,786)
Changes in temporarily restricted net assets	7,615	9,754	18,562	35,931
Changes in permanently restricted net assets	-	175	370	545
	<u>\$ 44,986</u>	<u>\$105,222</u>	<u>\$ 155,813</u>	<u>\$ 306,021</u>
	2016			
	Interest and Dividends	Realized Gains	Unrealized Losses	Total
Nonoperating gains (losses)	\$ 36,003	\$ 16,994	\$ (60,103)	\$ (7,106)
Other changes in unrestricted net assets	-	-	(1,390)	(1,390)
Changes in temporarily restricted net assets	5,919	2,231	(13,303)	(5,153)
Changes in permanently restricted net assets	-	409	(313)	96
	<u>\$ 41,922</u>	<u>\$ 19,634</u>	<u>\$ (75,109)</u>	<u>\$ (13,553)</u>

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Patient Accounts Receivable

Patient accounts receivable are stated at estimated net realizable value, and collateral is generally not required. Significant concentrations of patient accounts receivable at June 30, 2017 and 2016 include:

	<u>2017</u>	<u>2016</u>
Government-related programs	36%	34%
Managed care providers, commercial insurers and other payors	45%	46%
Self-pay patients	<u>19%</u>	<u>20%</u>
	<u>100%</u>	<u>100%</u>

Receivables from government-related programs (i.e., Medicare and Medicaid) represent the only concentrated group of payors for the System's receivables, and management does not believe there is any unusual level of collectability risks associated with these government programs. Commercial and managed care receivables consist of receivables from various payors involved in diverse activities and subject to differing economic conditions and do not represent any concentrated collectability risks to the System.

The System maintains allowances for uncollectible accounts for estimated losses resulting from a payor's inability to make payments on accounts. The System assesses the reasonableness of the allowance account based on historical write-offs, cash collections, the aging of the accounts and other economic factors. Accounts are written off when collection efforts have been exhausted. Management continually monitors and adjusts its allowances associated with its receivables.

Premiums Receivable and Premium Revenue

Premium revenue is recognized as income in the period that members are entitled to receive services, as specified by the provisions of the arrangement. Premiums billed or received in advance of the service period are reported as unearned premiums.

Premiums receivable also includes annual settlements under the cost contract established between the Health Plan and the Centers for Medicare & Medicaid Services (CMS). The CMS Medicare Part B (Section 1876) cost plan contract covers Medicare-covered members' medical services allowed under Medicare Part B coverage, and contains provisions for risk sharing and reimbursement of allowed costs for which the Health Plan is not at risk. Final reporting of each plan year's total allowed costs is not completed until June 30 of the year following the plan year, at which time an interim settlement of costs due to/from the plan

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occurs. Part B cost report audits, conducted on a triennial basis, may result in further adjustments to the total allowable costs reported in the current period and may affect the reimbursement to the Health Plan. Premium revenue increased approximately \$7,091,000 and decreased approximately \$833,000 for the years ended June 30, 2017 and 2016, respectively, due to changes in amounts previously estimated. At June 30, 2017 and 2016, the settlement amounts receivable from CMS under this contract were \$31,224,000 and \$7,647,000, respectively. Premiums receivable generally are not collateralized.

Significant concentrations of premiums receivable were 99% and 91% from local, state, and federal government-related programs at June 30, 2017 and 2016, respectively. Premium revenue from local, state, and federal agencies accounted for 62% and 66% of total premium revenue for the years ended June 30, 2017 and 2016, respectively.

Property and Equipment

Property and equipment are stated at cost on the date of purchase or fair value on the date of contribution or business acquisition. Property and equipment and related accumulated depreciation and amortization are summarized below as of June 30, 2017 and 2016 (in thousands):

	<u>Useful Life</u>	<u>2017</u>	<u>2016</u>
Land	-	\$ 279,555	\$ 266,593
Buildings and improvements	5-40 Years	3,752,341	3,876,544
Major movable equipment and other	3-20 Years	2,550,199	2,496,670
Construction-in-progress	-	<u>308,050</u>	<u>237,797</u>
		6,890,145	6,877,604
Accumulated depreciation and amortization		<u>(3,364,761)</u>	<u>(3,321,977)</u>
		<u>\$ 3,525,384</u>	<u>\$ 3,555,627</u>

Property and equipment financed under capital leases totaled approximately \$399,651,000 and \$440,103,000 at June 30, 2017 and 2016, respectively, and related accumulated amortization was approximately \$142,695,000 and \$141,803,000 at June 30, 2017 and 2016, respectively. Amortization expense is included in depreciation and amortization expense in the accompanying combined statements of operations and changes in net assets.

Depreciation and amortization expense is calculated using the straight-line method over the estimated useful lives of the property and equipment or the lease term, whichever is less. Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase capacities or extend useful lives are capitalized.

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Goodwill and Intangible Assets

Goodwill and intangible assets recorded in connection with acquisitions completed by the System are accounted for under ASC 350, “*Intangibles - Goodwill and Other.*” Goodwill consists of costs in excess of tangible and intangible net assets acquired. Intangible assets consist of management service contract rights and other intangibles.

Goodwill and indefinite-lived intangible assets are tested for impairment annually or more frequently if changing circumstances warrant. No impairments were identified in 2017 or 2016, other than approximately \$6,750,000 included in the impairment losses in 2017 discussed in Note 1 related to the classification of BSWMC - Garland and White Rock to assets held for sale.

The System amortizes definite-lived intangible assets over their respective useful lives to the estimated residual values and reviews for impairment in the same manner as long-lived assets discussed below. No impairments were identified in 2017 or 2016, other than approximately \$5,910,000 included in the impairment losses in 2017 discussed in Note 1 related to the classification of BSWMC - Garland and White Rock to assets held for sale.

At June 30, 2017 and 2016, intangible assets and goodwill consisted of the following (in thousands):

	2017		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:			
Definite-lived intangible assets	\$ 36,016	\$ 16,449	\$ 19,567
Indefinite-lived intangible assets	14,451	-	14,451
Total intangible assets	50,467	16,449	34,018
Goodwill	702,906	2,633	700,273
Total intangible assets and goodwill	\$ 753,373	\$ 19,082	\$ 734,291

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	2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets:			
Definite-lived intangible assets	\$ 40,585	\$ 13,388	\$ 27,197
Indefinite-lived intangible assets	13,584	-	13,584
Total intangible assets	54,169	13,388	40,781
Goodwill	635,377	2,633	632,744
Total intangible assets and goodwill	\$ 689,546	\$ 16,021	\$ 673,525

Impairment of Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset, or related groups of assets, may not be recoverable from estimated future undiscounted cash flows. If circumstances suggest that the recorded amounts cannot be recovered based upon estimated future undiscounted cash flows, the carrying values of such assets are reduced to fair value. In the event of impairment, measurement of the amount of impairment may be based on valuation models using Level 3 inputs consisting of appraisals, fair values of similar assets, or estimates of future discounted cash flows resulting from the use and ultimate disposition of the asset. During the year ended June 30, 2017, BSWH recorded impairment losses related to the classification of assets held for sale, as discussed in Note 1.

Based on continued deterioration in financial performance, and the resulting impact on projections of future cash flows, BSWH determined impairment indicators were present in 2017. The long-lived assets that were reviewed for impairment consist of a building, a building under capital lease, leasehold improvements, and major moveable equipment. Using a market approach, management assessed the estimated fair value of the buildings and leasehold improvements. Management determined the estimated fair value of the building and leasehold improvements was less than their carrying value and thus recorded an impairment of approximately \$17,319,000, which is included in impairment losses in the accompanying statements of operations and changes in net assets. Management determined the fair value of the major moveable equipment was not less than the carrying value and was not impaired. No impairments were identified in 2016.

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Medical Claims Payable

Medical claims payable represents management’s estimate of the ultimate net cost of all reported and unreported claims and claim adjustment expenses incurred through June 30, 2017 and 2016. Reserves for unpaid claims are actuarially estimated using individual case-basis valuations and statistical analysis. These estimates are subject to the effects of trends in claim severity and frequency. Although considerable variability is inherent in such estimates, management believes that reserves for unpaid claims are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known. Such adjustments are included in operations when determined. There were no material adjustments to these estimates recorded during the years ended June 30, 2017 and 2016.

A rollforward of medical claims payable for the years ended June 30, 2017 and 2016, is as follows (in thousands):

	2017	2016
Medical claims payable - beginning of year	\$ 34,950	\$ 27,422
Incurred related to:		
Current year	346,503	303,091
Prior years	11,357	579
	357,860	303,670
Paid related to:		
Current year	(324,070)	(277,220)
Prior years	(31,386)	(18,922)
	(355,456)	(296,142)
Medical claims payable - end of year	\$ 37,354	\$ 34,950

Income Taxes

Due to the organizational structure, certain of the System’s entities are taxable under the Internal Revenue Code and some entities are tax exempt but are required to pay income taxes for unrelated business activities. The overall impact of federal income taxes to the System’s combined financial statements is not significant. In addition, certain of the System’s entities file partnership income tax returns in the U.S. federal jurisdiction and franchise tax returns in the state of Texas. These entities are no longer subject to U.S. federal, state, and local income tax examinations by authorities for years prior to 2013.

The Texas franchise tax applies to certain of the System’s entities. The tax is calculated on a margin base and is therefore reflected in the System's combined statements of operations and changes in net assets as income tax expense.

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The System follows the provisions of ASC 740, “*Income Taxes.*” As of June 30, 2017 and 2016, the System had no material gross unrecognized tax benefits.

Insurance

For 2017 and 2016, excess policies that covered claims that exceeded \$10,000,000 per incident and \$50,000,000 in the general aggregate (shared) for hospital professional liability, general liability, and HealthTexas Provider Network professional liability were provided by Baylor Scott & White Assurance SPC (BSWA). The excess liability policies are reinsured 100% by ACE American Insurance Company (Chubb) and various other reinsurers.

Reserves for Losses and Loss Adjustment Expenses

The reserve for losses and loss adjustment expenses are based upon management’s estimate of the ultimate liability for outstanding losses and loss adjustment expenses determined in comparison with historical and industry loss statistics. Management uses case basis evaluations and actuarial analysis to develop their estimate. Management believes that the reserves for losses and loss adjustment expenses are adequate. However, because of the extended period of time over which losses are settled and the general uncertainty surrounding the estimates, the ultimate settlement cost of the losses and the related loss adjustment expenses could vary and these differences could be material. The estimate is continuously reviewed and, as adjustments to the liability become necessary, they are reflected in current operations.

Liabilities for outstanding claims, including estimates for claims incurred but not reported, as well as reported claims pending settlement, are actuarially determined and discounted using an interest rate of 2.0% in both 2017 and 2016. Total undiscounted reserves for losses and loss adjustment expenses were approximately \$104,021,000 and \$90,017,000 at June 30, 2017 and 2016, respectively. Discounted reserves for losses and loss adjustment expenses including a risk margin at an approximate seventy percent confidence level were approximately \$105,570,000 and \$94,125,000 at June 30, 2017 and 2016, respectively.

Contributions and Gifts

When received or pledged, unrestricted gifts are reported as contributions to unrestricted net assets, and donor-restricted items are reported as contributions to temporarily or permanently restricted net assets. These donor-restricted contributions are restricted as to use and are transferred from temporarily restricted net assets to unrestricted net assets when the restrictions are satisfied or, in the case of endowment funds, when related earnings are appropriated for expenditure.

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Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are donor restricted as to use or time, and are transferred from temporarily restricted net assets to unrestricted net assets when the restrictions are satisfied. Temporarily restricted net assets are primarily available for patient care, medical education, and research.

Permanently restricted net assets include donor restrictions that the principal be invested in perpetuity and only the income from the investments be expended for designated purposes.

Income on endowment funds restricted for specified purposes is reported in the accompanying combined statements of operations and changes in net assets as temporarily restricted realized gains and investment income, net and unrealized gains (losses) on investments, net.

Income on endowment funds which is required by donors to be invested in perpetuity is reported in the accompanying combined statements of operations and changes in net assets as permanently restricted realized gains and investment income, net and unrealized gains (losses) on investments, net.

Revenue and Gains in Excess of Expenses and Losses

The combined statements of operations and changes in net assets include revenues and gains in excess of expenses and losses. Other changes in unrestricted net assets which are excluded from revenue and gains in excess of expenses and losses, consistent with industry practice, include unrealized losses on investments other than trading securities, transactions related to noncontrolling interests, and net assets released from restrictions for capital expenditures.

Derivative Financial Instruments

ASC 815, “*Derivatives and Hedging*,” requires that all derivative financial instruments be recognized in the financial statements and measured at fair value regardless of the purpose or intent for holding them. Changes in the fair value of derivative financial instruments are recognized periodically in nonoperating gains (losses). The System’s policy is to not hold or issue derivatives for trading purposes and to avoid derivatives with leverage features.

Use of Estimates

The preparation of 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 of the financial statements and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

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Reclassification

Certain reclassifications were made to the 2016 financial statements to conform to the 2017 presentation.

3. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair Value Measurements

As defined in ASC 820, “*Fair Value Measurements*”, fair value is based on the prices 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. In order to increase consistency and comparability in fair value measurements, ASC 820 establishes a three-tier fair value hierarchy for disclosure of fair value measurements.

The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable by market participants for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 - Inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability are unobservable and developed based on the best information available in the circumstances.

A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The carrying values of cash and cash equivalents, THVG funds due from USPI, patient accounts receivable, other receivables, investments of insurance subsidiaries, accounts payable, accrued liabilities, and estimated third-party payor settlements payable are reasonable estimates of their fair value due to the short-term nature of these financial instruments.

Fair values of short-term investments and long-term investments are generally based on quoted prices for similar instruments in active markets, quoted prices for identical or similar

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instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources including market participants, dealers, and brokers. This applies to investments such as domestic equities, U.S. treasuries, exchange-traded mutual funds, and agency securities.

Alternative Investments

Investments held consist of marketable securities as well as securities that do not have readily determinable fair values. Private equity investments, real estate investments, and hedge funds are collectively referred to as “alternative investments.” These are included in unrestricted long-term investments in the accompanying combined balance sheets, other than those held at HA. The investments in alternative investments are valued by management at fair value utilizing the net asset value (NAV) provided by the underlying investment companies unless management determines some other valuation is more appropriate. Such fair value estimates do not reflect early redemption penalties as the System does not intend to sell such investments before the expiration of the early redemption periods. The fair values of the securities held by limited partnerships that do not have readily determinable fair values are determined by the general partner and are based on historical cost, appraisals, or other estimates that require varying degrees of judgment. If no public market exists for the investment securities, the fair value is determined by the general partner taking into consideration, among other things, the cost of securities, prices of recent significant placements of securities of the same issuer, and subsequent developments concerning the companies to which the securities relate. As this valuation methodology is based primarily on unobservable inputs, these investments represent Level 3 assets. Any hedge funds valued at NAV which are redeemable by the System at NAV per share (or its equivalent) at the measurement date are transferred from Level 3 assets to Level 2 assets. Any hedge funds valued at NAV that were classified in prior year as Level 2 assets that are not redeemable by the System at NAV per share (or its equivalent) at the measurement date are transferred from Level 2 assets to Level 3 assets.

Included in collective investment funds held at HA for the BHCS Foundation are alternative investment interests in private equity funds and oil and gas interests. These interests are included in restricted long-term investments in the accompanying combined balance sheets. These alternative investments are in limited partnership interests and are carried at the NAV provided by the underlying investment companies unless management determines some other valuation is more appropriate. As this valuation methodology is based primarily on unobservable inputs, these investments represent Level 3 assets. Also included in Level 3 assets for the BHCS Foundation are other real estate and oil and gas interests which are carried at lower of cost or market.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Beneficial Interest

The System records charitable remainder trusts, where it is not the trustee, at the discounted present value of the estimated future cash flows. These trusts are reported in contributions receivable, net, in the accompanying combined balance sheets. When a third-party serves as trustee, the beneficial interest is required to be measured at fair value on a recurring basis. As beneficial interests utilize multiple unobservable inputs, including no active markets, and are measured using management's assumption about risk inherent in the valuation technique, beneficial interests in split-interest agreements represent Level 3 assets.

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

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**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

The following tables set forth below, by level, the financial assets and liabilities measured at fair value on a recurring basis at June 30, 2017 and 2016 (in thousands):

	June 30, 2017			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents				
Cash	\$1,148,905	\$1,148,905	\$ -	\$ -
Money market funds	40,701	40,701	-	-
Total cash and cash equivalents	<u>1,189,606</u>	<u>1,189,606</u>	-	-
Short-term investments				
Mutual funds	60,016	60,016	-	-
Certificates of deposit	101,183	101,183	-	-
Fixed income securities	29,499	2	29,493	4
U.S. government securities	28	-	28	-
Mortgage-backed securities	389	-	389	-
Other	1,154	1,054	100	-
Total short-term investments	<u>192,269</u>	<u>162,255</u>	<u>30,010</u>	<u>4</u>
Unrestricted long-term investments				
Cash	9,632	9,632	-	-
Mutual funds	23,299	23,299	-	-
Equity securities	1,207,335	327,429	879,906	-
Fixed income securities	389,471	28	389,443	-
U.S. government securities	231,569	-	231,569	-
Mortgage-backed securities	240,728	12,564	228,164	-
Hedge fund/diversifiers alternative investments	551,327	-	406,010	145,317
Private equity alternative investments	180,590	-	-	180,590
Real estate alternative investments	122,362	-	-	122,362
Common funds, held at HA				
Group investment fund	2,735	-	2,735	-
Group bond fund	159	-	159	-
Group equity fund	380	-	380	-
Other funds	105	85	-	20
Other	436	-	1	435
Total unrestricted long-term investments	<u>2,960,128</u>	<u>373,037</u>	<u>2,138,367</u>	<u>448,724</u>

In the accompanying combined balance sheets, unrestricted long-term investments at June 30, 2017 includes an investment of approximately \$131,057,000 accounted for under the cost method.

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

	June 30, 2017			
	Total	Level 1	Level 2	Level 3
Assets (continued):				
Restricted long-term investments				
Cash	\$ 5,217	\$ 5,217	\$ -	\$ -
Mutual funds	47,547	47,547	-	-
Equity securities	175,624	46,068	129,556	-
Fixed income securities	30,589	77	30,512	-
U.S. government securities	18,226	-	18,226	-
Mortgage-backed securities	17,792	932	16,860	-
Hedge fund/diversifiers alternative investments	66,605	-	47,382	19,223
Private equity alternative investments	36,854	-	-	36,854
Real estate alternative investments	11,486	-	-	11,486
Split-interest agreements	7,329	-	7,329	-
Real estate	338	-	-	338
Cash surrender value of life insurance	1,260	-	-	1,260
Other	299	1	-	298
Common funds, held at HA				
Group investment fund	42,021	-	42,021	-
Group bond fund	2,444	-	2,444	-
Group equity fund	5,835	-	5,835	-
Other funds	<u>1,609</u>	<u>1,307</u>	<u>-</u>	<u>302</u>
Total restricted long-term investments	<u>471,075</u>	<u>101,149</u>	<u>300,165</u>	<u>69,761</u>
Assets whose use is limited				
Cash	95,908	95,908	-	-
Money market funds	19,940	19,940	-	-
Mutual funds	146,254	146,254	-	-
Equity securities	1,652	1,652	-	-
Fixed income securities	29,378	-	29,378	-
U.S. government securities	31,230	-	31,230	-
Other	<u>164</u>	<u>-</u>	<u>164</u>	<u>-</u>
Total assets whose use is limited	<u>324,526</u>	<u>263,754</u>	<u>60,772</u>	<u>-</u>

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

	June 30, 2017			
	Total	Level 1	Level 2	Level 3
Assets (continued):				
Contributions receivable, net				
Beneficial interest in split-interest agreements	\$ 21,596	\$ -	\$ -	\$ 21,596
Total contributions receivable, net	21,596	-	-	21,596
Total assets at fair value	\$5,159,200	\$2,089,801	\$2,529,314	\$ 540,085
 Liabilities:				
Interest rate swap agreements, net of collateral	\$ 265,129	\$ -	\$ 265,129	\$ -
Total liabilities at fair value	\$ 265,129	\$ -	\$ 265,129	\$ -

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**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

	June 30, 2016			
	Total	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents				
Cash	\$1,487,920	\$1,487,920	\$ -	\$ -
Money market funds	<u>39,829</u>	<u>39,829</u>	-	-
Total cash and cash equivalents	<u>1,527,749</u>	<u>1,527,749</u>	-	-
Short-term investments				
Mutual funds	55,329	55,329	-	-
Certificates of deposit	400	400	-	-
Equity securities	7	-	7	-
Fixed income securities	30,515	-	30,515	-
U.S. government securities	13,616	-	13,616	-
Other	<u>1,303</u>	<u>1,221</u>	<u>82</u>	-
Total short-term investments	<u>101,170</u>	<u>56,950</u>	<u>44,220</u>	-
Unrestricted long-term investments				
Cash	5,871	5,871	-	-
Mutual funds	4,889	4,889	-	-
Equity securities	1,034,241	442,546	591,695	-
Fixed income securities	439,145	30	438,109	1,006
U.S. government securities	256,810	-	256,810	-
Mortgage-backed securities	131,930	24,820	107,110	-
Hedge fund/diversifiers alternative investments	493,879	-	345,275	148,604
Private equity alternative investments	160,262	-	-	160,262
Real estate alternative investments	106,191	-	-	106,191
Common funds, held at HA				
Group investment fund	313	-	313	-
Group bond fund	20	-	20	-
Group equity fund	42	-	42	-
Other funds	18	13	-	5
Other	<u>504</u>	-	-	<u>504</u>
Total unrestricted long-term investments	<u>2,634,115</u>	<u>478,169</u>	<u>1,739,374</u>	<u>416,572</u>

In the accompanying combined balance sheets, unrestricted long-term investments at June 30, 2016, includes an investment of approximately \$80,508,000 accounted for under the cost method.

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

	June 30, 2016			
	Total	Level 1	Level 2	Level 3
Assets (continued):				
Restricted long-term investments				
Cash	\$ 34,249	\$ 34,249	\$ -	\$ -
Mutual funds	23,232	23,232	-	-
Equity securities	160,705	67,413	93,292	-
Fixed income securities	36,871	70	36,750	51
U.S. government securities	23,720	-	23,720	-
Mortgage-backed securities	10,926	2,082	8,844	-
Hedge fund/diversifiers alternative investments	60,525	-	41,198	19,327
Private equity alternative investments	34,594	-	-	34,594
Real estate alternative investments	10,414	-	-	10,414
Split-interest agreements	7,315	-	7,315	-
Real estate	742	-	-	742
Cash surrender value of life insurance	1,260	-	-	1,260
Other	275	-	-	275
Common funds, held at HA				
Group investment fund	40,064	-	40,064	-
Group bond fund	2,543	-	2,543	-
Group equity fund	5,382	-	5,382	-
Other funds	2,324	1,655	-	669
Total restricted long-term investments	455,141	128,701	259,108	67,332
Assets whose use is limited				
Cash	73,254	73,254	-	-
Money market funds	28,454	28,454	-	-
Mutual funds	98,301	98,301	-	-
Equity securities	11,266	11,266	-	-
Fixed income securities	27,796	-	27,796	-
U.S. government securities	36,735	-	36,735	-
Other	164	164	-	-
Total assets whose use is limited	275,970	211,439	64,531	-

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**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

	June 30, 2016			
	Total	Level 1	Level 2	Level 3
Assets (continued):				
Contributions receivable, net				
Beneficial interest in split-interest agreements	\$ 22,565	\$ -	\$ -	\$ 22,565
Total contributions receivable, net	22,565	-	-	22,565
Total assets at fair value	\$5,016,710	\$2,403,008	\$2,107,233	\$ 506,469
 Liabilities:				
Interest rate swap agreements, net of collateral	\$ 357,006	\$ -	\$ 357,006	\$ -
Total liabilities at fair value	\$ 357,006	\$ -	\$ 357,006	\$ -

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**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

The following table is a roll forward of the combined balance sheet amounts for financial instruments classified by the System within Level 3 of the valuation hierarchy defined above for the years ended June 30, 2017 and 2016 (in thousands):

	2017						
	Private Equity	Real Estate	Hedge Funds	Other Funds	Split-Interest Agreements	Common Investment Funds	Total
Balance, beginning of period	\$ 194,856	\$ 116,605	\$ 167,931	\$ 3,838	\$ 22,565	\$ 674	\$ 506,469
Realized gains (losses), net	13,022	6,658	18,225	478	(1,837)	-	36,546
Unrealized (losses) gains, net	(11,254)	4,248	9,361	(52)	877	(352)	2,828
Purchases	52,776	28,054	115,285	151	-	-	196,266
Settlements	(31,956)	(21,717)	(64,131)	(2,080)	(9)	-	(119,893)
Transfers out of Level 3	-	-	(82,131)	-	-	-	(82,131)
Balance, end of period	<u>\$ 217,444</u>	<u>\$ 133,848</u>	<u>\$ 164,540</u>	<u>\$ 2,335</u>	<u>\$ 21,596</u>	<u>\$ 322</u>	<u>\$ 540,085</u>
	2016						
	Private Equity	Real Estate	Hedge Funds	Other Funds	Split-Interest Agreements	Common Investment Funds	Total
Balance, beginning of period	\$ 182,479	\$ 94,031	\$ 144,055	\$ 2,376	\$ 22,645	\$ 803	\$ 446,389
Realized gains (losses), net	9,532	3,432	(734)	(83)	(2,494)	-	9,653
Unrealized gains (losses), net	4,706	196	(10,071)	127	(835)	(129)	(6,006)
Purchases	80,461	121,083	27,002	1,452	6,650	-	236,648
Settlements	(82,322)	(102,137)	(21,416)	(34)	(3,401)	-	(209,310)
Transfers into Level 3	-	-	29,095	-	-	-	29,095
Balance, end of period	<u>\$ 194,856</u>	<u>\$ 116,605</u>	<u>\$ 167,931</u>	<u>\$ 3,838</u>	<u>\$ 22,565</u>	<u>\$ 674</u>	<u>\$ 506,469</u>

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BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

At June 30, 2017 and 2016, alternative investments recorded at NAV consisted of the following (in thousands):

	2017			
	<u>Fair Value</u>	<u>Unfunded Commitments</u>	<u>Redemption Frequency if Currently Eligible</u>	<u>Redemption Notice Period</u>
Equity-linked investments ^a	\$ 48,721	\$ -	quarterly, annually	60-90 days
Event-driven investments ^b	55,712	-	quarterly, annually	30-90 days
Credit-linked investments ^c	85,557	-		
Multi-strategy investments ^d	16,472	-	monthly, quarterly	30-90 days
Tactical trading investments ^e	203,032	-	daily, monthly	2-90 days
Risk parity and global asset allocation fund ^f	208,438	-	monthly	5-30 days
Real estate funds - open ended ^g	73,586	-	quarterly	90 days
Real estate funds - close ended ^h	60,262	33,783		
Oil and gas funds ^j	267	-		
Private equity funds ^k	185,750	142,798		
Private debt funds ^l	31,694	23,869		
Non-agency asset backed security ^m	<u>4</u>	<u>-</u>		
Total	<u>\$ 969,495</u>	<u>\$ 200,450</u>		

	2016			
	<u>Fair Value</u>	<u>Unfunded Commitments</u>	<u>Redemption Frequency if Currently Eligible</u>	<u>Redemption Notice Period</u>
Equity-linked investments ^a	\$ 54,306	\$ -	quarterly, annually	60-90 days
Event-driven investments ^b	43,253	-	quarterly, annually	30-90 days
Credit-linked investments ^c	72,270	-		
Multi-strategy investments ^d	33,585	-	monthly, quarterly	30-90 days
Tactical trading investments ^e	156,498	-	daily, monthly	2-90 days
Risk parity and global asset allocation fund ^f	194,492	-	monthly	5-30 days
Real estate funds - open ended ^g	68,829	-	quarterly	90 days
Real estate funds - close ended ^h	47,776	32,637		
Mortgage loan and real estate fund ⁱ	388	-		
Oil and gas funds ^j	233	-		
Private equity funds ^k	155,790	94,021		
Private debt funds ^l	39,066	37,284		
Non-agency asset backed security ^m	<u>1,057</u>	<u>-</u>		
Total	<u>\$ 867,543</u>	<u>\$ 163,942</u>		

- a) Equity-linked fund managers buy equities that are expected to increase in value and sell short equities that are expected to decrease in value. Portfolios range from net short to net long, depending on market conditions. Aggressive funds may capture returns by exceeding 100% exposure while conservative funds mitigate market risk by maintaining

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

net exposures of between 0-50%. Typically, equity-linked strategies are based on "bottom up" fundamental analysis of the individual companies, in which investments are made. There may also be "top down" analysis of the risks and opportunities offered by industries, sectors, countries, and the macroeconomic situation. Equity-linked managers may be generalists or focus on certain industries, sectors, regions, or equity category (i.e. small or large cap and value or growth). There are many trading styles, with frequent or dynamic traders and some longer-term investors. Returns are generally more correlated with the direction of the equity markets, although reduction in market risk exposure through shorting is expected to enhance the absolute and risk-adjusted returns relative to the overall performance of the asset class. The fair values of the investments in this class have been estimated using the net asset value per share of the funds.

- b) Event-driven fund managers seek to exploit pricing inefficiencies that may occur before or after corporate events such as an earnings announcement, bankruptcy, merger, acquisition, or spinoff. Returns are less correlated with the general direction of market movements primarily due to the idiosyncratic nature of individual events. Several investment managers include quarterly percentage redemption limits. The fair values of the investments in this class have been estimated using the net asset value per share of the funds.
- c) Credit-linked fund managers seek to profit from the mispricing of related securities. These strategies utilize quantitative and qualitative analysis to identify securities or spreads between securities that deviate from their fair value and/or historical norms. Examples include convertible arbitrage, fixed arbitrage, statistical arbitrage, and select global macro strategies. Fund returns are generally not dependent on the direction of market movements. The fair values of the investments in this class have been estimated using the net asset value per share of the funds.
- d) Multi-strategy fund managers focus on large, long-term mispricing in the global fixed-income, equity and credit markets, capturing relative-value anomalies via multi-product trades. Returns are relatively uncorrelated with the general direction of market movements since they avoid taking a directional bias with regards to the price movement of a specific stock or market. Several investment managers include quarterly percentage redemption limits and/or early redemption penalties. The fair values of the investments in this class have been estimated using the net asset value per share of the funds.
- e) Tactical trading fund managers generally invest on a large scale around the world using economic theory to justify the decision making process on either a discretionary or systematic basis. Strategies are typically based on forecasts and analysis about interest rates trends, the general flow of funds, political changes, government policies, inter-government relations, and other broad systemic and technical factors. Returns are

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

relatively uncorrelated with the general direction of market movements. Several investment managers include quarterly percentage redemption limits. The fair values of the investments in this class have been estimated using the net asset value per share of the funds.

- f) Risk parity and global asset allocation fund managers invest across global markets including equities, nominal government bonds, inflation-linked bonds, commodities, and emerging markets on a risk balanced framework. Typically, these strategies incorporate leverage to increase the risk contribution from low volatility asset classes (e.g., inflation-linked bonds and nominal government bonds). The fair values of the investments in this class have been estimated using the net asset value per share of the funds.
- g) Real estate - open end fund managers invest in U.S. commercial real estate. Redemptions are available on a quarterly basis, subject to the discretion of the General Partners. The General Partners may elect to establish a redemption queue should the level of redemptions for a given quarter be detrimental to the fund's overall performance. The fair values of the investments in this class have been estimated using the net asset value, which is based on the ownership interest of partners' capital.
- h) Real estate - closed end fund managers invest primarily in U.S. commercial real estate and industries related to real estate, with some having minimal exposure outside of the U.S. These partnerships are illiquid and therefore do not have a redemption feature. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of these funds will be liquidated over the next six years with the value of those underlying assets being replaced by investments in new real estate funds. The fair values of the investments in this class have been estimated using the net asset value, which is based on the ownership interest of partners' capital.
- i) The mortgage loan and real estate fund manager primarily invests in real estate and loans secured by real estate located in the Dallas/Fort Worth area. This fund is illiquid and redemption is subject to fund management approval. Distributions from the fund will be received as the underlying investments are liquidated. The fund in this category is closed to new investors. The fair value of the investments has been estimated based on internal appraisals using the fund management's knowledge of the properties, current real estate market for similar properties, and recent sales of comparative properties. BSWH sold the investment in this fund in August 2016.
- j) Oil and gas fund managers invested in mineral properties located in Texas and Wyoming. The fund in this category is closed to new investors, is illiquid, and redemption is subject

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

to fund management approval. Royalty income is distributed quarterly subject to fund management approval (\$0.50 per unit per quarter in 2017 and \$0.75 per unit per quarter in 2016). Distributions from the fund will be received as the underlying investments are depleted. The fair value of the mineral properties has been estimated by multiplying the most recent twelve months of royalty income, excluding lease bonus income, times a factor of five. The fund's management used a multiple of five for the valuation based on current industry methodology, recent market transactions, and the fund's extensive experience in mineral properties.

- k) Thirty-seven private equity fund managers invest in a variety of mostly private companies. These investments have a drawdown structure where a portion of commitments (which are made upon entering the partnership) are called gradually over the first 3-6 years of the partnership's life. It is expected that most of the unfunded commitments should be called within the next 6 years. These partnerships are illiquid and therefore do not have a redemption feature. Instead, the nature of the investments in this class is that distributions are received as the investment in the underlying companies are sold. It is estimated that the current underlying assets of these partnerships should be liquidated within the next 10 years. The investments are valued based on each partnership's valuation policy which is then subject to annual third-party financial audits. Financial audits are available approximately 90 days following year end. Therefore, the valuation at year end reflects the latest reported manager valuation with adjustments for new capital calls and distributions.
- l) Seven private debt fund managers invest in a variety of mostly private companies. These investments have a drawdown structure where a portion of commitments (which are made upon entering the partnership) are called gradually over the first 1-3 years of the partnership's life. It is expected that most of the unfunded commitments should be called within the next 4 years. These partnerships are illiquid and therefore do not have a redemption feature. Instead, the nature of the investments in this class is that distributions are received as income from the debts received and as the investment in the underlying companies are sold or the debt principal is repaid. It is estimated that the current underlying assets of these partnerships should be liquidated within the next 6 years. The investments are valued based on each partnership's valuation policy which is then subject to annual third-party financial audits. Financial audits are available approximately 90 days following year end. Therefore, the valuation at year end reflects the latest reported manager valuation with adjustments for new capital calls and distributions.
- m) The non-agency asset backed security is a term note (the "Note") issued by Ocwen Loan Servicing LLC. The Note is secured by servicing advance receivables associated with Ocwen's servicing portfolio. The parent company Ocwen Financial Corporation is a

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

financial services holding company which, through its subsidiaries, is engaged in the servicing and origination of mortgage loans. This security is priced using bid evaluation prices from Bloomberg.

Long-term Debt

The System's long-term debt obligations, excluding capital leases, are reported in the accompanying combined balance sheets at carrying value which totaled approximately \$2,980,084,000 and \$2,959,401,000 at June 30, 2017 and 2016, respectively. The fair value of these obligations is estimated based primarily on quoted market prices for related bonds and is therefore classified as Level 2. The fair value of the System's long-term debt obligations, excluding capital leases totaled approximately \$3,054,518,000 and \$3,158,064,000 at June 30, 2017 and 2016, respectively.

4. ENDOWMENTS

The System's endowments consist of donor-restricted and board-designated endowment funds for a variety of purposes. The net assets associated with endowment funds are classified and reported based on the existence or absence of donor imposed restrictions.

The System has interpreted the State of Texas Uniform Prudent Management of Institutional Funds Act (UPMIFA) as not requiring the maintaining of purchasing power of permanently restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the System classifies as permanently restricted net assets, (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the System in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the System considers the following factors in making a determination to appropriate or accumulate endowment funds:

- 1) The duration and preservation of the fund
- 2) The purposes of the System and the donor restricted endowment fund
- 3) General economic conditions
- 4) The possible effect of inflation and deflation
- 5) The expected total return from income and the appreciation of investments
- 6) Other resources of the System and
- 7) The investment policies of the System

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

Endowment net asset composition by type of fund as of June 30, 2017 and 2016, is as follows (in thousands):

	2017			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted endowment funds	\$ 1,322	\$ 107,003	\$ 243,575	\$ 351,900
Board-designated endowment funds	<u>61,612</u>	<u>-</u>	<u>-</u>	<u>61,612</u>
Total endowment funds	<u>\$ 62,934</u>	<u>\$ 107,003</u>	<u>\$ 243,575</u>	<u>\$ 413,512</u>
	2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted endowment funds	\$ 1,247	\$ 88,245	\$ 240,183	\$ 329,675
Board-designated endowment funds	<u>60,816</u>	<u>-</u>	<u>-</u>	<u>60,816</u>
Total endowment funds	<u>\$ 62,063</u>	<u>\$ 88,245</u>	<u>\$ 240,183</u>	<u>\$ 390,491</u>

Changes in endowment net assets for the years ended June 30, 2017 and 2016 are as follows (in thousands):

	2017			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, as of June 30, 2016	\$ 62,063	\$ 88,245	\$ 240,183	\$ 390,491
Investment income and realized gains	3,680	13,739	24	17,443
Net appreciation and unrealized gains	797	17,613	-	18,410
Gifts	38	20	829	887
Appropriation of endowment assets for expenditure	(1,405)	(12,624)	-	(14,029)
Other	<u>(2,239)</u>	<u>10</u>	<u>2,539</u>	<u>310</u>
Endowment net assets, as of June 30, 2017	<u>\$ 62,934</u>	<u>\$ 107,003</u>	<u>\$ 243,575</u>	<u>\$ 413,512</u>
	2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, as of June 30, 2015	\$ 63,323	\$ 106,438	\$ 222,218	\$ 391,979
Investment income and realized gains (losses)	835	5,716	(158)	6,393
Net depreciation and unrealized losses	(1,123)	(12,074)	-	(13,197)
Gifts	130	34	15,600	15,764
Appropriation of endowment assets for expenditure	(916)	(12,058)	-	(12,974)
Other	<u>(186)</u>	<u>189</u>	<u>2,523</u>	<u>2,526</u>
Endowment net assets, as of June 30, 2016	<u>\$ 62,063</u>	<u>\$ 88,245</u>	<u>\$ 240,183</u>	<u>\$ 390,491</u>

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Permanently Restricted Net Assets

The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by State of Texas UPMIFA as of June 30, 2017 and 2016 is as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Education	\$ 48,967	\$ 48,376
Patient care	119,409	119,061
Research	73,000	70,547
General operations	<u>2,199</u>	<u>2,199</u>
Total endowment assets classified as permanently restricted net assets	<u>\$ 243,575</u>	<u>\$ 240,183</u>

Endowment Funds with Deficits

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the value of the initial and subsequent donor gift amounts (deficit). When donor endowment deficits exist, they are classified as a reduction of unrestricted net assets. Deficits of this nature reported in unrestricted net assets were \$138,000 and \$212,000 as of June 30, 2017 and 2016, respectively. These deficits resulted from unfavorable market fluctuations and authorized appropriation that was deemed prudent.

Endowment Return Objectives and Risk Parameters

The System follows an investment policy that attempts to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of endowment assets. Under this policy, the return objective for the endowment assets, measured over a full market cycle, shall be to maximize the return against various indices, based on the endowment's target allocation applied to the appropriate individual benchmarks.

To achieve its long-term rate of return objectives, the System relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized gains) and current yield (interest and dividends). The System targets a diversified asset allocation that places greater emphasis on equity-based investments to achieve its long-term objectives within prudent risk constraints.

Relationship of Endowment Spending Practices to Investment Objectives

The System determines the appropriation of endowment funds for expenditure reimbursement through the budgeting process. Distribution policies for the System's endowments govern the amount of endowment funds that may be appropriated during this process. In establishing its policies, the System considered the long-term expected return on its endowments.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Accordingly, over the long-term, the System expects the current distribution policies to allow its endowments to grow at an average of the long-term rate of inflation and maintain its purchasing power. In order to maintain the purchasing power of endowment assets, expenditures are based on investment performance and spending is curbed in response to deficit situations. Over the long-term, the System expects its endowment to grow consistent with its intention to maintain the purchasing power of the endowment assets as well as to provide additional real growth through new gifts.

5. LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS

Long-term debt and capital lease obligations as of June 30, 2017 and 2016, consist of the following:

	2017	2016
	(In thousands)	
BSW Holdings -		
Series 2016 Revenue Bonds (Taxable) -		
Term Bonds, fixed interest rate ranging from 1.95% to 3.97%, payable semi-annually, principal payable November 2021, 2026, and 2046	\$ 534,785	\$ 534,785
Series 2016A Revenue Bonds -		
Term Bonds, fixed interest rate ranging from 3% to 5%, payable semi-annually, principal payable through November 2045	369,840	373,340
Series 2015 Revenue Bonds (Taxable) -		
Term Bonds, fixed interest rate ranging from 2.12% to 4.19%, payable semi-annually, principal payable November 2020, 2025, and 2045	549,935	549,935
Series 2015A Revenue Bonds -		
Term Bonds, fixed interest rate of 2.19%, payable semi-annually, principal payable through November 2027	172,875	175,615
Series 2015B Revenue Bonds -		
Variable rate interest payable monthly (1.18% at June 30, 2017), principal payable November 2032 through November 2050	45,120	45,120

**BAYLOR SCOTT & WHITE HOLDINGS
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Notes to Combined Financial Statements – continued

	2017	2016
	(In thousands)	
Series 2015C Revenue Bonds - Variable rate interest payable monthly (1.20% at June 30, 2017), principal payable August 2030 through August 2041	\$ 85,775	\$ 85,775
Series 2015D Revenue Bonds - Variable rate interest payable monthly (1.06% at June 30, 2017), principal payable November 2032 through November 2050	43,940	43,940
BHCS - Series 2000 Taxable Notes (Auction Rate Securities) - Serial Notes, variable interest (1.36% at June 30, 2017), payable monthly, principal payable November 2019 through 2025	19,700	19,700
Series 2011A Revenue Bonds - Term Bonds, fixed interest rate ranging from 3% to 5%, payable semi-annually, principal payable through November 2030	42,695	62,010
Series 2011B Revenue Bonds - Window Variable Rate Demand Bonds, variable interest (1.21% at June 30, 2017) payable monthly, principal payable November 2032 through 2050	50,000	50,000
Series 2011C Revenue Bonds - Variable Rate Demand Bonds, variable interest (0.91% at June 30, 2017), payable monthly, principal payable November 2032 through 2050	45,120	45,120
Series 2011F & G Revenue Bonds - Floating Rate Note, variable interest rates (1.41% to 1.44% at June 30, 2017) payable monthly, principal payable November 2032 through 2040	75,000	75,000

**BAYLOR SCOTT & WHITE HOLDINGS
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Notes to Combined Financial Statements – continued

	2017	2016
	(In thousands)	
Series 2013A Revenue Bonds - Term Bonds, fixed interest rate ranging from 3.38% to 5.00%, payable semi-annually, principal payable November 2028 through 2043	\$ 168,565	\$ 168,565
Series 2013B Revenue Bonds - Window Variable Rate Demand Bonds, variable interest (1.21% at June 30, 2017) payable monthly, principal payable November 2033 through 2050	45,000	45,000
Series 2013C Revenue Bonds (Taxable) - Term Bonds, fixed interest rate of 4.45%, payable semi-annually, principal payable November 2033 through 2043	63,045	63,045
Term Loan - Variable interest priced at one to six month intervals (2.13% at June 30, 2017) payable in one to three month intervals, principal payable November 2018 through 2031	91,655	91,655
Building Lease - Crutcher Annex - Interest of 2.85% payable monthly, principal and interest payments through May 2025	9,878	10,862
HRT Properties of Texas, Ltd., Building Leases - Interest of 4.88%, payable monthly, principal and interest payments through September 2017	4,441	5,557
SWH -		
Series 2013A Revenue Bonds - Term Bonds, fixed interest rate ranging from 4.00% to 5.00%, payable semi-annually, principal payable through August 2043	172,960	174,900
Series 2013B Revenue Bonds - Variable rate interest payable monthly (1.51% at June 30, 2017), principal payable through August 2045	78,065	79,305

**BAYLOR SCOTT & WHITE HOLDINGS
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Notes to Combined Financial Statements – continued

	2017	2016
	(In thousands)	
Series 2013C Revenue Bonds - Variable rate interest payable monthly (1.59% at June 30, 2017), principal payable August 2030 through August 2046	\$ 94,395	\$ 94,395
Tax-Exempt Note Payable – Variable rate interest (1.83% at June 30, 2017), principal payable December 2017	56,225	56,225
Note Payable – Variable rate interest payable quarterly (2.15% at June 30, 2017), principal payable through February 2019	40,000	42,000
Baylor Medical Center at Irving - Building Lease - Interest of 3.68% payable monthly, principal and interest payments through March 2045	153,469	156,498
Baylor Medical Center at Carrollton (BMCC) - Building Lease - Interest of 9.50%, payable monthly, principal and interest payments through December 2033	54,891	56,208
THVG - Equipment Notes Payable - Interest ranging from 2% to 8%, payable monthly, principal and interest payments through December 2023	36,490	32,545
Building Lease, Frisco Medical Center, LLP - Interest at 11.63%, payable monthly, principal and interest payments through June 2027	56,026	57,703
Building Lease, Arlington Ortho - Interest at 8.61%, payable monthly, principal and interest payments through February 2030	26,037	23,619
Building Lease, Dallas Uptown - Interest at 9.43%, payable monthly, principal and interest payments through January 2031	22,017	22,483

**BAYLOR SCOTT & WHITE HOLDINGS
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Notes to Combined Financial Statements – continued

	2017	2016
	(In thousands)	
Building Lease, Lewisville Surgicare - Interest at 11.39%, payable monthly, principal and interest payments through December 2022	\$ 3,562	\$ 3,996
Building Lease, Grapevine Surgicare Partners - Interest at 12.66%, payable monthly, principal and interest payments through October 2021	2,601	3,012
Other - Interest ranging from 9.13% to 14.47%, payable monthly, principal and interest payments through May 2029	6,170	8,059
Lake Pointe Construction Loan - Interest at 4.21% payable month, principal and interest payments January 2019 through December 2026	45,000	-
Other Capital Leases and Long-Term Debt	74,916	66,174
	3,340,193	3,322,146
Net unamortized original issue premium/discount and bond issuance costs	53,288	55,400
Current maturities	(126,644)	(63,416)
Long-term debt subject to short-term remarketing arrangements	(95,000)	(95,000)
	<u>\$ 3,171,837</u>	<u>\$ 3,219,130</u>

BSW Holdings

BSW Holdings and certain of its affiliates issue and secure debt under a Master Indenture of Trust and Security Agreement, dated as of February 1, 2014, as supplemented and amended (the “Master Indenture”), among BSW Holdings, the affiliates from time to time obligated thereunder (the “Obligated Affiliates”), and The Bank of New York Mellon Trust Company, National Association, as trustee. The following entities are currently Obligated Affiliates: BSW Holdings, BSW Health, BHCS, SWH, BUMC, SWMH, Baylor All Saints Medical Center, a Texas nonprofit corporation, Garland, Baylor Regional Medical Center at Grapevine, a Texas nonprofit corporation, Baylor Medical Center at Waxahachie, a Texas nonprofit corporation, Baylor Regional Medical Center at Plano, a Texas nonprofit corporation, Scott & White Hospital – College Station (College Station), a Texas nonprofit

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

corporation, Scott & White Clinic, a Texas nonprofit corporation, Scott & White Hospital – Round Rock, a Texas nonprofit corporation, Scott & White Continuing Care Hospital, a Texas nonprofit corporation, and Hillcrest Baptist Medical Center, a Texas nonprofit corporation.

BSW Health, Garland, and College Station were admitted to the single obligated credit group as Obligated Affiliates under the Fourth Supplement to the Master Indenture, effective April 19, 2016. BSW Holdings is currently the Combined Group Representative under the Master Indenture.

In January 2015, BSW Holdings entered into a four-year revolving line of credit. Under this line of credit, BSW Holdings may borrow at variable rates through January 14, 2019. The borrowing capacity under the line of credit is \$400,000,000, of which \$0 was drawn as of June 30, 2017 and 2016.

In April and May 2015, BSW Holdings issued the \$549,935,000 Series 2015 Taxable Revenue Bonds and the \$176,960,000 Series 2015A Revenue Bonds (collectively, the “BSW Holdings 2015 Series Bonds”), respectively. Proceeds of the BSW Holdings 2015 Series Bonds were used to advance refund approximately \$406,595,000 of the outstanding principal of the SWH Series 2008A and BHCS Series 2009 bonds and to partially advance refund the SWH Series 2010 bonds. Upon issuance of the BSW Holdings 2015 Series, \$270,835,000 of the SWH Series 2010 bonds remained outstanding. Remaining proceeds of the Series 2015 Taxable Revenue Bonds were issued to fund development and construction costs of various expansion and construction projects, pay costs of issuance, and provide for any eligible corporate purpose. A loss on extinguishment of debt of approximately \$70,131,000 was recorded in 2015 related to the advance refundings undertaken through the BSW Holdings Series 2015 Bonds.

On December 23, 2015, BSW Holdings placed its Series 2015B, 2015C, and 2015D revenue bonds (the “BSW Holdings Series 2015B, C and D”) with various banks. Proceeds of the BSW Holdings Series 2015B, C and D were used to refinance the following variable rate demand bonds issued via the Tarrant County Cultural Education Facilities Corporation (TCCEFC) conduit issuer: Hospital Revenue Bonds (Scott and White Memorial Hospital and Scott, Sherwood and Brindley Foundation Project) Series 2008-1, Hospital Revenue Bonds (Baylor Health Care System Project) Series 2011D, and Hospital Revenue Bonds (Baylor Health Care System Project) Series 2011E (collectively, the “Refinanced VRDBs”) with an aggregate outstanding balance of \$174,835,000. In conjunction with the Refinanced VRDBs, three direct-pay letters of credit were terminated; two with Wells Fargo Bank, N.A. and one with J.P. Morgan Bank, N.A. A loss on extinguishment of debt of approximately \$1,748,000 was recorded related to this transaction in 2016.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

In April 2016, BSW Holdings issued \$534,785,000 of Taxable Bonds Series 2016 (the “Series 2016 Bonds”). Proceeds, net of underwriting fees, totaling approximately \$534,826,000 were used to pay off a \$250,000,000 bridge facility and costs of issuance. The remaining Series 2016 Bonds proceeds will be used for eligible corporate purposes.

Additionally, in April 2016, TCCEFC issued \$373,340,000 of Hospital Revenue Bonds (Baylor Scott & White Health Project, Series 2016A) (the “Series 2016A Bonds”) to completely advance refund \$267,305,000 of outstanding par value of the TCCEFC Hospital Revenue Bonds (Scott & White Healthcare Project) Series 2010 plus accrued interest. In connection with the defeasance of the Series 2010 Bonds, the Obligated Affiliates’ revenue pledge under the Master Indenture was released as provided in such document. As a result, no collateral secures the debt and swap obligations issued by the Obligated Affiliates under the Master Indenture. The remaining Series 2016A bond proceeds will be used for various tax exempt projects and to pay costs of issuance. A loss on extinguishment of debt of approximately \$51,505,000 was recorded in 2016 related to the refunding undertaken through the Series 2016A Bonds.

BHCS

In June 2011, BHCS issued \$359,220,000 of Hospital Revenue Bonds through the TCCEFC. Proceeds, net of underwriter’s discount, totaling approximately \$364,815,000 were used to repay \$75,000,000 in borrowings under the taxable revolving line of credit and refund \$150,000,000 of Series 2006B and 2006C Revenue Bonds. The remaining bond proceeds were deposited into the fund’s account for costs of issuance and future project expenditures.

The 2011 issuance included \$50,000,000 of Window Variable Rate Demand Bonds. These bonds are subject to long-term amortization periods and may be put to the System at the option of the bondholders in connection with certain remarketing arrangements. To the extent the bondholders may, under the terms of the debt, put their bonds within 12 months after June 30, 2017 and 2016, the principal amount of such bonds has been classified as a current obligation in the accompanying combined balance sheets. Management believes the likelihood of a material amount of bonds being put to the System to be remote. However, management has taken steps to provide various sources of liquidity in the event any bonds were to be put back to the System.

In April 2013, BHCS issued \$276,610,000 of Hospital Revenue Bonds, Hospital Refunding Revenue Bonds, and Taxable Hospital Revenue Bonds through the TCCEFC. Proceeds, net of underwriter’s discount, totaling approximately \$278,753,000 were used to repay \$112,400,000 in borrowings under the taxable revolving line of credit. The remaining bond

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

proceeds were deposited into the fund's general account for costs of issuance and future project expenditures.

The 2013 issuance included \$45,000,000 of Window Variable Rate Demand Bonds. These bonds are subject to long-term amortization and may be put to the System at the option of the bondholders in connection with certain remarketing arrangements. To the extent the bondholders may, under the terms of the debt, put their bonds within 12 months after June 30, 2017 and 2016, the principal amount of such bonds has been classified as a current obligation in the accompanying combined balance sheets. Management believes the likelihood of a material amount of bonds being put to the System to be remote. However, management has taken steps to provide various sources of liquidity in the event any bonds are put back to the System.

SWH

In June 2008, SWH issued \$236,395,000 of variable rate demand bonds in three subseries. In October 2010, the Series 2008-3 bonds were refunded with a tax-exempt note in the amount of \$56,225,000. In March 2013, the Series 2008-2 bonds were refunded with the Series 2013C bonds. The direct-pay letters of credit associated with the Series 2008-2 and 2008-3 bonds were terminated at the time of the 2013 refunding. In December 2015, the Series 2008-1 bonds were refunded with the BSW Holdings Series 2015B, C and D bonds. The direct-pay letter of credit associated with the Series 2008-1 bonds was terminated at the time of the 2015 refunding.

In June 2010, SWH issued Series 2010 Revenue Bonds with a total par amount of \$345,775,000. The majority of the proceeds were used to fund development and construction costs of various expansion and construction projects. The Series 2010 Revenue Bonds were refunded with the Series 2016A bonds.

In March 2013, SWH issued Series 2013A Revenue Bonds with an aggregate principal of \$176,690,000. Simultaneous to the issuance of its Series 2013A bonds, Scott & White issued Series 2013B Revenue Bonds. The Series 2013B bonds, were issued as direct placement variable rate bonds. Proceeds of the Series 2013B bonds, along with the majority of proceeds for the Series 2013A bonds, were used to advance refund the Series 2006 FHA Revenue Bonds. The remaining portion of the Series 2013A bonds were used to fund development and construction costs of various expansion and construction projects.

In March 2013, SWH issued Series 2013C Revenue Bonds to refinance the Series 2008-2 bonds. Series 2013C bonds were issued as direct placement variable rate bonds.

**BAYLOR SCOTT & WHITE HOLDINGS
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Notes to Combined Financial Statements – continued

Future maturities of long-term debt and capital lease obligations as of June 30, 2017, are shown below (in thousands):

	<u>Long-Term Debt</u>	<u>Capital Lease Obligations</u>	<u>Total</u>
2018	\$ 204,696	\$ 42,181	\$ 246,877
2019	110,329	40,935	151,264
2020	44,643	38,333	82,976
2021	86,682	38,349	125,031
2022	40,914	37,162	78,076
Thereafter	<u>2,492,820</u>	<u>418,008</u>	<u>2,910,828</u>
	2,980,084	614,968	3,595,052
Less imputed interest	<u>-</u>	<u>(254,859)</u>	<u>(254,859)</u>
	<u>\$ 2,980,084</u>	<u>\$ 360,109</u>	<u>\$ 3,340,193</u>

6. INTEREST RATE SWAPS

Effective July 30, 2014, BSWH consolidated its separate International Swaps and Derivatives Association (ISDA) agreements with Goldman Sachs Bank USA (Goldman) and related swap portfolios at BHCS and SWH under a single BSW Holdings ISDA. Upon completion of the BSW Holdings ISDA, BHCS and SWH swaps with Goldman Sachs were novated to the new BSW Holdings ISDA in an aggregate notional amount of \$250,155,000.

Effective August 29, 2014, SWH novated a portion (cash flows through August 15, 2022) of two swaps with JP Morgan to Wells Fargo. The residual remaining cash flows (from September 15, 2022 through August 15, 2045) remain at JP Morgan.

Effective October 23, 2014, BHCS novated the two SWH swaps with Wells Fargo (originally novated from JP Morgan to Wells Fargo on August 29, 2014) from the SWH ISDA to the BHCS ISDA. Concurrent with this novation, the Wells Fargo collateral thresholds under the BHCS Credit Support Annex were increased to accommodate the novated swaps.

On January 15, 2016, the fixed swap rate payments and variable rate swap receipts on eleven swaps originally structured between BHCS and various swap counterparties were reactivated. The payments under the eleven swaps had been suspended since February 2013. A portion of these swaps were novated to BSW Holdings in July 2014. BSWH has been and continues to be subject to the collateral posting requirements under the referenced swaps.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Effective November 15, 2016, BSW Holdings, BHCS, and SWH entered into a swap novation transaction that novated two swaps previously between BHCS and Deutsche Bank, NA and two swaps previously between SWH and Deutsche Bank, NA so that all four swaps are now between BSW Holdings and Citibank, NA.

At June 30, 2017, BSW Holdings, SWH and BHCS (collectively, the “BSWH Swap Entities”) had twenty-one interest rate swap agreements with a total notional amount of \$1,024,320,000 comprised of \$438,665,000 in notional fixed payer swaps held by BSW Holdings, \$312,750,000 in notional fixed payer swaps held by BHCS and \$272,905,000 in notional fixed receiver and fixed payer swaps held by SWH.

Net settlements on interest rate swap agreements totaled \$28,683,000 and \$30,450,000 for the years ended June 30, 2017 and 2016, respectively. Net settlement and the change in fair value on interest rate swap agreements are reported in interest rate swap activity in the nonoperating section of the combined statements of operations and changes in net assets. The fair value of interest rate swap agreements is reported in other long-term liabilities on the combined balance sheets. The change in the fair value of interest rate swap agreements was an unrealized gain of approximately \$111,307,000 and an unrealized loss of approximately \$136,936,000 for the fiscal years ended June 30, 2017 and 2016, respectively, and is included as a line item on the combined statements of cash flows.

The following table summarizes the fair value of interest rate swaps by counterparty as of June 30, 2017 and 2016 (in thousands):

	Notional* <u>Amount</u>	Fair Value	
		<u>2017</u>	<u>2016</u>
Bank of America, N.A.	\$ 73,740	\$ (26,012)	\$ (36,644)
Citibank, N.A.	188,510	(61,533)	-
Deutsche Bank AG	-	-	(86,425)
Goldman Sachs Bank, USA	250,155	(85,024)	(119,384)
JP Morgan	216,680	(36,120)	(45,919)
Wells Fargo Bank, N.A.	<u>295,235</u>	<u>(75,471)</u>	<u>(107,095)</u>
Total interest rate swap liability	1,024,320	(284,160)	(395,467)
Less interest rate swap collateral	<u>-</u>	<u>19,031</u>	<u>38,461</u>
Total interest rate swap liability, net	<u>\$ 1,024,320</u>	<u>\$ (265,129)</u>	<u>\$ (357,006)</u>

*Notional amount is the face value of a financial instrument used in the calculation of interest.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

7. NET PATIENT CARE REVENUE

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. Payment arrangements include prospectively determined rates per case, reimbursed costs, discounted charges, and per diem payments. Net patient care revenue (exclusive of charity care - see Note 8) is recognized at the time service is rendered and is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated contractual adjustments under reimbursement agreements with third-party payors.

Contractual 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. These contractual adjustments are related to the Medicare and Medicaid programs and managed care contracts. The System offers a discount to uninsured patients.

Net patient care revenue from the Medicare and Medicaid programs accounted for approximately 33% and 35% of total net patient care revenue for the years ended June 30, 2017 and 2016, respectively. Net patient care revenue from managed care contracts accounted for approximately 60% and 58% of total net patient care revenue for the years ended June 30, 2017 and 2016, respectively. Net patient care revenue from other payors accounted for approximately 7% and 7% of total net patient care revenue for the years ended June 30, 2017 and 2016, respectively.

Federal Regulations require the submission of annual cost reports covering medical costs and expenses associated with services provided to program beneficiaries. Medicare and Medicaid cost report settlements are estimated in the period services are provided to beneficiaries. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is a reasonable possibility that recorded estimates may change by a material amount as interpretations are clarified and cost reports are settled.

These initial estimates are revised as needed until the final cost report is settled. Net patient care revenue from the Medicare and Medicaid programs increased approximately \$7,979,000 and \$13,017,000 for the years ended June 30, 2017 and 2016, respectively, due to changes in allowances previously estimated for amounts due to Medicare and Medicaid, as a result of changes in regulations and final settlement of numerous cost reports.

Baylor

Charity Care Access

BSWH hospitals in North Texas voluntarily participate in indigent care corporations (established by the BSWH hospitals and other private hospitals) in order to improve access to

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

and the quality of health care for patients in the community. These non-profit, indigent care corporations arrange for the provision of health care services to patients in the hospitals' respective communities under various services agreements, with the compensation set in advance, consistent with fair market value, and commercially reasonable for the services performed. For the years ended June 30, 2017 and 2016, BSWH hospitals provided approximately \$71,729,000 and \$64,578,000, respectively, to the Dallas County Indigent Care Corporation and \$8,774,000 and \$6,626,000, respectively, to the Tarrant County Indigent Care Corporation for professional health care and related services furnished to and for the benefit of patients receiving services under the various services agreements, which amounts are recorded as other operating expenses in the combined statements of operations and changes in net assets.

Section 1115 Waiver Program

In December 2011, the Centers for Medicare & Medicaid Services (CMS) approved the Texas Health and Human Services Commission's (THHSC) request for a Section 1115 waiver (Waiver Program) replacing Upper Payment Limit funding with new supplemental payment methodology, coupled with allowing managed care expansion to additional areas of the State. CMS initially approved the Waiver Program for the time period December 12, 2011, through September 30, 2016. In May 2016, CMS approved an extension of the Waiver Program for an additional fifteen months through December 2017, at the then-current level of funding. THHSC is currently negotiating with CMS for an extension of the Waiver Program through September 30, 2019. The current Waiver Program is entitled the "Texas Healthcare Transformation and Quality Improvement Program." The Waiver Program provides for two pools of Medicaid supplemental funding – an uncompensated care (UC) pool and a delivery system reform incentive pool (DSRIP). UC pool payments are intended to improve access to and the quality of health care for patients as served under a Regional Healthcare Partnership (RHP). DSRIP pool payments are incentive payments to hospitals and other providers that develop programs or strategies (approved by CMS) to enhance access to health care and to improve the quality of care, the cost-effectiveness of care provided, and the health of the patients and families served. A provider's eligibility to receive UC pool payments and/or DSRIP pool payments requires participation in a RHP and affiliation with a local governmental entity.

During the years ended June 30, 2017 and 2016, certain BSWH hospitals (legacy Baylor Health Care System (BHCS) hospitals except as otherwise noted herein) participated in the Waiver Program.

During the years ended June 30, 2017 and 2016, BHCS (on behalf of Baylor University Medical Center, Baylor Medical Center at Irving d/b/a Baylor Scott & White Medical Center – Irving, and Baylor Medical Center at Carrollton), Baylor Heart and Vascular Center, LLP

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

d/b/a Baylor Jack and Jane Hamilton Heart and Vascular Hospital, BT Garland JV, LLP d/b/a Baylor Scott & White Medical Center – Garland, BT East Dallas JV, LLP d/b/a Baylor Scott & White Medical Center – White Rock, and Texas Regional Medical Center, LLC d/b/a Baylor Scott & White Medical Center – Sunnyvale were parties to the Amended and Restated Dallas and Neighboring Counties Indigent Care Affiliation Agreement with the Dallas County Hospital District d/b/a Parkland Health & Hospital System (Dallas Affiliation Agreement) and participated in RHP Nine and the Waiver Program.

During the years ended June 30, 2017 and 2016, Baylor All Saints Medical Center d/b/a Baylor Scott & White All Saints Medical Center – Fort Worth and Baylor Regional Medical Center at Grapevine d/b/a Baylor Scott & White Medical Center – Grapevine were parties to the Tarrant County Regional Healthcare Partnership Affiliation Agreement with the Tarrant County Hospital District d/b/a JPS Health Network (Tarrant Affiliation Agreement) and participated in RHP Ten and the Waiver Program.

As recipients of Waiver Program payments, these BSWH hospitals are subject to extensive federal and state laws, regulations, conditions of participation, and certification requirements.

For the years ended June 30, 2017 and 2016, as result of their participation in the Waiver Program, these BSWH hospitals (as parties to the Dallas Affiliation Agreement and Tarrant Affiliation Agreement) expected to achieve required metrics, recorded as other receivables in the accompanying balance sheets, and received Waiver Program payments (DSRIP payments and UC funds) totaling approximately \$123,290,000 and \$165,385,000, respectively, which amounts are Medicaid supplemental payments and recognized as net patient care revenue in the combined statements of operations and changes in net assets.

BSWH hospitals in North Texas incurred expenditures of \$13,514,000 and \$11,802,000 for the years ended June 30, 2017 and 2016, respectively, in the operation and maintenance of the hospital's DSRIP projects approved under the 1115 Waiver Program, which are recorded as other operating expenses in the combined statements of operations and changes in net assets.

In a September 30, 2014, letter to THHSC, CMS announced that it was deferring the federal share (Federal Financial Participation (FFP)) of Waiver Program UC payments to hospitals in certain counties, including Dallas County and Tarrant County. The initial total amount of the deferral was \$74,891,536 in FFP for Waiver Program UC payments made during the third quarter of federal fiscal year 2014 to private hospitals in Dallas, Tarrant, and Nueces Counties (\$47,403,926 of which was attributable to private hospitals in Dallas and Tarrant Counties). Certain BSWH hospitals were subject to the deferral. CMS indicated that it would review various funding arrangements under the Waiver Program to ensure that the arrangements

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

complied with applicable federal requirements. CMS ultimately released this deferral, which allowed the continuation of UC payments, provided CMS during its continuing review of Texas' funding mechanisms does not find alleged violations of the federal provider donation prohibitions.

In a letter dated September 1, 2016, to THHSC, CMS announced that it is disallowing \$20,373,436 in FFP to private hospitals participating in the Dallas Affiliation Agreement and \$6,471,115 in FFP to private hospitals participating in the Tarrant Affiliation Agreement, as reported on the CMS-64, for the quarter ending December 31, 2015. CMS alleges that these private hospitals failed to comply with the federal provider-related donation requirements. BSWH hospitals and affiliated hospitals subject to the disallowance are: (i) BHCS (on behalf of Baylor University Medical Center, Baylor Medical Center at Irving, Baylor Medical Center at Carrollton, and Baylor Medical Centers at Garland and McKinney d/b/a Baylor Medical Center at Garland) (now BT Garland JV, LLP d/b/a Baylor Scott & White Medical Center-Garland); (ii) Baylor Heart and Vascular Center, LLP d/b/a Baylor Jack and Jane Hamilton Heart and Vascular Hospital; (iii) Baylor All Saints Medical Center; (iv) Baylor Regional Medical Center at Grapevine; and (v) and Baylor Medical Center at Waxahachie. THHSC requested reconsideration of the disallowance by the Secretary of Health & Human Services, which request was denied. THHSC then appealed the disallowance to the Department of Health and Human Services' Departmental Appeals Board - Appellate Division (Departmental Appeals Board). Baylor Health Care System (on behalf of the BSWH hospitals participating in the Dallas and Tarrant County Affiliation Agreements) and certain other private hospital systems are participating as intervenors in the Departmental Appeals Board litigation. On October 5, 2017, the Departmental Appeals Board granted a joint stay request from CMS and THHSC to allow the parties to negotiate further. At this time, management cannot reasonably determine the likelihood of success or the outcome of the matter or its potential application to other supplemental payment arrangements such as local health care provider participation programs discussed below.

The Dallas County Indigent Care Corporation did not enter into any new services agreements effective October 1, 2017, for the provision of health care services to patients in Dallas County. Also, the Tarrant County Indigent Care Corporation's obligations under various services agreements for the provision of health care services to patients in Tarrant County were terminated effective Midnight, September 30, 2017.

The Texas Legislature approved legislation effective in May 2017, amending the Texas Health & Safety Code to enable the Dallas County Hospital District to create and operate a Local Provider Participation Fund program (LPPF) that would require mandatory payments by all hospitals in the county based upon net patient revenue and the option of using the

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

mandatory payment revenue as the non-federal share of supplemental Medicaid payments. The Dallas County Hospital District's board of managers subsequently authorized creation of a LPPF in Dallas County and chose to utilize mandatory payment revenue as the non-federal share of Medicare payments under the Waiver Program for the current time period. BSWH hospitals that are parties to the Dallas Affiliation Agreement are able to receive supplemental payments funded through the LPPF program. Effective July 20, 2017, BSWH (on behalf of Baylor Medical Center at Waxahachie d/b/a Baylor Scott & White Medical Center - Waxahachie, Baylor Medical Centers at Garland and McKinney d/b/a Baylor Scott & White Medical Center - McKinney, and Baylor Regional Medical Center at Plano d/b/a Baylor Scott & White Medical Center – Plano), BT East Dallas JV, LLP, d/b/a Baylor Scott & White Medical Center – Centennial, and Lake Pointe Operating Company, LLC, d/b/a Baylor Scott & White Medical Center – Lake Pointe) entered into an Indigent Care Affiliation Agreement with the Dallas County Hospital District for purposes of participating in the LPPF program in Dallas County and receiving Medicaid supplemental payments. Also effective July 20, 2017, Texas Heart Hospital of the Southwest, L.L.P., d/b/a The Heart Hospital Baylor Plano and THHBP Management Company, L.L.C., d/b/a The Heart Hospital Baylor Denton entered into an Indigent Care Affiliation Agreement with the Dallas County Hospital District for purposes of participating in the LPPF program in Dallas County and receiving Medicaid supplemental payments.

The Texas Legislature approved legislation effective in June 2017, amending the Texas Health & Safety Code to enable the Tarrant County Hospital District to create and operate a health care provider participation program that would require mandatory payments by all hospitals in the county based upon net patient revenue and the option of using the mandatory payment revenue as the non-federal share of Medicaid payments. The Tarrant County Hospital District's board of managers subsequently authorized creation of a LPPF in Tarrant County and chose to utilize mandatory payment revenue as the non-federal share of Medicare payments under the Waiver Program for the current time period. BSWH hospitals that are parties to the Tarrant County Affiliation Agreement are able to receive supplemental payments funded through the LPPF program.

Scott & White

Section 1115 Waiver Program

During the years ended June 30, 2017 and 2016, certain BSWH hospitals (from the legacy Scott & White Healthcare) participated in the Waiver Program.

Scott & White Memorial Hospital is a party to the Bell County Healthcare Collaborative and under this agreement participates in RHP Eight and the Waiver Program.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Hillcrest Baptist Medical Center is a party to the McLennan Area Clinical Services Affiliation and under this agreement participates in RHP Sixteen and the Waiver Program.

Scott & White Hospital - Round Rock is a party to the Williamson County and Cities Services Affiliation and under this agreement participates in RHP Eight and the Waiver Program.

Scott & White Hospital Brenham is a party to a Washington County affiliation and under this agreement participates in RHP Seventeen and the Waiver Program.

Scott & White Hospital - Llano is a party to a Llano County affiliation and under this agreement participates in RHP Eight and the Waiver Program.

Scott & White Memorial Hospital, Scott & White College Station, and Hillcrest Baptist Medical Center participate in LPPF programs in Bell, Brazos, and McLennan Counties respectively pursuant to legislative proposals approved by the Texas Legislature. The bills amended the Texas Health & Safety Code to create health care provider participation programs that would require mandatory payments by all hospitals in the counties based upon net revenue and the option of using the mandatory payment revenue as the non-federal share of Medicaid payments. Bell, Brazos and McLennan Counties authorized creation of LPPF programs in the respective counties and chose to utilize mandatory payment revenue as the non-federal share of Medicaid payments. Scott & White Memorial Hospital, Scott & White College Station, and Hillcrest Baptist Medical Center receive Medicaid payments as a result of their participation in these LPPF programs. Baylor Medical Center at Waxahachie d/b/a Baylor Scott & White Medical Center -Waxahachie, Scott & White Hospital - Round Rock, Scott & White Hospital - Marble Falls, Scott & White Hospital – Taylor, and Scott & White Hospital - Llano are also affiliated with Brazos and McLennan Counties and receive Medicaid payments under the McLennan County LPPF program.

BSWH hospitals in Central Texas incurred expenditures of \$60,036,000 and \$53,309,000 for the years ended June 30, 2017 and 2016, respectively, through the hospital's participation in the various LPPF programs discussed above.

As recipients of Waiver Program payments, these BSWH hospitals are subject to extensive federal and state laws, regulations, conditions of participation, and certification requirements.

BSWH hospitals in Central Texas incurred expenditures of \$1,473,000 and \$2,097,000 for the years ended June 30, 2017 and 2016, respectively, in the operation and maintenance of the hospital's DSRIP projects approved under the 1115 Waiver Program, which are recorded as other operating expenses in the combined statements of operations and changes in net assets.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

For the years ended June 30, 2017 and 2016, BSWH hospitals in Central Texas expected to achieve required metrics, recorded as other receivables in the accompanying balance sheets, and received Waiver Program payments totaling approximately \$130,504,000 and \$153,127,000, respectively, which amounts are Medicaid supplement payments and recognized as net patient care revenue in the combined statements of operations and changes in net assets.

Charity Care Access

BSWH hospitals in Central Texas also voluntarily participate in nonprofit corporations (established by the Scott & White hospitals and other private hospitals) in order to improve access to and the quality of health care for patients. These nonprofit corporations arrange for the provision of health care services to patients under certain services agreements, with compensation set in advance, consistent with fair market value, and commercially reasonable for the services performed. The total expenditures related to these programs were \$6,287,000 and \$4,677,000 for the years ended June 30, 2017 and 2016, respectively, and are included in other operating expenses in the combined statements of operations and changes in net assets.

In a September 2014, letter to THHSC, CMS announced that it was deferring the FFP of Waiver Program UC payments to hospitals in certain counties. While Scott & White Hospital - Llano and Scott & White Hospital - Round Rock were included in CMS' original deferral list of private hospitals, subsequently THHSC reported that these hospitals were erroneously included and were removed from the deferral list. CMS reserved the right to include other hospitals in the deferral process. CMS indicated that it would review various funding arrangements under the Waiver Program to ensure that the arrangements complied with applicable federal requirements. CMS ultimately released this deferral, which allowed the continuation of UC payments, provided CMS during its continuing review of Texas' funding mechanisms does not find alleged violations of the federal provider donation prohibitions.

In a letter dated September 1, 2016, to THHSC, CMS announced that it is disallowing \$20,373,436 in FFP to private hospitals participating in the Dallas County affiliation and \$6,471,115 in FFP to private hospitals participating in the Tarrant County affiliation, as reported on the CMS-64, for the quarter ending December 31, 2015. CMS alleges that these private hospitals failed to comply with the federal provider-related donation requirements. THHSC has appealed the disallowance to the Departmental Appeals Board. On October 5, 2017, the Departmental Appeals Board granted a joint stay request from CMS and THHSC to allow the parties to negotiate further. At this time, management cannot reasonably determine the likelihood of success or the outcome of the matter or its potential application to LPPF programs.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

8. CHARITY CARE

BSWH provides care to patients who lack financial resources and are deemed medically or financially indigent. Because BSWH does not pursue collection of amounts determined to qualify as charity care, these amounts have been removed from net patient care revenue as described in Note 7. The estimated direct and indirect cost of providing these services, calculated using the ratio of patient care cost to charges, was approximately \$293,259,000 and \$244,207,000 for the years ended June 30, 2017 and 2016, respectively. The ratio of cost to charges is calculated based on total expenses, less non-patient care activities and other community benefit expenses, divided by gross patient services revenue. In addition, BSWH provides services through government-sponsored indigent health care programs to other indigent patients.

BSWH also commits time and resources to endeavors and critical services which meet otherwise unfulfilled community needs. Many of these activities are entered into with the understanding that they will not be self-supporting or financially viable. The expenditures for medical research activities and direct medical education are reported in Note 10.

9. RETIREMENT BENEFITS

ASC 715, “*Compensation - Retirement Benefits*,” requires the System to recognize the funded status (i.e., the difference between the fair value of plan assets and the benefit obligation) of its defined benefit pension and other postretirement benefit plans in the accompanying combined balance sheets with a corresponding adjustment to unrestricted net assets. The net unrecognized actuarial losses and unrecognized prior service benefits are recognized as a component of future net periodic cost pursuant to the System’s policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods are not recognized as net periodic pension cost in the same periods and are recognized as other changes in unrestricted net assets. Those amounts are recognized as a component of net periodic cost.

The System provides 401(k) defined contribution plans for eligible employees. Employees are eligible to contribute to the plan immediately with no minimum service or age requirement. The System’s contributions to the 401(k) plan totaled approximately \$98,384,000 and \$85,701,000 for the years ended June 30, 2017 and 2016, respectively, and are included in salaries, wages, and employee benefits expenses in the accompanying combined statements of operations and changes in net assets.

BHCS and six of its affiliated hospitals provided a defined benefit plan, the Baylor Health Care System Retirement Security Plan (the “BEST Plan”), for employees, which was

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discontinued on January 1, 1984. All BEST Plan assets were invested in cash and cash equivalents at June 30, 2017 and 2016.

The following table sets forth the benefit obligations, plan assets, and funded status of the BEST Plan as of June 30, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Fair value of plan assets	\$ 745	\$ 447
Benefit obligation	<u>(20,940)</u>	<u>(23,985)</u>
Unfunded benefit obligation	<u>\$ (20,195)</u>	<u>\$ (23,538)</u>

All Saints Health System provided a defined benefit plan, the All Saints Health System Pension Plan (the "All Saints Plan"), for employees of All Saints, which was frozen to future benefit accruals as of January 1, 2002, with the All Saints Health System purchase by BHCS. Effective December 31, 2016, the All Saints Plan was merged into the Texas Hospital Association Retirement Plan for King's Daughters (the "King's Daughters Plan"). The All Saints Plan assets were invested in cash and cash equivalents and equity securities at June 30, 2016.

The following table sets forth the benefit obligations, plan assets, and funded status of the All Saints Plan as of June 30, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Fair value of plan assets	\$ -	\$ 18,577
Benefit obligation	<u>-</u>	<u>(29,641)</u>
Unfunded benefit obligation	<u>\$ -</u>	<u>\$ (11,064)</u>

King's Daughters Hospital provided a defined benefit plan, the King's Daughters Plan, for employees of King's Daughters Hospital, which was frozen to future benefit accruals as of March 31, 2009, with the King's Daughters Hospital purchase by Scott & White. Effective March 31, 2017, the King's Daughters Plan was merged into the Texas Hospital Association Defined Benefit Retirement Plan for Scott & White Hospital-Brenham (the "Brenham Plan").

The following table sets forth the benefit obligations, plan assets, and funded status of the King's Daughters Plan as of June 30, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Fair value of plan assets	\$ -	\$ 25,640
Benefit obligation	<u>-</u>	<u>(37,124)</u>
Unfunded benefit obligation	<u>\$ -</u>	<u>\$ (11,484)</u>

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Scott & White Hospital-Brenham provided a defined benefit plan, the Brenham Plan, for employees of Scott & White Hospital-Brenham, which was frozen to future benefit accruals as of June 30, 2010, with the Brenham Hospital purchase by Scott & White. Effective March 31, 2017, the Brenham Plan was renamed the Baylor Scott & White Health Consolidated Frozen Benefit Plan (the “BSWH Plan”).

The following table sets forth the benefit obligations, plan assets, and funded status of the BSWH Plan as of June 30, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Fair value of plan assets	\$ 70,314	\$ 21,494
Benefit obligation	<u>(92,926)</u>	<u>(28,829)</u>
Unfunded benefit obligation	<u>\$ (22,612)</u>	<u>\$ (7,335)</u>

Certain Scott & White employees participate in Scott & White’s medical postretirement benefit plan. This plan provides medical and dental benefits to retirees who meet specific eligibility requirements upon retirement. The plan is unfunded and requires covered retirees to contribute a portion of the cost of benefits based on age at retirement and years of service.

Scott & White uses an incremental cost approach in estimating the annual accrued cost related to the postretirement benefit plan, which is based on estimates by independent actuaries. Such an approach is considered appropriate since substantially all of the health care benefits are provided by Scott & White to retirees, using the Health Plan to manage the care provided.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 introduced a prescription drug benefit under Medicare (Medicare Part D), as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. Scott & White has not made the determination that the prescription drug benefit provided by its medical postretirement benefit plan is actuarially equivalent to the benefit provided by Medicare Part D. Therefore, the measures of the accumulated benefit obligation or net periodic benefit cost do not reflect any amounts associated with the federal subsidy.

The following table sets forth a reconciliation of benefit obligations, plan assets, and balance sheet position for the postretirement benefit obligation as of June 30, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Fair value of plan assets	\$ -	\$ -
Benefit obligation	<u>(24,856)</u>	<u>(22,208)</u>
Unfunded benefit obligation	<u>\$ (24,856)</u>	<u>\$ (22,208)</u>

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

10. FUNCTIONAL EXPENSES

The System provides general health care services to residents within its geographic area. Expenses related to providing these services are as follows for the years ended June 30, 2017 and 2016 (in thousands):

	2017	2016
Patient care	\$ 6,326,605	\$ 5,661,092
Education	104,867	87,793
Research	64,196	56,924
Health Plan	663,999	572,904
General and administrative	1,399,244	1,313,336
Other	233,692	180,018
	<u>\$ 8,792,603</u>	<u>\$ 7,872,067</u>

Other includes expenses related to the System’s construction activities, professional office building management, and fundraising.

11. COMMITMENTS AND CONTINGENCIES

BSWH

The System leases various equipment and property under operating leases. These payments are due monthly through October 2032. Future minimum lease commitments under operating leases that have initial or remaining non-cancelable lease terms in excess of one year are as follows as of June 30, 2017 (in thousands):

2018	\$ 159,361
2019	144,595
2020	131,482
2021	115,786
2022	108,690
Thereafter	565,897
	<u>\$1,225,811</u>

The System has incurred rental expense for both cancelable and noncancelable equipment and space leases totaling approximately \$208,684,000 and \$184,501,000 for the years ended June 30, 2017 and 2016, respectively. Rental expense is included in other operating expenses in the accompanying combined statements of operations and changes in net assets.

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters

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Notes to Combined Financial Statements – continued

such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, physician ownership and self-referral, and Medicare and Medicaid fraud and abuse. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the System is in compliance with applicable fraud and abuse laws and regulations as well as other applicable federal and state laws and regulations.

Irving

The Irving Hospital Authority (Authority) entered into a Master Agreement (Master Agreement) with Baylor Medical Center at Irving (Irving) and BHCS, and a Lease Agreement (Lease Agreement) with Irving.

Under the terms of the Lease Agreement, Irving agreed to manage and lease substantially all properties of the Authority over an initial lease term of twenty years, beginning August 1, 1995, with an option to renew the lease for two additional ten year terms. An Amended and Restated Lease Agreement (Amended Lease Agreement) was entered into by the Authority and Irving effective April 1, 2010, to extend the lease thirty-five years through March 31, 2045, and to supersede nearly all the obligations of the original Master Agreement and Lease Agreement.

The Amended Lease Agreement is accounted for as a capital lease with (a) fixed rent payments of approximately \$8,825,000 per year, as adjusted by a September 24, 2010 amendment to the Amended Lease Agreement, plus (b) a contingent rent payment equal to 20.0% of the excess operating cash flow derived from the prior fiscal year's operations, as defined in the Amended Lease Agreement. Irving accrued \$1,804,000 and \$4,392,000 at June 30, 2017 and 2016, respectively, for the contingent rent payment due to the Authority within five business days following the issuance of Irving's audited statements of operations and changes in net assets.

BHCS signed a Limited Joinder to evidence its agreement with the BHCS obligations included in the Amended Lease Agreement and to covenant that BHCS will pay the rent and the early termination fee/liquidated damages if Irving fails to pay those obligations. During the initial six year term of the Revised Lease Agreement, Irving pays BHCS a management fee, based on a percentage of the excess operating cash flow, as defined in the Revised Lease Agreement. BHCS continues to be required to contribute \$100,000 per year to Irving, to be matched by the Irving Healthcare Foundation, for community health projects, which are mutually agreed upon by BHCS and Irving. BHCS contributed \$100,000 directly to Irving in

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

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2017 and 2016. At the end of the lease term the leased facilities will be surrendered to the Authority. At June 30, 2017 and 2016, no liability under the Revised Lease Agreement was recorded as no amount can be reasonably estimated.

12. AFFILIATION AGREEMENTS

On February 1, 2007, BHCS entered into a five year affiliation agreement (that automatically renews for additional five year terms) with 99-bed Decatur Hospital Authority d/b/a Wise Health System, located in Decatur, Texas (approximately 40 miles northwest of Fort Worth). Under the affiliation agreement, BHCS provides certain services for a fee which include advisory services, physician recruitment, and access to continuing education programs. Decatur Hospital Authority is not owned or controlled by any member of the System.

On October 1, 2008, BHCS entered into a five year affiliation agreement (that automatically renews for additional five year terms) with Glen Rose Medical Foundation d/b/a Glen Rose Medical Center, a 16-bed hospital located in Glen Rose, Texas (approximately 54 miles southwest of Fort Worth). As of March 24, 2010, the agreement was assigned to Somervell County Hospital Authority, which assumed operation of the hospital. Under the affiliation agreement, BHCS provides certain services for a fee which include group purchasing organization sponsorship, advisory services, physician recruitment, and access to continuing education programs. Somervell County Hospital Authority is not owned or controlled by any member of the System.

On January 1, 2009, BHCS entered into a five year affiliation agreement (that automatically renews for additional five year terms) with Hunt Memorial Hospital District, which operates Hunt Medical Center at Greenville located approximately 45 miles northeast of Dallas and is a 201-bed acute care hospital. Under the affiliation agreement, both organizations remain independent, but BHCS provides certain services for a fee including advisory services, physician recruitment, and access to continuing education programs. Hunt Memorial Hospital District is not owned or controlled by any member of the System.

On December 17, 2013, BHCS entered into a five year affiliation agreement (that automatically renews for additional five year terms) with Essent PRMC LP d/b/a Paris Regional Medical Center. Paris Regional Medical Center is a 360-bed hospital located in Paris, Texas (approximately 105 miles northeast of Dallas). In March 2016, Apollo Global Management, LLC became the capital partner for a new entity, Regional Care Capella Health Partners (RCCH) which operates Paris Regional Medical Center. Under the affiliation agreement, both organizations remain independent, but BHCS provides certain services for a fee including advisory services, physician recruitment, and access to continuing education programs. Paris Regional Medical Center is not owned or controlled by any member of the System.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

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On August 11, 2016, BSWH entered into a five year affiliation agreement (that automatically renews for additional five year terms) with Fairfield Hospital District. The hospital is operating as Freestone Medical Center under a management agreement with Community Hospital Corporation in Plano (CHC). Freestone Medical Center is a 25-bed hospital located in Fairfield, Texas (approximately 90 miles southeast of Dallas). The hospital also operates a rural health care clinic staffed by primary care physicians and advanced practice providers. Under the affiliation agreement, both organizations remain independent, but BSWH provides certain services for a fee including advisory services, physician recruitment/alignment, and access to continuing education programs. Freestone Medical Center is not owned or controlled by any member of the System.

13. NONCONTROLLING INTERESTS

The System controls and therefore consolidates certain investees of its subsidiaries. The System regularly engages in the purchase and sale of noncontrolling interests in these investees that do not result in a change of control. These transactions are accounted for as equity transactions as they are undertaken among the System, its consolidated subsidiaries, and noncontrolling interests, and their cash flow effect is classified within financing activities. The System reflects noncontrolling interests in subsidiaries as either noncontrolling interests - redeemable in the mezzanine section of the accompanying combined balance sheets, or noncontrolling interests - nonredeemable in net assets in the combined balance sheets, according to ASC 810.

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BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

The activity for unrestricted net assets presented as attributable to the System and noncontrolling interest - nonredeemable for the years ended June 30, 2017 and 2016 are summarized below (in thousands):

	<u>Attributable to the System</u>	<u>Noncontrolling Interests - Nonredeemable</u>	<u>Total Unrestricted Net Assets</u>
Balances, as of June 30, 2015	\$ 4,326,067	\$ 141,627	\$ 4,467,694
Revenue and gains in excess of expenses and losses	190,775	62,307	253,082
Unrealized losses on investments, net	(1,390)	-	(1,390)
Net assets released from restrictions for capital expenditures	24,053	-	24,053
Distributions to noncontrolling interests	-	(56,504)	(56,504)
Purchases of noncontrolling interests	-	(409)	(409)
Sales of noncontrolling interests	-	10,275	10,275
Net assets acquired	13,001	-	13,001
Other changes in controlling interest	(1,518)	-	(1,518)
Revenue and gains in excess of expenses and losses attributable to noncontrolling interests - redeemable	(222,826)	-	(222,826)
Noncontrolling interest of acquired entities	-	38,397	38,397
Other	<u>(16,999)</u>	<u>-</u>	<u>(16,999)</u>
Change in unrestricted net assets	<u>(14,904)</u>	<u>54,066</u>	<u>39,162</u>
Balances, as of June 30, 2016	4,311,163	195,693	4,506,856
Revenue and gains in excess of expenses and losses	558,718	71,737	630,455
Unrealized losses on investments, net	(1,786)	-	(1,786)
Net assets released from restrictions for capital expenditures	25,584	-	25,584
Distributions to noncontrolling interests	-	(69,161)	(69,161)
Purchases of noncontrolling interests	-	(1,666)	(1,666)
Sales of noncontrolling interests	-	4,161	4,161
Net assets acquired	185	-	185
Other changes in controlling interest	(1,044)	-	(1,044)
Revenue and gains in excess of expenses and losses attributable to noncontrolling interests - redeemable	(206,727)	-	(206,727)
Noncontrolling interest of acquired entities	-	1,839	1,839
Other	<u>9,306</u>	<u>-</u>	<u>9,306</u>
Change in unrestricted net assets	<u>384,236</u>	<u>6,910</u>	<u>391,146</u>
Balances, as of June 30, 2017	<u>\$ 4,695,399</u>	<u>\$ 202,603</u>	<u>\$ 4,898,002</u>

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The activity for noncontrolling interests - redeemable for the years ended June 30, 2017 and 2016 is summarized below (in thousands):

Balance, as of June 30, 2015	\$ 313,005
Net income attributable to noncontrolling interests - redeemable	222,826
Distributions to noncontrolling interests	(230,537)
Purchases of noncontrolling interests	(19,513)
Sales of noncontrolling interests	29,278
Noncontrolling interest of acquired entities	<u>156,507</u>
Balance, as of June 30, 2016	471,566
Net income attributable to noncontrolling interests - redeemable	206,727
Distributions to noncontrolling interests	(251,185)
Purchases of noncontrolling interests	(14,534)
Sales of noncontrolling interests	20,474
Noncontrolling interest of acquired entities	<u>10,080</u>
Balance, as of June 30, 2017	<u>\$ 443,128</u>

14. CHANGE IN ACCOUNTING PRINCIPLE

Effective June 30, 2017, the System adopted ASU 2015-03, “*Interest - Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs.*” The amendments in ASU 2015-03 are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability, consistent with debt discounts. All periods presented have been reclassified to conform to this presentation. The System’s adoption of this standard had no net impact on its financial position, results of operations, or cash flows.

15. SUBSEQUENT EVENTS

Sale of Equity Method Investment

In July 2017, BSWH sold its equity investment in Med Fusion and ClearPoint Diagnostic Labs to Quest Diagnostics. The gain on sale of approximately \$37,322,000 will be recorded in nonoperating gains (losses).

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Notes to Combined Financial Statements – continued

Line of Credit

In July 2017, BSW Holdings drew approximately \$24,000,000 on its revolving line of credit to purchase a building in Waco, Texas that was previously recorded as an operating lease to Hillcrest Baptist Medical Center, an affiliate of BSWH.

Texas Spine & Joint Hospital

In August 2017, THVG purchased a controlling interest in Texas Spine & Joint Hospital in Tyler, Texas, a 20 bed orthopedic hospital and related outpatient facilities.

Irving Hospital Authority Contribution to Irving

In August 2017, Irving executed lease amendments in which the Authority agreed to renovate the properties leased from the Authority, with an estimated completion date of early 2019. These transactions will be recorded as a temporarily restricted contribution receivable of approximately \$71,589,000.

Debt Portfolio Refinancing

On September 1, 2017, BSW Holdings placed its Series 2017A, 2017B, and 2017C revenue bonds (the “BSW Holdings Series 2017A, B and C”) with various banks. Proceeds from the BSW Holdings Series 2017A, B and C were used to refinance the following revenue bonds via the TCCEFC conduit issuer: Hospital Revenue Bonds (Scott & White Healthcare Project) Series 2013B, Hospital Revenue Bonds (Baylor Health Care System Project) Series 2011F, Hospital Revenue Bonds (Baylor Health Care System Project) Series 2011G, and Hospital Revenue Refunding Bonds (Baylor Scott & White Health Project) Series 2015D with an aggregate outstanding balance of \$195,700,000. A loss on extinguishment of debt of approximately \$306,000 will be recorded related to this transaction in fiscal year 2018.

On September 6, 2017, BSW Holdings created its Series 2017A commercial paper program (the “BSW Holdings Series 2017A CP Program”). Under the BSW Holdings Series 2017A CP Program, BSWH may issue up to \$400,000,000 of commercial paper notes of which \$188,162,000 was issued on September 6, 2017 at a discount of approximately \$282,000. Proceeds from the issuances under the BSW Holdings Series 2017A CP Program were used to refinance various outstanding debt, with an aggregate outstanding balance of \$187,880,000. A loss on extinguishment of debt of approximately \$414,000 will be recorded related to this transaction in fiscal year 2018.

On September 6, 2017, BHCS substituted its irrevocable direct-pay letter of credit supporting its Series 2011C Revenue Bonds with a new irrevocable direct-pay letter by a different issuer.

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Notes to Combined Financial Statements – continued

Additionally, BHCS converted the Series 2011C Revenue Bonds from a weekly interest rate period to a daily interest rate period.

The System has performed an evaluation of subsequent events through November 3, 2017, which is the date the financial statements were issued.

**BAYLOR SCOTT & WHITE HOLDINGS
AND ITS CONTROLLED AFFILIATES**

Supplementary Unaudited Information

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BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

OTHER COMMUNITY BENEFITS - UNAUDITED

Nonprofit hospitals are required to report community benefits under the requirements of Texas Health and Safety Code Chapter 311. For Texas state law purposes, unaudited community benefits include the unreimbursed cost of charity care; the unreimbursed cost of government-sponsored indigent health care (i.e., Medicaid); the unreimbursed cost of government-sponsored health care (i.e., Medicare), medical education, and other community benefits and services. The amount of community benefits reportable for Texas state law purposes by all Baylor and Scott & White nonprofit hospitals totaled approximately \$812,332,000 and \$754,886,000 for the years ended June 30, 2017 and 2016, respectively.



Report of Independent Auditors

To the Board of Trustees:
Baylor Scott & White Holdings:

We have audited the combined financial statements of Baylor Scott & White Holdings and its controlled affiliates as of June 30, 2017 and for the year then ended and our report thereon appears on page one of this document. That audit was conducted for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the combined financial statements. The combining information has been subjected to the auditing procedures applied in the audit of the combined financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the combined financial statements or to the combined financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America. In our opinion, the combining information is fairly stated, in all material respects, in relation to the combined financial statements taken as a whole. The combining information is presented for purposes of additional analysis of the combined financial statements rather than to present the financial position, results of operations and changes in net assets and cash flows of the individual companies and is not a required part of the combined financial statements. Accordingly, we do not express an opinion on the financial position, results of operations and changes in net assets and cash flows of the individual companies.

PricewaterhouseCoopers LLP

November 3, 2017

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Combining Balance Sheets (Note A) June 30, 2017 (In thousands)

	Obligated Affiliates	SWHP	Other System Entities	Reclassifications & Eliminations	Total Financials
ASSETS					
CURRENT ASSETS:					
Cash and cash equivalents	\$ 705,901	\$ 94,074	\$ 389,631	\$ -	\$ 1,189,606
Short-term investments	166,587	6,609	19,073	-	192,269
THVG funds due from United Surgical Partners, Inc.	-	-	85,888	-	85,888
Accounts receivable:					
Patient, net	466,934	-	382,821	(33,157)	816,598
Premiums	-	116,182	-	-	116,182
Affiliates, net	63,589	-	-	(63,589)	-
Other	56,931	51,292	82,695	(5,056)	185,862
Other current assets	147,205	7,330	99,913	18	254,466
Total current assets	1,607,147	275,487	1,060,021	(101,784)	2,840,871
LONG-TERM INVESTMENTS:					
Unrestricted	2,575,747	46,814	468,624	-	3,091,185
Restricted	2,737	-	468,338	-	471,075
Total long-term investments	2,578,484	46,814	936,962	-	3,562,260
ASSETS WHOSE USE IS LIMITED:					
Other designated assets	107,858	2,200	55,070	-	165,128
Self insurance reserves	-	-	98,272	-	98,272
Funds held by bond trustee	61,126	-	-	-	61,126
Total assets whose use is limited	168,984	2,200	153,342	-	324,526
ASSETS HELD FOR SALE	-	-	16,354	-	16,354
PROPERTY AND EQUIPMENT, net	2,584,825	15,849	1,081,578	(156,868)	3,525,384
CONTRIBUTIONS RECEIVABLE, net	-	-	61,070	(56)	61,014
DUE FROM AFFILIATES	184,096	-	2,636	(186,732)	-
INTEREST IN NET ASSETS OF RELATED FOUNDATIONS	489,052	-	99,334	(584,338)	4,048
INVESTMENTS IN SUBSIDIARIES AND AFFILIATES	1,613,101	-	-	(1,613,101)	-
OTHER LONG-TERM ASSETS:					
Equity investment in unconsolidated entities	42,044	177	15,327	-	57,548
Goodwill and intangible assets, net	75,084	-	661,671	(2,464)	734,291
Other	10,099	2,421	14,782	(6,992)	20,310
Total other long-term assets	127,227	2,598	691,780	(9,456)	812,149
Total assets	\$ 9,352,916	\$ 342,948	\$ 4,103,077	\$ (2,652,335)	\$ 11,146,606

Note (A): The supplemental combining financial information of the Obligated Affiliates and the BSWH System includes Obligated Affiliates, SWHP, Other System Entities, and Reclassifications and Eliminations. It has been prepared in a manner consistent with generally accepted accounting principles and is presented only for purposes of additional analysis and not as a presentation of financial position and results of operations of each component of the combined group. The supplemental combining financial information was derived from the accounting records used to prepare the combined financial statements. All material combining entries and intracompany/intercompany eliminations have been properly recorded. The accompanying notes are an integral part of the accompanying supplemental combining financial information.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Combining Balance Sheets - continued
(Note A)
June 30, 2017
(In thousands)

	Obligated Affiliates	SWHP	Other System Entities	Reclassifications & Eliminations	Total Financials
LIABILITIES					
CURRENT LIABILITIES:					
Current maturities of long-term debt and capital lease obligations	\$ 91,230	\$ -	\$ 35,414	\$ -	\$ 126,644
Long-term debt subject to short- term remarketing arrangements	95,000	-	-	-	95,000
Accounts payable:					
Trade accounts payable	132,837	6,722	174,033	(9,699)	303,893
Affiliates, net	-	10,861	56,189	(67,050)	-
Accrued liabilities:					
Payroll related	314,196	94	59,108	-	373,398
Third-party programs	39,356	4,055	10,440	33,344	87,195
Medical claims payable	-	103,855	-	(66,501)	37,354
Other	<u>217,713</u>	<u>73,675</u>	<u>122,340</u>	<u>(14,832)</u>	<u>398,896</u>
Total current liabilities	<u>890,332</u>	<u>199,262</u>	<u>457,524</u>	<u>(124,738)</u>	<u>1,422,380</u>
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS,					
less current maturities	<u>2,730,929</u>	-	<u>440,908</u>	-	<u>3,171,837</u>
OTHER LONG-TERM LIABILITIES:					
Self insurance and other insurance liabilities	617	-	98,591	-	99,208
Interest rate swap liabilities, net	265,129	-	-	-	265,129
Other	<u>165,556</u>	<u>23,319</u>	<u>123,236</u>	<u>(6,147)</u>	<u>305,964</u>
Total other long-term liabilities	<u>431,302</u>	<u>23,319</u>	<u>221,827</u>	<u>(6,147)</u>	<u>670,301</u>
DUE TO AFFILIATES	-	-	<u>260,151</u>	<u>(260,151)</u>	-
Total liabilities	<u>4,052,563</u>	<u>222,581</u>	<u>1,380,410</u>	<u>(391,036)</u>	<u>5,264,518</u>
COMMITMENTS AND CONTINGENCIES					
NONCONTROLLING INTERESTS - REDEEMABLE	-	-	166,211	276,917	443,128
NET ASSETS:					
Unrestricted - attributable to BSWH	4,801,014	120,367	1,865,762	(2,091,744)	4,695,399
Unrestricted - noncontrolling interests nonredeemable	<u>12,580</u>	-	<u>59,010</u>	<u>131,013</u>	<u>202,603</u>
Total unrestricted net assets	<u>4,813,594</u>	<u>120,367</u>	<u>1,924,772</u>	<u>(1,960,731)</u>	<u>4,898,002</u>
Temporarily restricted	295,637	-	318,184	(337,236)	276,585
Permanently restricted	<u>191,122</u>	-	<u>313,500</u>	<u>(240,249)</u>	<u>264,373</u>
Total net assets	<u>5,300,353</u>	<u>120,367</u>	<u>2,556,456</u>	<u>(2,538,216)</u>	<u>5,438,960</u>
Total liabilities and net assets	<u>\$ 9,352,916</u>	<u>\$ 342,948</u>	<u>\$ 4,103,077</u>	<u>\$ (2,652,335)</u>	<u>\$ 11,146,606</u>

Note (A): The supplemental combining financial information of the Obligated Affiliates and the BSWH System includes Obligated Affiliates, SWHP, Other System Entities, and Reclassifications and Eliminations. It has been prepared in a manner consistent with generally accepted accounting principles and is presented only for purposes of additional analysis and not as a presentation of financial position and results of operations of each component of the combined group. The supplemental combining financial information was derived from the accounting records used to prepare the combined financial statements. All material combining entries and intracompany/intercompany eliminations have been properly recorded. The accompanying notes are an integral part of the accompanying supplemental combining financial information.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Combining Statements of Operations and Changes in Net Assets
(Note A)
For the Year Ended June 30, 2017
(In thousands)

	Obligated Affiliates	SWHP	Other System Entities	Reclassifications & Eliminations	Total Financials
OPERATING REVENUE:					
Net patient care revenue	\$ 4,978,941	\$ -	\$4,212,844	\$ (526,974)	\$ 8,664,811
Less patient related bad debt expense	<u>428,439</u>	<u>-</u>	<u>498,729</u>	<u>-</u>	<u>927,168</u>
Net patient care revenue, net of patient related bad debt expense	4,550,502	-	3,714,115	(526,974)	7,737,643
Premium revenue	-	903,748	-	(487)	903,261
Other operating revenue	394,205	17,681	600,068	(633,622)	378,332
Net assets released from restrictions for operations	<u>9,566</u>	<u>-</u>	<u>68,599</u>	<u>(12,925)</u>	<u>65,240</u>
Total operating revenue	<u>4,954,273</u>	<u>921,429</u>	<u>4,382,782</u>	<u>(1,174,008)</u>	<u>9,084,476</u>
OPERATING EXPENSES:					
Salaries, wages, and employee benefits	2,619,530	44,392	1,752,427	(49,155)	4,367,194
Supplies	800,377	343	781,688	-	1,582,408
Other operating expenses	1,063,733	87,241	1,360,462	(618,158)	1,893,278
Medical claims	-	894,872	-	(537,012)	357,860
Losses on fixed asset sales and disposals, net	120	-	2,529	-	2,649
Impairment losses	250	-	110,757	(23,064)	87,943
Depreciation and amortization	249,727	509	140,520	(5,228)	385,528
Interest	<u>86,300</u>	<u>1,307</u>	<u>38,921</u>	<u>(10,785)</u>	<u>115,743</u>
Total operating expenses	<u>4,820,037</u>	<u>1,028,664</u>	<u>4,187,304</u>	<u>(1,243,402)</u>	<u>8,792,603</u>
INCOME (LOSS) FROM OPERATIONS	<u>134,236</u>	<u>(107,235)</u>	<u>195,478</u>	<u>69,394</u>	<u>291,873</u>
NONOPERATING GAINS (LOSSES):					
Gains (losses) on investments, net	211,130	8,247	58,228	(6,274)	271,331
Interest rate swap activity	82,624	-	-	-	82,624
Contributions	35,687	-	1,311	(36,219)	779
Equity in (losses) earnings of unconsolidated entities	(592)	-	(8,934)	11	(9,515)
Other	<u>104,631</u>	<u>(75)</u>	<u>12,246</u>	<u>(116,424)</u>	<u>378</u>
Total nonoperating gains (losses)	<u>433,480</u>	<u>8,172</u>	<u>62,851</u>	<u>(158,906)</u>	<u>345,597</u>
REVENUE AND GAINS IN EXCESS (DEFICIT) OF EXPENSES AND LOSSES BEFORE INCOME TAXES	567,716	(99,063)	258,329	(89,512)	637,470
LESS INCOME TAX EXPENSE	<u>942</u>	<u>702</u>	<u>5,371</u>	<u>-</u>	<u>7,015</u>
REVENUE AND GAINS IN EXCESS (DEFICIT) OF EXPENSES AND LOSSES	566,774	(99,765)	252,958	(89,512)	630,455

Note (A): The supplemental combining financial information of the Obligated Affiliates and the BSWH System includes Obligated Affiliates, SWHP, Other System Entities, and Reclassifications and Eliminations. It has been prepared in a manner consistent with generally accepted accounting principles and is presented only for purposes of additional analysis and not as a presentation of financial position and results of operations of each component of the combined group. The supplemental combining financial information was derived from the accounting records used to prepare the combined financial statements. All material combining entries and intracompany/intercompany eliminations have been properly recorded. The accompanying notes are an integral part of the accompanying supplemental combining financial information.

BAYLOR SCOTT & WHITE HOLDINGS AND ITS CONTROLLED AFFILIATES

Combining Statements of Operations and Changes in Net Assets - continued
(Note A)
For the Year Ended June 30, 2017
(In thousands)

	Obligated Affiliates	SWHP	Other System Entities	Reclassifications & Eliminations	Total Financials
OTHER CHANGES IN					
UNRESTRICTED NET ASSETS:					
Unrealized (losses) gains on investments, net	\$ -	\$ (4,720)	\$ 2,934	\$ -	\$ (1,786)
Net assets released from restrictions for capital expenditures	110	-	25,713	(239)	25,584
Other changes in net assets attributable to noncontrolling interests-nonredeemable	(1,034)	-	(338,007)	273,170	(65,871)
Revenue and gains in excess of expenses and losses attributable to noncontrolling interests - redeemable	-	-	(153,683)	(53,044)	(206,727)
Transfers between entities under common control	(13,576)	179,381	122,989	(288,794)	-
Net assets acquired	-	-	185	-	185
Other	<u>8,233</u>	<u>-</u>	<u>1,073</u>	<u>-</u>	<u>9,306</u>
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	<u>560,507</u>	<u>74,896</u>	<u>(85,838)</u>	<u>(158,419)</u>	<u>391,146</u>
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS:					
Contributions	9,565	-	72,969	(13,165)	69,369
Realized gains and investment income, net	-	-	17,369	-	17,369
Unrealized gains on investments, net	-	-	18,562	-	18,562
Change in value of split-interest agreements	58	-	328	-	386
Net assets released from restrictions for operations	(9,566)	-	(68,599)	12,925	(65,240)
Net assets released from restrictions for capital expenditures	(110)	-	(25,713)	239	(25,584)
Transfer between entities under common control	25	-	(25)	-	-
Change in net assets of related foundations	4,286	-	1,878	(5,883)	281
Other	<u>(252)</u>	<u>-</u>	<u>372</u>	<u>1</u>	<u>121</u>
INCREASE (DECREASE) IN TEMPORARILY RESTRICTED NET ASSETS	<u>4,006</u>	<u>-</u>	<u>17,141</u>	<u>(5,883)</u>	<u>15,264</u>
CHANGES IN PERMANENTLY RESTRICTED NET ASSETS:					
Contributions	-	-	918	-	918
Realized gains and investment income, net	-	-	175	-	175
Unrealized gains on investments, net	-	-	370	-	370
Change in value of split-interest agreements	46	-	871	1	918
Change in net assets of related foundations	9,244	-	578	(9,795)	27
Other	<u>-</u>	<u>-</u>	<u>111</u>	<u>-</u>	<u>111</u>
INCREASE (DECREASE) IN PERMANENTLY RESTRICTED NET ASSETS	<u>9,290</u>	<u>-</u>	<u>3,023</u>	<u>(9,794)</u>	<u>2,519</u>
INCREASE (DECREASE) IN NET ASSETS	573,803	74,896	(65,674)	(174,096)	408,929
NET ASSETS, beginning of period	<u>4,726,550</u>	<u>45,471</u>	<u>2,622,130</u>	<u>(2,364,120)</u>	<u>5,030,031</u>
NET ASSETS, end of period	<u>\$ 5,300,353</u>	<u>\$ 120,367</u>	<u>\$ 2,556,456</u>	<u>\$ (2,538,216)</u>	<u>\$ 5,438,960</u>

Note (A): The supplemental combining financial information of the Obligated Affiliates and the BSWH System includes Obligated Affiliates, SWHP, Other System Entities, and Reclassifications and Eliminations. It has been prepared in a manner consistent with generally accepted accounting principles and is presented only for purposes of additional analysis and not as a presentation of financial position and results of operations of each component of the combined group. The supplemental combining financial information was derived from the accounting records used to prepare the combined financial statements. All material combining entries and intracompany/intercompany eliminations have been properly recorded. The accompanying notes are an integral part of the accompanying supplemental combining financial information.