THE QUEEN'S HEALTH SYSTEMS

1301 Punchbowl Street • Honolulu, Hawaii 96813 • Phone (808) 691-5900

January 29, 2018

via email:ShanaB@DACBond.com
support@dacbond.com

Ms. Shana Blanchard
Digital Assurance Certification LLC
315 E. Robinson Street, Ste. 300
Orlando, FL 32801

RE: The Queen's Health Systems Annual Report as of and for the year ended June 30, 2017 (as defined in the Master Continuing Disclosure Agreement, dated January 1, 2015)

Dear Ms. Blanchard:

Attached is the Annual Report of The Queen's Health Systems as of and for the year ended June 30, 2017, as required pursuant to Section 4 of the Master Continuing Disclosure Agreement, dated January 1, 2015 ("Master Continuing Disclosure Agreement"). I certify that the enclosed Annual Report complies with the terms as defined in the Master Continuing Disclosure Agreement.

The Annual Report is filed for the following bond issues with their corresponding CUSIP numbers in parenthesis:

- The Queen's Health Systems, Special Purpose Revenue Bonds 2015 Series A (Department of Budget and Finance of the State of Hawaii), $206,345,000 (419800KV8, 419800KW6, 419800KX4, 419800KY2, 419800KZ9, 419800LA3, 419800LB1, 419800LC9, 419800LD7, 419800LE5, 419800LF2, 419800LG0, 419800LH8, 419800LJ4, 419800LK1, 419800LL9, 419800LM7)
- The Queen's Health Systems, Special Purpose Revenue Bonds 2015 Series B (Department of Budget and Finance of the State of Hawaii), $57,350,000 and 2015 Series C (Department of Budget and Finance of the State of Hawaii), $57,350,000, (419800LN5 and 419800LP0, respectively)
- The Queen's Health Systems, Taxable Bonds, 2015 Series D, $80,110,000 (74825QAA8)

Please submit the enclosed electronic version of the Annual Report to the Electronic Municipal Market Access System (EMMA) in accordance with the Master Continuing Disclosure Agreement and notify us of this action in writing.

If you have any questions, please contact Clinton Yee, System Corporate Finance Director, at clyee@queens.org or 808.691.5272, or me at mriccioni@queens.org or 808.691.5957.

Sincerely,

Mich Riccioni
Executive Vice President and
Chief Financial Officer

Enclosure

ANNUAL REPORT

(as defined in the Master Continuing Disclosure Agreement, dated January 1, 2015)

The Queen's Health Systems
As of and For the Year Ended June 30, 2017

ANNUAL REPORT
The Queen's Health Systems
As of and For the Year Ended June 30, 2017

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Annual Report Certificate

The undersigned duly appointed as Executive Vice President and Chief Financial Officer of The Queen's Health Systems (the "Obligated Group Representative"), hereby certifies on behalf of the Obligated Group pursuant to the Master Continuing Disclosure Agreement, dated as of January 1, 2015 ("Master Continuing Disclosure Agreement") between the Obligated Group Representative and Digital Assurance Certification, L.L.C., as Dissemination Agent (the "Dissemination Agent"), as follows:

1. **Definitions.** Capitalized terms used but not defined herein shall have the meanings ascribed thereto in the Master Continuing Disclosure Agreement.

2. **Annual Report**. Attached to this Annual Report Certificate is the Annual Report for the Fiscal Year ended June 30, 2017. The Annual Report consists of two Schedules. Schedule 1 includes Financial Information and Operating Data (attached as Schedule 1-A) and the Audited Financial Statements for the Fiscal Year ended June 30, 2017 (Schedule 1-B). Schedule 2 contains a list of Obligated Persons as of June 30, 2017.

3. **Compliance with Master Continuing Disclosure Agreement.** The Annual Report is being delivered to the Dissemination Agent herewith not later than the January 31 (or in the event the Fiscal Year ends on a date other than June 30, not later than the last day of the seventh calendar month) after the Fiscal Year which is the applicable Annual Report Date for purposes of such Annual Report. The Annual Report includes Financial Information and Operating Data of the types identified in the Continuing Disclosure Certificate most recently delivered to the Dissemination Agent pursuant to Section 5 of the Master Continuing Disclosure Agreement. The Financial Information and Operating Data relate to the Obligated Persons identified in Schedule 2 hereto to the extent such Financial Information and Operating Data are relevant to such Obligated Persons' operations, and such Obligated Persons constitute all of the Obligated Persons with respect to the Related Bonds for the Fiscal Year covered by the Annual Report. To the extent any such Financial Information or Operating Data is included in the Annual Report by reference, any document so referred to has been previously filed with the MSRB.

Such Financial Information and Operating Data have been prepared on the basis of the Audited Financial Statements. The Audited Financial Statements are included as part of the Annual Report, and are attached to this Annual Report Certificate as Schedule 1-B.

IN WITNESS WHEREOF the undersigned has executed and delivered this Annual Report Certificate to the Dissemination Agent, which has received such certificate and the Annual Report, all as of the 29th day of January, 2018.

THE QUEEN'S HEALTH SYSTEMS,
as Obligated Group Representative

By: Mich Riccioni
Mich Riccioni
Its: Executive Vice President and
Chief Financial Officer

Acknowledgment of Receipt:

DIGITAL ASSURANCE CERTIFICATION, L.L.C.,
as Dissemination Agent

By: Diana Blanchard
Its: Client Service Manager, Deputy Director

SCHEDULE 1
TO
ANNUAL REPORT CERTIFICATE

ANNUAL REPORT OF THE QUEEN'S HEALTH SYSTEMS
FOR FISCAL YEAR 2017

Capitalized Terms

Capitalized terms used, but not defined, herein have the meanings set forth in the hereinafter-defined Official Statement.

Background

The annual report of The Queen's Health Systems (the "Corporation") under Rule 15c2-12 (the "Rule") of the Securities and Exchange Commission for its fiscal year ended June 30, 2017 has been prepared pursuant to the Master Continuing Disclosure Agreement dated as of January 1, 2015 (the "Master Continuing Disclosure Agreement") between The Queen's Health Systems, as Obligated Group Representative and Digital Assurance Certification L.L.C., as Dissemination Agent (the "Dissemination Agent").

Series 2015A Bonds

An official statement dated January 22, 2015 (the "Official Statement") has been prepared for the $206,345,000 The Queen's Health Systems Special Purpose Revenue Bonds 2015 Series A. The Official Statement has been filed with the Municipal Securities Rulemaking Board (the "MSRB") pursuant to the MSRB's Rule G-36 and with the MSRB's Electronic Municipal Market Access system ("EMMA").

Annual Report for Fiscal Year 2017

The Annual Report of the Credit Group for its fiscal year ended June 30, 2017 consists of the following material:

Attached hereto as Schedule I-A is the following information, which the Obligated Group Representative has agreed to provide on an annual basis pursuant to the Rule and the Master Continuing Disclosure Agreement, together with a calculation of Income Available for Debt Service to Debt Service Requirements for the prior Fiscal Year.

Attached hereto as Schedule I-B is the audited consolidated or combined financial statements of The Queen's Health Systems and Subsidiaries, together with supplemental schedules as of June 30, 2017 and June 30, 2016 and for the two fiscal years then ended, which the Corporation has agreed to provide on an annual basis pursuant to the Rule and the Master Continuing Disclosure Agreement.

SCHEDULE 1
TO
ANNUAL REPORT CERTIFICATE

ANNUAL REPORT OF THE QUEEN'S HEALTH SYSTEMS
FOR FISCAL YEAR 2017

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Background

The annual report of The Queen's Health Systems (the "Corporation") under Rule 15c2-12 (the "Rule") of the Securities and Exchange Commission for its fiscal year ended June 30, 2017 has been prepared pursuant to the Master Continuing Disclosure Agreement dated as of January 1, 2015 (the "Master Continuing Disclosure Agreement") between The Queen's Health Systems, as Obligated Group Representative and Digital Assurance Certification L.L.C., as Dissemination Agent (the "Dissemination Agent").

Series 2015B&C Bonds

An official statement dated January 22, 2015 (the "Official Statement") has been prepared for the $114,700,000 The Queen's Health Systems Special Purpose Revenue Bonds $57,350,000 2015 Series B and $57,350,000 2015 Series C. The Official Statement has been filed with the Municipal Securities Rulemaking Board (the "MSRB") pursuant to the MSRB's Rule G-36 and with the MSRB's Electronic Municipal Market Access system ("EMMA").

Annual Report for Fiscal Year 2017

The Annual Report of the Credit Group for its fiscal year ended June 30, 2017 consists of the following material:

Attached hereto as Schedule I-A is the following information, which the Obligated Group Representative has agreed to provide on an annual basis pursuant to the Rule and the Master Continuing Disclosure Agreement, together with a calculation of Income Available for Debt Service to Debt Service Requirements for the prior Fiscal Year.

Attached hereto as Schedule I-B is the audited consolidated or combined financial statements of The Queen's Health Systems and Subsidiaries, together with supplemental schedules as of June 30, 2017 and June 30, 2016 and for the two fiscal years then ended, which the Corporation has agreed to provide on an annual basis pursuant to the Rule and the Master Continuing Disclosure Agreement.

SCHEDULE 1
TO
ANNUAL REPORT CERTIFICATE

ANNUAL REPORT OF THE QUEEN'S HEALTH SYSTEMS
FOR FISCAL YEAR 2017

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Background

The annual report of The Queen's Health Systems (the "Corporation") under Rule 15c2-12 (the "Rule") of the Securities and Exchange Commission for its fiscal year ended June 30, 2017 has been prepared pursuant to the Master Continuing Disclosure Agreement dated as of January 1, 2015 (the "Master Continuing Disclosure Agreement") between The Queen's Health Systems, as Obligated Group Representative and Digital Assurance Certification L.L.C., as Dissemination Agent (the "Dissemination Agent").

Annual Report for Fiscal Year 2017

The Annual Report of the Credit Group for its fiscal year ended June 30, 2017 consists of the following material:

Attached hereto as Schedule I-A is the Financial Information and Operating Data required to be delivered pursuant to Section 4 of the Continuing Disclosure Agreement.

Attached hereto as Schedule I-B is the audited consolidated or combined financial statements of The Queen's Health Systems and Subsidiaries, together with supplemental schedules as of June 30, 2017 and June 30, 2016 and for the two fiscal years then ended, which the Corporation has agreed to provide on an annual basis pursuant to Section 4 of the Continuing Disclosure Agreement.

SCHEDULE 1-A

Condensed Consolidated Summary of Revenues and Expenses - System
For the year ended June 30, 2017
(dollars in thousands)

Operating revenues and other support:	
Net patient service revenues	$ 1,142,464
Rental revenues	81,133
Other revenues and support	55,882
Total operating revenues and other support	1,279,479
Operating expenses:	
Salaries, wages, and benefits	716,419
Other operating expenses	277,148
Supplies	222,959
Depreciation and amortization	62,772
Interest	17,093
Total operating expenses	1,296,391
Operating loss	(16,912)
Total nonoperating income, net	130,938
Excess of revenues over expenses	$ 114,026

Condensed Consolidated Summary of Revenues and Expenses - Credit Group
For the year ended June 30, 2017
(dollars in thousands)

Operating revenues and other support:	
Net patient service revenues	$ 1,142,464
Rental revenues	15,643
Other revenues and support	60,257
Total operating revenues and other support	1,218,364
Operating expenses:	
Salaries, wages, and benefits	712,811
Other operating expenses	266,902
Supplies	222,920
Depreciation and amortization	55,756
Interest	19,617
Total operating expenses	1,278,006
Operating loss	(59,642)
Total nonoperating income, net	95,804
Excess of revenues over expenses	$ 36,162

SCHEDULE 1-A

Condensed Balance Sheet
The Queen's Health Systems Credit Group
At June 30, 2017
(dollars in thousands)

Assets	
Current assets:	
Cash and investments	$ 864,484
Receivables – net	221,372
Other current assets	56,238
Total current assets	1,142,094
Land, buildings, and equipment – net	532,539
Investments – less current portion	50,413
Other assets	228,048
Total	$ 1,953,094
Liabilities and net assets	
Accounts payable and other accrued liabilities	$ 162,110
Short-term and long-term debt – current	9,386
Long-term debt subject to short-term remarketing arrangements	103,380
Other current liabilities	47,411
Total current liabilities	322,287
Long-term debt – less current portion	372,893
Other long-term liabilities	278,695
Total liabilities	973,875
Net assets:	
Unrestricted	836,039
Temporarily and permanently restricted	143,180
Total net assets	979,219
Total liabilities and net assets	$ 1,953,094

SCHEDULE 1-A

The Queen's Health Systems Credit Group
Sources of Revenue
For Year Ended June 30, 2017

	Percent of Total Revenue
Net Patient Service Revenue [1]	
Medicare	31.9%
HMSA [2]	27.0%
Medicaid/QUEST	12.8%
Commercial, Self-Pay and Other [3]	22.1%
Subtotal	93.8%
Other Revenue	
Other unrestricted revenue	5.2%
Net assets released from restriction	1.0%
Subtotal	6.2%
Total	100.0%

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[1] For financial statement reporting purposes, patient service revenue is reported net of contractual allowances.

[2] Hawaii's Blue Cross/Blue Shield Plan.

[3] Revenue includes net patient service revenue from health maintenance organizations (HMOs) and preferred provider organizations (PPOs), Civilian Health and Medical Program of the Uniformed Services (CHAMPUS), Veterans Health Administration (VHA), workers' compensation, automobile no-fault insurance, commercial payors, and other institutions.

SCHEDULE 1-A

The Queen’s Health Systems Credit Group
Liquidity
As of June 30, 2017
(dollars in thousands)

	Assets With Same-Day Liquidity	Assets With Next-Day Liquidity	Assets With > Next Day Liquidity	Total
Cash and Cash Equivalents	$ 51,562	$ 12,951	$ —	$ 64,513
Fixed Income				
Core Index			34,907	34,907
Core Bond		74,890	—	74,890
Core Bond Plus			129,207	129,207
Equities		80,657	385,777	466,434
Real Assets		82,657		82,657
Total Liquidity	**$ 51,562**	**$ 251,155**	**$ 549,891**	**$ 852,608**

SCHEDULE 1-A

The Queen's Health Systems Credit Group
Capitalization [(1)]
As of June 30, 2017
(dollars in thousands)

Debt:	
2015 Series A Bonds	$ 202,245
2015 Series B & C Bonds	109,630
2015 Series D Bonds	80,110
2015 Bank Loan	75,000
Bond Premium 2015 Series A Bonds	23,586
Capital Lease and Other Obligations	11
Deferred financing fees	(4,923)
Subtotal Long-Term Debt	485,659
Less Current Portion of Long-Term Debt	112,766
Long-Term Debt	372,893
Total Capitalization	$1,953,234
Percent Long-Term Debt to Capitalization [(2)]	19.09%

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(1) Refer to The Queen's Health Systems and Subsidiaries Consolidated Financial Statements and Credit Group Schedules, June 30, 2017 and 2016, with Independent Auditors' Report Thereon, Note 4, for a description of the outstanding long-term debt of The Queen's Health Systems.

(2) The calculation of the Long-Term Debt to Capitalization Ratio is defined in the Loan Agreement dated January 22, 2015, Section 10.25.

SCHEDULE 1-A

The Queen's Health Systems Credit Group
Debt Service Coverage
As of June 30, 2017
(dollars in thousands)

(a)	Income available for debt service	$	61,893	=	2.11	Required > 1.1
(b)	Debt service requirement	$	29,383			

Income available for debt service:			
Excess of revenues over expenses	$	36,162	
Excluding:			
Gain on sale of assets		(8)	
Depreciation and amortization expense		55,756	
Interest expense		19,617	
Unrealized gain from interest rate hedges		(9,568)	
Unrealized investment gains		(40,066)	
Loss on debt extinguishment		—	
Adjustments for realized investment gains:			
Deduct realized investment gains		—	
Add three year average realized investment gains		—	
Total	$	61,893	(a)

Principal Reduction	$	9,170	
Interest Paid		20,213	
Debt Service Requirement	$	29,383	(b)

SCHEDULE 1-A

The Queen's Health Systems
Management's Discussion and Analysis of Recent Finance Performance
For the Year ended June 30, 2017

Consolidation

The consolidated financial statements of The Queen's Health Systems ("QHS") include the results of The Queen's Medical Center ("QMC"), Molokai General Hospital ("MGH"), North Hawaii Community Hospital ("NHCH"), Queen Emma Land Company ("QEL"), Queen's Development Corporation ("QDC"), Queen's Insurance Exchange ("QIE") and The Queen's Health Systems (the Parent Company).

Results of Operations

Total revenues were $1,279.5 million in FY 2017, an increase of $24.0 million, or 1.9%, over the prior year. This increase was primarily due to a $24.6 million increase in net patient service revenues.

Total operating expenses were $1,296.4 million in FY 2017, an increase of $62.6 million, or 5.1%, over the prior year. This increase was primarily volume driven and reflected additional payroll and supplies expenses.

Net operating loss for the fiscal year ended June 30, 2017 was $16.9 million, which represented an operating margin of (1.3%). This was $38.6 million lower than prior year. This decrease was primarily due to the $62.6 million increase in operating expenses, partially offset by the $24.6 million increase in net patient service revenues. Non-operating income was $130.9 million, comprised primarily of investment income.

The excess of revenues over expenses was $114.0 million in FY 2017, compared to $13.9 million in the prior year. The increase of $100.1 million was primarily due to the increase in investment income.

Balance Sheet

The balance sheet as of June 30, 2017 remained solid and liquidity remained strong.

<u>Cash</u>
Days cash on hand as of June 30, 2017 was 384 days compared to 367 days in the prior year. This increase was primarily due to the increase in investments from the prior year.

The Queen's Health Systems Credit Group

QMC, the Parent Company, MGH, and NHCH are members of The Queen's Health Systems Obligated Group (the Obligated Group) as of January 2015. Each member of the Obligated Group is jointly and severally liable for long-term debt issued by the Obligated Group.

The Obligated Group, QDC and DLS are members of The Queen's Health Systems Credit Group (the Credit Group) as of January 2015.

The Credit Group had an operating loss of $59.6 million in FY 2017. This was primarily due to operating losses of $39.9 million and $24.0 million at QMC and NHCH, respectively.

SCHEDULE 1-A

The Queen's Health Systems
Operating Data
For the Year Ended June 30, 2017

Historical Utilization:	QMC-P	QMC-W	MGH	NHCH
Licensed beds	535*	80	15	35
Staffed acute beds	476	80	15	35
Occupancy (%)	92%	84%	3%	46%
Acute admissions	24,673	4,884	53	1,784
Acute patient days	159,960	24,505	169	5,846
Emergency room visits	65,522	57,299	5,613	14,338
Average acute length of stay w/o waitlist	5.82	4.43	3.19	3.28
Outpatient visits	405,933	123,773	24,500	78,595
Outpatient surgeries	14,331	3,754	N/A	1,606

* Excludes Hale Pulama Mau

SCHEDULE 1-A

The Queen's Health Systems
Operating Data (Continued)
For the Year Ended June 30, 2017

Employees

As of June 30, 2017, the System collectively employed approximately 7,431 employees. The entities that compose the Credit Group employed approximately 7,066 employees. QMC, NHCH and MGH have employees who are members of collective bargaining units. Management believes that relations with employees are satisfactory.

The Hawaii Nurses Association ("HNA") covers approximately 1,725 staff nurses at QMC Punchbowl and West Oahu under a three-year contract that expires February 28, 2018. The HNA represents approximately 46 transporters at QMC under a contract that expires on October 8, 2018. The HNA also represents approximately 94 staff nurses at NHCH's hospital under a contract that expires on March 31, 2019 and they represent about 12 Radiation Therapists located at QMC Punchbowl under a contract that expires October 31, 2018. The Hawaii Teamsters and Allied Workers, Local 996, International Brotherhood of Teamsters (Teamsters), represents approximately 761 licensed practical nurses, nursing assistants, psychiatric assistants, and other service workers at QMC under a contract that expires on June 30, 2019. The United Public Workers, AFSCME, Local 646, AFL-CIO represents approximately 33 housekeeping, dietary, maintenance, licensed practical nurses, nursing assistants and other service workers at MGH's hospital under a contract that expires on July 31, 2018. The International Longshore & Warehouse Union (ILWU) represents approximately 24 PBX, Front Office Assistant, Patient Service Representatives, and Patient Financial Counselors at our North Hawaii Community Hospital under a contract that expires August 31, 2019.

SCHEDULE 1-B

Consolidated Financial Statements and Credit Group Schedules, June 30, 2017 and 2016, With Independent Auditor's Report Thereon

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Financial Statements
and Credit Group Schedules

June 30, 2017 and 2016

(With Independent Auditors' Report Thereon)

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

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KPMG LLP
Suite 2100
1003 Bishop Street
Honolulu, HI 96813-6400

Independent Auditors' Report

The Board of Trustees
The Queen's Health Systems and Subsidiaries:

We have audited the accompanying consolidated financial statements of The Queen's Health Systems and its subsidiaries, which comprise the consolidated balance sheets as of June 30, 2017 and 2016, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Queen's Health Systems and its subsidiaries as of June 30, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

KPMG

Other Matters

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information as of and for the year ended June 30, 2017 included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the 2017 consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the 2017 consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the 2017 consolidated financial statements as a whole.

Restriction on Use

This report is intended solely for the information and use of the Board of Trustees and management of The Queen's Health Systems; U.S. Bank National Association, as Master Trustee and Bond Trustee; the Department of Budget and Finance of the State of Hawaii, as Issuer; Bank of Hawaii, as Lender; and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

Honolulu, Hawaii
October 19, 2017

THE QUEEN’S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2017 and 2016

(In thousands)

Assets		**2017**	**2016**
Current assets:			
Cash and cash equivalents	$	80,803	79,310
Receivables – less allowances for uncollectible accounts of $46, 930 in 2017 and $43,581 in 2016		223,778	225,816
Inventories		19,965	19,157
Investments		1,145,999	1,054,130
Assets whose use is limited or restricted – current		14,116	15,898
Deferred income tax asset – current		1,783	1,832
Prepaid expenses and other assets		12,044	10,287
Total current assets		1,498,488	1,406,430
Investments – less current portion		71,073	46,313
Assets whose use is limited or restricted – less current portion		63,577	76,370
Land, buildings, and equipment, net		656,554	641,621
Goodwill		7,619	7,619
Deferred income tax asset – less current portion		9,499	10,097
Straight-line rents receivable		61,277	55,001
Beneficial interests in trusts		108,821	110,066
Other assets		31,705	31,384
Total	$	2,508,613	2,384,901
Liabilities and Net Assets			
Current liabilities:			
Accounts payable and other accrued liabilities	$	102,605	100,058
Accrued salaries and benefits		66,754	63,642
Other current liabilities		16,583	19,157
Due to government reimbursement programs – current		6,037	11,713
Short-term and long-term debt – current		9,386	9,583
Long-term debt subject to short-term remarketing arrangements		103,380	109,630
Total current liabilities		304,745	313,783
Long-term debt – less current portion		372,893	378,271
Pension and postretirement liabilities		224,994	251,219
Due to government reimbursement programs – less current portion		14,952	17,577
Other long-term liabilities		54,378	61,272
Total liabilities		971,962	1,022,122
Net assets:			
Unrestricted		1,399,980	1,230,333
Temporarily restricted		22,203	17,915
Permanently restricted		114,468	114,531
Total net assets		1,536,651	1,362,779
Total	$	2,508,613	2,384,901

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2017 and 2016

(In thousands)

	2017	2016
Unrestricted operating revenues:		
Net patient service revenues	$ 1,142,464	1,117,880
Rental revenues	81,133	76,162
Other	51,223	56,123
Total unrestricted operating revenues	1,274,820	1,250,165
Net assets released from restrictions	4,659	5,293
Total operating revenues and other support	1,279,479	1,255,458
Unrestricted operating expenses:		
Salaries, wages, and employee benefits	716,419	665,606
Supplies	222,959	212,116
Purchased services	104,198	108,967
Professional fees	66,785	71,909
Depreciation and amortization	62,772	56,940
Sustainability fees and taxes – other than income taxes	37,239	34,256
Rent and utilities	31,822	28,305
Interest	17,093	16,833
Other	37,104	38,846
Total unrestricted operating expenses	1,296,391	1,233,778
Operating (loss) income	(16,912)	21,680
Nonoperating income (expense):		
Investment income, net	127,657	1,390
Income tax expense	(3,451)	(3,529)
Gain (loss) on interest rate swap	9,568	(3,455)
Other expense	(2,836)	(2,207)
Total nonoperating income (expense), net	130,938	(7,801)
Excess of revenues over expenses, carried forward	114,026	13,879

(Continued)

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2017 and 2016

(In thousands)

		2017	2016
Excess of revenues over expenses, brought forward	$	114,026	13,879
Other changes:			
Net assets released from restrictions used for capital expenditures		380	1,178
Net unrealized gain (loss) on investments		16,705	(9,966)
Pension related changes other than net periodic pension cost		38,751	(45,934)
Other changes, net		(215)	—
Total other changes		55,621	(54,722)
Increase (decrease) in unrestricted net assets		169,647	(40,843)
Temporarily restricted net assets:			
Gifts and grants		7,471	4,969
Investment gains (losses), net		1,567	(181)
Net assets released from restrictions used for capital expenditures		(380)	(1,178)
Net assets released from restrictions used for operating expenses		(4,363)	(4,055)
Other changes, net		(7)	136
Increase (decrease) in temporarily restricted net assets		4,288	(309)
Permanently restricted net assets:			
Cash distributions from perpetual trusts		(296)	(1,238)
Other changes, net		233	(170)
Decrease in permanently restricted net assets		(63)	(1,408)
Increase (decrease) in net assets		173,872	(42,560)
Net assets – beginning of year		1,362,779	1,405,339
Net assets – end of year	$	1,536,651	1,362,779

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended June 30, 2017 and 2016

(In thousands)

		2017	2016
Operating activities:			
Increase (decrease) in net assets	$	173,872	(42,560)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:			
Net realized and unrealized losses on investments		(134,442)	16,525
Gain (loss) on interest rate swap		(9,568)	3,455
Depreciation and amortization		62,772	56,940
Provision for bad debts		50,397	32,203
Amortization of bond premium		(2,370)	(2,380)
Gain (loss) on disposition of land, buildings, and equipment		(994)	321
Gain on investment in subsidiary		—	(306)
Pension related changes other than net periodic pension cost		(38,751)	45,934
Deferred income taxes		(209)	(1,222)
Change in value of beneficial interests in trusts		1,245	1,615
Changes in operating assets and liabilities:			
Receivables		(54,635)	(68,251)
Due to government reimbursement programs		(8,301)	(7,470)
Accounts payable and accrued salaries, benefits, and other liabilities		19,130	25,170
Other assets and liabilities		1,173	22,091
Net cash provided by operating activities		59,319	82,065
Investing activities:			
Purchases of investments and assets whose use is limited or restricted		(497,140)	(298,262)
Proceeds from sales of investments and assets whose use is limited or restricted		529,530	311,926
Purchases of land, buildings, and equipment		(80,507)	(96,653)
Proceeds from sales of land, buildings, and equipment		392	14
Other		—	(788)
Net cash used in investing activities		(47,725)	(83,763)
Financing activities:			
Repayment of debt		(9,501)	(619)
Payment of deferred financing costs		—	(23)
Dividend distribution to minority interest holder		(600)	(800)
Net cash used in financing activities		(10,101)	(1,442)
Increase (decrease) in cash and cash equivalents		1,493	(3,140)
Cash and cash equivalents – beginning of year		79,310	82,450
Cash and cash equivalents – end of year	$	80,803	79,310
Supplemental cash flow information:			
Interest paid – net of amounts capitalized	$	20,213	14,217
Income taxes paid		4,890	2,717
Supplemental disclosures of noncash investing and financing activities:			
Purchase of buildings and equipment included in accounts payable and other accrued liabilities at year-end	$	8,441	11,960

See accompanying notes to consolidated financial statements.

(1) Organization and Summary of Significant Accounting Policies

Organization and Mission

The mission of The Queen's Health Systems (QHS, or the Parent Company) is to fulfill the intent of Queen Emma and King Kamehameha IV to provide in perpetuity quality health care services to improve the well-being of Native Hawaiians and all of the people of Hawaii. QHS is a tax-exempt support organization as described in Sections 501(c)(3) and 509(a)(3) of the Internal Revenue Code. QHS is the sole member of The Queen's Medical Center (QMC), Queen Emma Land Company (QEL), Molokai General Hospital (MGH) and North Hawaii Community Hospital (NHCH). The Parent Company is also the parent of Queen's Development Corporation (QDC) and Queen's Insurance Exchange, Inc. (QIE).

QMC's Punchbowl facility opened its doors in 1859, and relocated shortly thereafter to its permanent location on Punchbowl Street in the city of Honolulu. Today, QMC Punchbowl operates a 535-bed acute care hospital and a 40-bed offsite acute care unit located on the 7th floor of Kuakini Health System's Hale Pulama Mau building. QMC's West O'ahu facility is an 80-bed community hospital with 24 hour emergency services. QEL oversees QHS's investment portfolio, as well as manages its substantial land and real estate holdings, most of which exist under leases to produce rental income. MGH operates a 15-bed hospital on the island of Molokai. NHCH is an acute-care hospital with 35 licensed beds and 24 hour emergency services located in Kamuela on the island of Hawaii. QMC, MGH and NHCH provide services to patients, substantially all of whom are Hawaii residents, under unsecured credit terms. QDC owns and manages income-producing, health care-related real estate and is engaged in other health-related business activities. QIE is a Hawaii-domiciled, pure captive insurance company.

QHS, QMC, MGH and NHCH are all members of The Queen's Health Systems Obligated Group (the Obligated Group). Each member is jointly and severally liable for long-term debt issued by the Obligated Group.

Also the Obligated Group, QDC and Diagnostic Laboratory Services, Inc. (DLS), a 90% owned QDC subsidiary, are all members of The Queen's Health Systems Credit Group (the Credit Group).

Effective fiscal year ending June 30, 2018, QEL became a member of the Credit Group.

Significant Accounting Policies

(a) Principles of Consolidation

These consolidated financial statements include the accounts of all entities for which the Parent Company is the sole member or controlling stockholder (collectively, QHS). Intercompany balances and transactions have been eliminated in the consolidated financial statements.

(b) Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions based on available information that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include contractual and uncollectible allowances for receivables, valuation of investments, and reserves for self-insurance and pension and postretirement obligations. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash equivalents include money market funds and short-term, highly liquid investments with maturities of three months or less at date of purchase, and are stated at cost, which approximates fair value. Excluded are amounts whose use is limited or restricted by board designations or other arrangements under trust agreements.

(d) Allowance for Uncollectible Accounts

QHS provides for accounts receivable that could become uncollectible by establishing an allowance to reduce the carrying value of such receivables to their estimated net realizable value. QHS estimates the allowance based on the aging of the accounts receivable, historical collection experience by payor, and other relevant factors.

(e) Inventories

Inventories, consisting principally of medical drugs and supplies, are valued at the lower of cost (average cost method) or market.

(f) Investments

Investments, including assets limited or restricted as to use, include money market funds, debt and equity securities, mutual funds, common trust funds and interests in limited partnerships including private equities. Money market funds classified as investments represent funds held temporarily until suitable investment opportunities are identified. Investments in money market funds, debt and equity securities, and mutual funds with readily determinable market values are measured at fair value based on quoted market prices or observed transactions. Investments also include alternative investments, such as common trust funds, and interests in limited liability entities (hedge funds, equity funds, real estate investments, and private equities), accounted for under the equity method of accounting. Management determines the appropriate classification of all investments at the date of purchase and evaluates such designations at each balance sheet date. QHS classifies its investments in debt and equity securities that are managed in "separate accounts" by fund managers as trading securities. Investments classified as other-than-trading securities are recorded at fair value, with changes in value recorded as other changes in unrestricted net assets. Investments that are available for current operations are classified as current assets. Investments that cannot be sold within a year due to restrictions contained in the agreements are classified as noncurrent assets.

Investment income, which is presented within the performance indicator, includes all dividends and interest, unrestricted realized gains and losses, other-than-temporary impairment (OTTI), unrealized gains and losses on trading securities, and equity in earnings and losses of alternative investments. Investment management fees are netted against investment income.

QHS assesses whether OTTI has occurred based upon a case-by-case evaluation of the underlying reasons for the decline in estimated fair value of its investments. All securities with a gross unrealized loss at each reporting period are subjected to a process for identifying OTTI. QHS considers a wide range of factors, as described below, about the security issuer and uses its best judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in the evaluation of each security are assumptions and estimates about the operations of the issuer and its future earnings potential.

Considerations used by QHS in the impairment evaluation process include, but are not limited to, the following:

- Duration and extent that the estimated fair value has been below net carrying amount
- Ability and intent to hold the investment for a period of time to allow for a recovery of value
- Fundamental analysis of the liquidity and financial condition of the specific issuers
- Industry factors or conditions related to a geographic area that are negatively affecting the security
- Underlying valuation of assets specifically pledged to support the credit
- Past due interest or principal payments or other violations of covenants
- Deterioration of the overall financial condition of the specific issuer
- Downgrades by a rating agency

The cost basis of securities that are deemed to be other-than-temporarily impaired is written down to estimated fair value in the period the other-than-temporary impairment is recognized.

(g) Assets Whose Use is Limited or Restricted

Assets whose use is limited or restricted include assets restricted by the donor and assets held by trustees for the repayment of bonds and purchase of capital assets. Amounts required to meet current obligations of QHS have been reflected as current assets in the consolidated balance sheets as of June 30, 2017 and 2016.

(h) Land, Buildings, and Equipment

Land, buildings and equipment are recorded on the basis of cost or fair market value at the date of acquisition or donation, respectively. Buildings and equipment, including amounts recorded under capital lease obligations, are depreciated by the straight-line method over their estimated useful lives ranging from 3 to 40 years. Leasehold improvements are amortized using the straight-line method over the lesser of their estimated useful lives or the remaining term of the related leases. Development and interest costs are capitalized during the construction period of major capital projects.

(i) Goodwill

Goodwill is not amortized. It is tested for impairment on an annual basis and when a triggering event occurs between annual impairment tests.

(j) Long-Lived Assets

Long-lived assets held and used by QHS are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When such events or changes occur, an estimate of the future cash flows expected to result from the use of the assets and their eventual disposition is made. If the sum of such expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the assets, an impairment loss is recognized in an amount by which the assets' net book values exceed fair values. Estimated useful lives are periodically reviewed and changes are made when necessary.

(k) Beneficial Interests in Trusts

NHCH holds beneficial interests in certain trusts. QHS measures these interests using Level 3 inputs (see note 2 for further discussion of the fair value hierarchy).

(l) Insurance Claims and Related Insurance Recoveries

QHS estimates its insurance reserves without consideration of insurance recoveries, and therefore records estimated recoveries separately from its reserves.

(m) Derivative Financial Instruments

QHS periodically uses derivative financial instruments, such as interest rate hedging products, to mitigate risk. The use of derivative instruments is limited to reducing its risk exposure by utilizing interest rate swap agreements. The swaps are not designated as hedges for accounting purposes. Accordingly, QHS records the value of its swaps as other assets or liabilities in its consolidated balance sheets and records the change in the fair value of the swaps as nonoperating income or expense.

(n) Income Taxes

QDC and its majority-owned subsidiary, DLS, file consolidated income tax returns. QIE files separate income tax returns. Deferred tax assets and liabilities are recorded for differences between the financial statement and income tax bases for assets and liabilities. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. A valuation allowance has been recorded to reduce certain future net deferred tax assets to the amounts that will more likely than not be realized.

All other consolidated affiliates are not-for-profit organizations that are exempt from federal and state income taxes pursuant to Section 501(a) of the Internal Revenue Code and related Hawaii Revised Statutes. QHS, QEL, QMC, NHCH and MGH are subject to federal and state income taxes solely on their unrelated business taxable income. Unrelated business taxable income is not material to the consolidated financial statements. QHS evaluates its uncertain tax positions and has no material unrecognized tax benefits as of June 30, 2017. QHS does not believe it is subject to audit by taxing jurisdictions for periods prior to fiscal year ended June 30, 2013.

(Dollars in thousands)

(o) Contributions and Temporarily and Permanently Restricted Net Assets

Unconditional promises by donors of cash and other assets are reported at fair value at the date the promise is received. Restricted net assets consist of donations and other funds where restrictions have been imposed by donors as to the use of the funds. Temporarily restricted net assets consist of those net assets whose use by QHS has been limited by donors to a specific purpose or time period. When a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. Permanently restricted net assets consist of the principal of net assets whose use by QHS has been restricted in perpetuity by the donors. Earnings on permanently restricted net assets are considered unrestricted, unless otherwise restricted by the donor.

(p) Net Patient Service Revenue

Net patient service revenue is recognized, and patient accounts receivable is recorded as services are provided, and are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

Significant concentrations of patient accounts receivable at June 30, 2017 and 2016 included the following:

	2017	2016
Medicare	37 %	34 %
Medicaid	15	16
Hawaii Medical Service Association	14	12

Accounts receivable are reduced by allowances for contractually obligated deductions and for doubtful accounts. Allowances are calculated based on recent negotiated reimbursement amounts, actual payments received and historical trends for every payor-source category. Management reviews and updates these calculations monthly. The difference between the standard rates and the amounts actually collected on patient accounts is charged off against these contractual allowances and allowances for doubtful accounts.

The QHS allowance for doubtful accounts was $46,930 and $43,581 as of June 30, 2017 and 2016, respectively. The provision for bad debts included in net patient service revenues was $50,397 and $32,203 for the years ended June 30, 2017 and 2016, respectively.

(q) Government Reimbursement Programs

QHS renders services to patients under contractual agreements with the Medicare and Medicaid programs. The percentage of patient service revenue attributable to the Medicare and Medicaid programs, approximated 42% and 21%, respectively, in both 2017 and 2016. Medicare acute inpatient services are reimbursed based on clinical, diagnostic and other factors. Medicaid inpatient services are reimbursed at a per diem rate for routine services and a per discharge rate for ancillary services. Outpatient services related to Medicare and Medicaid beneficiaries are paid based upon a prospective payment system, fee schedules, percentage of charges or a cost reimbursement method. Prospectively determined reimbursements are paid to QHS based on claims submitted; however, certain items, such as medical education costs, capital costs, bad debts and disproportionate share hospital (DSH) payment adjustments are reimbursed based upon estimated interim rates with final settlement determined after annual cost reports submitted by QHS are audited by the fiscal intermediary.

Estimation differences between final settlements and amounts accrued in previous years due to audit adjustments recorded by the fiscal intermediary are reported as current year increases to revenues and excess of revenues over expenses and amounted to $169 and $260 for the years ended June 30, 2017 and 2016, respectively. In the year ended June 30, 2017, QHS released $8,400 of Medicare Disproportionate Share Hospital (DSH) – Supplemental Security Income (SSI) liabilities due to the expiration of post-final settlement reopening windows for several cost report years. In the year ended June 30, 2016, QHS released $9,162 of Medicare Recovery Audit Contractor (RAC) liabilities as a result of new RAC regulations effective January 1, 2016, which limited the volume of RAC audit requests.

QHS participates in the State of Hawaii Hospital Sustainability Program. Under this program, private hospitals have historically received supplemental payments directly from the State of Hawaii Department of Health. Effective calendar year 2017, supplemental payments are received directly from the Quest Integration plans. These payments are funded by sustainability fees paid by participating hospitals and matching federal funds. Sustainability payments recognized by QHS were $40,151 and $37,648, and are reported in net patient service revenues for the years ended June 30, 2017 and 2016, respectively. Sustainability fees paid by QHS were $18,569 and $16,928, and are reported in sustainability fees and taxes – other than income taxes for the years ended June 30, 2017 and 2016, respectively. Amounts under this program are subject to annual determination by the State of Hawaii. A similar program has been established for fiscal 2018.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is a reasonable probability that recorded estimates will change by a material amount in the near term. QHS believes that it is in compliance with applicable laws and regulations and actively resolves issues as identified. Compliance with such laws and regulations can be subject to future government review and interpretation, and noncompliance could result in significant regulatory action, including fines, penalties and exclusion from the Medicare and Medicaid programs.

(r) Charity Care and Community Benefits

As part of its mission, QHS provides health care services to improve the well-being of the community. QHS provides care to patients who meet certain criteria under its financial assistance policy without charge or at amounts less than its established rates. Because collection of amounts determined to qualify as charity care are not pursued, they are not reported as net patient service revenues.

The estimated cost of these charity care services is determined using a ratio of cost to gross charges and applying that ratio to the gross charges forgone associated with providing care to charity patients for the period. Gross charges associated with providing care to charity patients includes only the related charges for those patients who are financially unable to pay, that qualify under the QHS charity care policy and that do not otherwise qualify for reimbursement from a governmental program. The estimated costs and expenses incurred to provide charity care were $2,664 and $3,235 for the years ended June 30, 2017 and 2016, respectively.

Community Benefits programs include health screenings, health care training, community education through various seminars and classes, medical research, clinic and community services as well as providing for costs in excess of third-party reimbursement. QHS participates in several residency programs and provides a clinical setting in nursing, pharmacy and cardiac fellowship training. Community education classes of health-related topics include women's health, diabetes, child safety, dealing with cancer, cardiology, support groups, glaucoma, weight loss, wellness and pregnancy. QHS operates the Queen Emma Clinic, Dental Clinic and Behavioral Health programs at a loss for the benefit of the community. The Queen's Transplant Center was established to provide access to life saving organ transplantation to the community of Hawaii. The efforts to improve health care in the community are also demonstrated through Native Hawaiian Health program clinical outcomes, health care training, research, access and outreach. QHS continually assesses and develops programs and services focused on the Native Hawaiian community through collaborations with the community. The recent affiliation with NHCH and the opening of the newly renovated West Oahu facility both improve access to quality health services and enhance population health.

(s) Rental Revenues

QHS recognizes revenues when delivery has occurred, persuasive evidence of an agreement exists, the fee is fixed or determinable and collectibility is reasonably assured. QHS, as lessor, has entered into certain lease agreements that provide for scheduled rent increases. For such leases, rental income is recognized on a straight-line basis over the terms of the respective leases. The difference between the straight-line amount and the rent received each period is recorded as straight-line rents receivable. Also included in rental revenues are certain percentage rents determined in accordance with the terms of the leases. Rental revenues that are contingent upon the lessee meeting certain pre-determined thresholds are recognized only after the contingency has been resolved (e.g., sales thresholds have been achieved).

(Dollars in thousands)

(t) Expenses by Functional Classification

Expenses incurred during the years ended June 30, 2017 and 2016 were for the following programs and support services:

		2017	2016
Patient services	$	895,310	906,585
Administrative and general		266,422	210,745
Other healthcare-related activities		105,913	85,896
Real property investment and management		28,746	30,552
Total	$	1,296,391	1,233,778

(u) Performance Indicator

The QHS performance indicator is the excess of revenues over expenses. The indicator excludes net unrealized gains (losses) on other-than-trading securities, net assets released from restrictions used for capital expenditures, and pension related changes other than net periodic pension cost.

(v) Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*. This guidance will enhance the comparability of revenue recognition practices and will be applied to all contracts with customers. Expanded disclosures related to the nature, amount, timing, and uncertainty of revenue that is recognized are requirements under the amended guidance. This guidance will be effective for the QHS's fiscal year ending June 30, 2019 and may be applied retrospectively, with early adoption permitted. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. ASU 2015-03 requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a deduction from the debt liability, similar to debt discounts. This new standard was adopted as of July 1, 2016. The standard requires retrospective transition. $5,051 of deferred financing fees at June 30, 2016 have been reclassified as a reduction to long-term debt.

In November 2015, the FASB issued ASU No. 2015-17, *Income Taxes (Topic 740)*. To simplify the presentation of deferred income taxes, the standard requires entities to classify all deferred income tax liabilities and assets as noncurrent on the balance sheet. Under the current guidance, deferred tax liabilities and assets are classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. Deferred tax liabilities and assets that are not related to an asset or liability for financial reporting are classified according to the expected reversal date of the temporary difference. The standard is effective for the QHS's fiscal year ending June 30, 2018. The standard may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10)*. The guidance requires entities to measure equity investments that are not accounted for under the equity method or do not result in consolidation to be recorded at fair value and recognize any changes in fair value to excess of revenue over expenses. This guidance will be effective for the QHS's fiscal year ending June 30, 2019. The guidance requires the use of the cumulative effect transition method, except for equity securities without readily determinable fair values, for which the standard requires the application of the prospective transition method. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. ASU 2016-02 amends the FASB Accounting Standards Codification and created Topic 842, *Leases*. Under Topic 842, lessees are required to recognize assets and liabilities on the balance sheet for most leases and provides for enhanced disclosures. Leases will continue to be classified as either finance or operating. This guidance will be effective for the QHS's fiscal year ending June 30, 2020. QHS is currently evaluating the impact of the adoption of this standard on the consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This guidance reduces the number of net asset classes presented on the balance sheet from three to two; requires presentation of expenses by their functional and natural classification in one location in the financial statements; and requires quantitative and qualitative information about management of liquid resources and availability of financial assets to meet cash needs within one year of the balance sheet date. This guidance will be effective for the QHS's fiscal year ending June 30, 2019. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

(Continued)

(Dollars in thousands)

(2) Investments and Assets Whose Use is Limited or Restricted and Fair Value Measurements

Investments including assets whose use is limited or restricted at June 30, 2017 and 2016 were as follows:

		2017	2016
Investments at fair value:			
Mutual funds	$	301,667	154,496
Debt securities		167,713	147,700
Money market funds		89,830	90,999
Equity securities		75,449	70,685
Total investments at fair value		634,659	463,880
Investments using equity method:			
Common trust funds		506,921	600,068
Private equities and other limited partnerships		153,185	128,763
Total investments using equity method		660,106	728,831
Total investments and assets whose use is limited or restricted	$	1,294,765	1,192,711

Common trust funds, private equities and other limited partnerships consist of hedge fund, real asset, and private equity pools which include but are not limited to both direct and commodity linked equities, public real estate, infrastructure investments, innovation, early state, venture growth, restructurings/distressed equity and buyouts. Ownership percentages range from less than 1% to 22%.

At June 30, 2017, QHS was committed to invest approximately $83,665 of additional capital in various private equity investments.

The classification of investments in the consolidated balance sheets as of June 30, 2017 and 2016 was as follows:

		2017	2016
Total investments	$	1,294,765	1,192,711
Less assets whose use is limited or restricted		(77,693)	(92,268)
Total unrestricted investments		1,217,072	1,100,443
Less current portion		(1,145,999)	(1,054,130)
Noncurrent portion	$	71,073	46,313

(Dollars in thousands)

Assets whose use is limited or restricted at June 30, 2017 and 2016 consisted of the following:

		2017	2016
Money market funds	$	57,404	73,825
Investments		20,289	18,443
Total assets whose use is limited or restricted		77,693	92,268
Less current portion		(14,116)	(15,898)
Noncurrent portion	$	63,577	76,370

QHS maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. The hierarchy places the highest priority on unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurements) and assigns the lowest priority to unobservable inputs (Level 3 measurements). The three levels of inputs within the hierarchy are defined as follows:

Level 1 – Quoted (unadjusted) prices for identical assets or liabilities in active markets

Level 2 – Other observable inputs, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets in nonactive markets (few transactions, limited information, noncurrent prices, high variability over time, etc.)
- Inputs other-than-quoted prices that are observable for the asset (interest rates, yield curves, volatilities, default rates, etc.)
- Inputs that are derived principally from or corroborated by other observable market data

Level 3 – Unobservable inputs that cannot be corroborated by observable market data

Fair values of other-than-trading and trading securities are based on quoted market prices, where available. The custodian obtains one price for each security primarily from a third-party pricing service (pricing service), which generally uses Level 1 or Level 2 inputs for the determination of fair value. The pricing service normally derives the security prices from recently reported trades for identical or similar securities, making adjustments through the reporting date based upon available observable market information. In the absence of a vendor, system trade/cost, or broker price for debt instruments, the pricing staff will price the security using the investment manager's price or last known price. As QHS is responsible for the determination of fair value, it performs periodic analyses on the prices received from the pricing service to determine whether the prices are reasonable estimates of fair value. As a result of the reviews, QHS has not historically adjusted the prices obtained from the pricing service.

(Dollars in thousands)

In the instances in which the inputs used to measure the fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest-level input that is significant to the fair value measurement in its entirety. The assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

QHS targets an investment mix in cash and cash equivalents, fixed income securities, equity securities, real assets, and private equities. The QHS investment strategy is to generate a return that is sufficient to meet its current and expected future financial requirements, with an acceptable level of risk. QHS has engaged a number of investment managers to implement various investment strategies to achieve the desired asset class mix, liquidity, and risk diversification objectives.

There were no reclassifications between Level 1 and Level 2 investments in 2017 and 2016.

The following tables present information about the fair value of the QHS financial instruments as of June 30, 2017 and 2016, according to the valuation techniques QHS used to determine their fair values:

	Fair value measurements at June 30, 2017			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents – money market funds	$ 17,869	—	—	17,869
Investments and assets whose use is limited or restricted:				
Trading securities:				
Money market funds	32,352	—	—	32,352
Debt securities	37,806	129,907	—	167,713
Equity securities:				
Domestic mid-cap	75,449	—	—	75,449
Mutual funds – fixed income	114,331	—	—	114,331
Total trading securities	259,938	129,907	—	389,845

(Dollars in thousands)

		Fair value measurements at June 30, 2017			
		Level 1	**Level 2**	**Level 3**	**Total**
Other-than-trading securities:					
Money market funds	$	57,478	—	—	57,478
Mutual funds:					
Mid-cap equities		72,451	—	—	72,451
Real assets		70,074	—	—	70,074
International equities		44,811	—	—	44,811
Total other-than-trading securities		244,814	—	—	244,814
Total investments and assets whose use is limited or restricted	$	504,752	129,907	—	634,659
Liabilities:					
Other long-term liabilities – interest rate swap liabilities	$	—	17,141	—	17,141

		Fair value measurements at June 30, 2016			
		Level 1	**Level 2**	**Level 3**	**Total**
Assets:					
Cash and cash equivalents – money market funds	$	7,849	—	—	7,849
Investments and assets whose use is limited or restricted:					
Trading securities:					
Money market funds		17,099	—	—	17,099
Debt securities		44,373	103,327	—	147,700
Equity securities:					
Domestic mid-cap		70,685	—	—	70,685
Mutual funds – fixed income		5,640	—	—	5,640
Total trading securities		137,797	103,327	—	241,124

(Dollars in thousands)

		Fair value measurements at June 30, 2016			
		Level 1	**Level 2**	**Level 3**	**Total**
Other-than-trading securities:					
Money market funds	$	73,900	—	—	73,900
Mutual funds:					
Mid-cap equities		67,700	—	—	67,700
Real assets		63,233	—	—	63,233
International equities		17,923	—	—	17,923
Total other-than-trading securities		222,756	—	—	222,756
Total investments and assets whose use is limited or restricted	$	360,553	103,327	—	463,880
Liabilities:					
Other long-term liabilities – interest rate swap liabilities	$	—	26,709	—	26,709

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Money Market Funds – Fair value estimates for money market funds are based on observed transactions.

Debt Securities – This category includes investments in U.S. government, corporate, and other bond securities, U.S. dollar and non-U.S. dollar-denominated securities, and money market instruments. The estimated fair values of U.S. government obligations, corporate, and other debt securities are based on quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing prices. Due to the nature of pricing fixed income securities, management has classified the debt securities as Levels 1 and 2.

Equity Securities – This category includes investments in both domestic equity securities of large-cap and mid-cap companies as well as domestic and foreign equities in developed and developing countries. Fair value estimates for publicly traded securities are based on quoted market prices.

Mutual Funds – This category includes investments in domestic, international equities and bonds, and commodities. The estimated fair value of mutual funds is based on quoted market prices.

Interest Rate Swap Liabilities – The fair values of interest rate swaps are estimated using the terms of the swaps and publicly available market yield curves. Because the swaps are unique and are not actively traded, the fair values are classified as Level 2 estimates.

(Dollars in thousands)

Investments and assets whose use is limited or restricted classified as other-than-trading securities at June 30, 2017 and 2016 consisted of the following:

		Cost	Gross unrealized gains	Gross unrealized losses	Fair value
2017:					
Money market funds	$	57,478	—	—	57,478
Mutual funds		166,912	23,091	(2,667)	187,336
Total investments	$	224,390	23,091	(2,667)	244,814
2016:					
Money market funds	$	73,900	—	—	73,900
Mutual funds		145,413	10,445	(7,002)	148,856
Total investments	$	219,313	10,445	(7,002)	222,756

The total return on the investment portfolios for the years ended June 30, 2017 and 2016 was comprised of the following:

		2017	2016
Total investment income, net:			
Interest and dividend income	$	10,674	7,410
Realized gain – net of expenses		14,034	4,207
Unrealized gain on trading securities		1,665	3,028
Equity in earnings (losses) of limited liability entities		101,284	(13,255)
Total unrestricted investment income, net	$	127,657	1,390
Other changes in unrestricted net assets – net unrealized gain (loss) on unrestricted investments	$	16,705	(9,966)
Other changes in temporarily restricted net assets:			
Investment gain	$	813	358
Net unrealized gain (loss) on investments		754	(539)
Total temporarily restricted investment gain (loss), net	$	1,567	(181)

For the year ended June 30, 2017, gross proceeds from sales of other-than-trading investments were $14,000, resulting in gross realized gains of $4,104. For the year ended June 30, 2016, there were no sales of other-than-trading investments. QHS uses the average cost method to determine the cost basis for securities sold.

(Continued)

(Dollars in thousands)

(3) Land, Buildings, and Equipment

Land, buildings, and equipment at June 30, 2017 and 2016 consisted of the following:

		2017	2016
Land and land improvements	$	105,897	103,355
Buildings and leasehold improvements		540,288	538,985
Equipment and furnishings		725,146	642,939
Equipment under capital leases		2,365	2,697
Construction in progress		76,881	87,103
Total		1,450,577	1,375,079
Less accumulated depreciation and amortization		(794,023)	(733,458)
Land, buildings, and equipment, net	$	656,554	641,621

Depreciation expense was $62,772 and $56,940 for the years ended June 30, 2017 and 2016, respectively.

(4) Debt

Debt at June 30, 2017 and 2016 consisted of the following:

		2017	2016
Special Purpose Revenue Bonds 2015 Series A, serial and term, fixed interest rates ranging from 3.00% to 5.00%, with final maturity in July 2040, including unamortized bond premium at June 30, 2017 and 2016 of $23,586 and $25,956, respectively	$	225,831	232,301
Special Purpose Revenue Bonds 2015 Series B, windows rate mode, variable interest rate (average interest rate of 1.12%), final maturity in July 2039		54,815	57,350
Special Purpose Revenue Bonds 2015 Series C, windows rate mode, variable interest rate (average interest rate of 1.12%), final maturity in July 2039		54,815	57,350
Special Purpose Revenue Bonds 2015 Series D, fixed interest rate of 4.464%, with final maturity in July 2045		80,110	80,110

(Dollars in thousands)

		2017	2016
Loan agreement with bank, variable interest rate (average interest rate of 1.44%), with final maturity in January 2025	$	75,000	75,000
Capital lease and other obligations		11	424
Deferred financing fees		(4,923)	(5,051)
Total		485,659	497,484
Less current portion		(9,386)	(9,583)
Less long-term debt subject to short-term remarketing arrangements and associated deferred financing fees		(103,380)	(109,630)
Total noncurrent portion	$	372,893	378,271

The Series 2015A Bonds are tax-exempt serial and term bonds with fixed interest rates. Interest is paid semi-annually. The Series 2015A serial bonds mature annually through 2030, with principal payments ranging from $4,385 to $10,020. The serial bonds maturing on or after July 1, 2026 are subject to optional redemption on or after July 1, 2025 at a redemption price equal to 100% of the principal amount being redeemed plus accrued interest to the redemption date. The Series 2015A term bonds mature on July 1, 2035 and 2040, with principal payments of $60,105 and $45,705, respectively. The bonds maturing on July 1, 2035, have five annual mandatory sinking fund installments ranging from $10,645 to $13,465, commencing July 1, 2031. The bonds maturing on July 1, 2040, have five annual mandatory sinking fund installments ranging from $5,000 to $15,290, commencing July 1, 2036.

The Series 2015B and 2015C Bonds are tax-exempt variable interest rate, initially windows rate mode bonds. Windows rate interest is paid monthly and calculated based on the windows rate spread plus each weekly Securities Industry & Financial Markets Association (SIFMA) index. The bonds are redeemed by application of sinking fund installments ranging from $4,990 to $4,410 through July 2039. The Obligated Group has several options of variable interest rate conversions and the option to redeem the bonds prior to their stated maturity date of July 1, 2039.

While in the windows rate mode, the holders of the Series 2015B and 2015C Bonds have the option to tender the bonds for redemption. Once tendered, the remarketing agent has 30 days to identify a purchaser for the bonds. In the event of a failed remarketing, the Obligated Group has the following options during the funding window (day 31 through day 210): call the bonds and issue refunding bonds, convert the bonds to another interest rate mode, remarket the bonds with a revised windows rate spread, or use available funds to redeem the bonds.

The Series 2015D Bonds are taxable bonds with a fixed interest rate. Interest is paid semi-annually and principal is due on July 1, 2045. The bonds are subject to earlier redemption at the option of the Obligated Group, at a make-whole redemption price, determined by an independent accounting firm or financial advisor, plus accrued interest to the redemption date.

(Dollars in thousands)

The bank loan bears a variable interest rate, either a base or LIBOR rate option, for up to five tranches. Interest is payable monthly or every 90 days, depending on the option. Principal is due on January 29, 2025 and may be prepaid with prior written notice.

The Obligated Group maintains interest rate swap agreements whereby the Obligated Group pays fixed interest rates to counterparties. The interest rate differential paid or received is recognized during the term of the agreements. The interest rate swap agreements expire in the years 2024 through 2029, or earlier if the Obligated Group exercises early termination provisions. At June 30, 2017, the notional swap amounts were $78,685, $47,125, and $30,325. The notional amounts decrease annually based on the originally scheduled principal payments of the respective refunded bond series.

During the years ended June 30, 2017 and 2016, the change in the fair value of the liabilities associated with the swap agreements discussed above resulted in a gain of $9,568 and a loss of $3,455, respectively, which were recognized in nonoperating income (expense). The fair value of liabilities associated with the swaps as of June 30, 2017 and 2016 was $17,141 and $26,709, respectively, and was included in other long-term liabilities.

The Series 2015A, 2015B, 2015C, and 2015D Bonds, bank loan and interest rate swap agreements are secured under a Master Trust Indenture (MTI). The gross revenues of the Obligated Group are pledged as security for the obligations. The MTI limits the ability of the Obligated Group to incur additional indebtedness, make certain other commitments or dispose of certain assets. A minimum debt service coverage ratio must be maintained.

QHS incurred total interest costs of $17,866 and $17,178 during 2017 and 2016, respectively, of which $773 and $345 was capitalized in construction in progress in 2017 and 2016, respectively.

At June 30, 2017, contractually stated debt maturities are as follows:

		Revenue bonds and bank loan	Capital leases and other obligations	Total
Year ending June 30:				
2018	$	9,375	11	9,386
2019		9,600	—	9,600
2020		9,885	—	9,885
2021		10,180	—	10,180
2022		10,560	—	10,560
Thereafter		417,385	—	417,385
Long-term debt payments		466,985	11	466,996
Plus net unamortized premium		23,586	—	23,586
Less deferred financing fees		(4,923)	—	(4,923)
Total	$	485,648	11	485,659

Series 2015B and 2015C variable rate demand obligations, while subject to long-term amortization periods, may be put at the option of the bondholders in the event of a failed bond remarketing. To the extent that bondholders may, under terms of the debt, put their bonds back to QHS and the repayment terms could be due within one year, the principal amount of such bonds has been classified as a current liability in the consolidated balance sheets. QHS has taken steps to provide various sources of liquidity in the event the bonds fail to remarket, including identifying alternate sources of financing and maintaining internally designated assets as a source of self-liquidity.

The estimated fair value of the fixed interest rate bonds with an aggregate carrying value of $305,941 was $306,050 at June 30, 2017. The estimated fair value of the fixed interest rate bonds with an aggregate carrying value of $312,411 was $326,910 at June 30, 2016. The carrying values of the variable interest rate bonds, commercial paper, bank loans, promissory note, and capital leases approximated their fair values at June 30, 2017 and 2016. The fair value of these debt instruments is deemed a Level 2 measurement.

At June 30, 2017, QHS has a $1,000 standby letter of credit related to QHS's self-insured workers' compensation program.

On June 30, 2017, QHS has an agreement with a lender for an unsecured revolving line of credit facility in the maximum principal amount of $25,000 to be made available to QHS for general corporate purposes. The revolving line of credit facility bears a variable interest rate, either a prime or LIBOR rate option. Interest is payable quarterly in arrears if a prime rate is selected or at the end of each LIBOR period not to exceed a three-month period if a LIBOR rate is selected. There were no outstanding borrowings under the credit facility at June 30, 2017.

(5) Self-Insurance Programs

(a) General and Professional Liability Reserve

QHS maintains a funded self-insurance program for its general and professional liability exposure. This self-insured program is funded through QIE. Premiums are determined based on the QHS loss experience, as well as insurance industry data.

QHS recorded a reserve for losses and loss adjustment expenses for the estimated reported and unreported losses incurred through June 30, 2017 and 2016. The reserve for unpaid losses and loss adjustment expenses was determined by QHS using estimates from independent consulting actuaries, based on industry and hospital-specific data. The general and professional liability reserve was $16,617 and $15,059 at June 30, 2017 and 2016, respectively, and was recorded in other long-term liabilities at June 30, 2017 and 2016.

QHS has excess general and professional insurance coverage through reinsurance agreements with unrelated insurers for amounts exceeding $2,000 per occurrence. The reinsurance agreements do not relieve QHS from its obligations should the third-party reinsurers not be able to meet the obligations assumed under the reinsurance agreements.

(Dollars in thousands)

(b) Workers' Compensation Reserve

QHS is self-insured for workers' compensation losses up to $400 per occurrence. Losses above this amount are insured with an independent excess carrier. QHS had workers' compensation reserves of $6,601 and $6,154 at June 30, 2017 and 2016, respectively. The workers' compensation reserves were recorded in other current liabilities at June 30, 2017 and 2016.

(c) Medical Reserve

QHS has a self-funded medical benefits plan covering substantially all of its employees. The medical reserve was $7,418 and $7,258 at June 30, 2017 and 2016, respectively, and was included in other current liabilities at June 30, 2017 and 2016.

(6) Restricted Net Assets

Temporarily restricted net assets at June 30, 2017 and 2016 were available for the following purposes:

		2017	2016
Education and research	$	4,252	3,563
Indigent care and other		10,002	11,096
Facility replacement and expansion		7,949	3,256
Total	$	22,203	17,915

Permanently restricted net assets at June 30, 2017 and 2016 were restricted to investment in perpetuity, the income from which is expendable to support the following purposes:

		2017	2016
Indigent care	$	3,787	3,787
Education and research		1,334	1,334
Restricted for NHCH hospital operations		108,517	108,580
Other		830	830
Total	$	114,468	114,531

The net assets restricted for NHCH hospital operations relate to a beneficial interest in a trust. QHS expects to receive periodic distributions from the trust to support NHCH's operations. According to the terms of the trust agreement, annual distributions shall not exceed 5% of the principal balance allocable to each beneficiary.

In accordance with the Uniform Prudent Management Institutional Funds Act (UPMIFA), QHS considers only permanently restricted net assets as donor-restricted endowment funds. In accordance with UPMIFA and when applicable, QHS considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds: a) the duration and preservation of the fund, b) the purposes of QHS and the endowment fund, c) general economic conditions, d) the possible effect of inflation and deflation, e) the expected total return from income and the appreciation of investments, f) other resources of QHS, and g) the investment policies of QHS. Amounts relating to investment income, net appreciation/depreciation and amounts appropriated for expenditure were not material during 2017 and 2016.

(Dollars in thousands)

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires QHS to retain as a fund of perpetual duration. Deficiencies of this nature are reported as adjustments in unrestricted net assets.

(7) Employee Benefit Plans

Eligible employees of QHS are covered by The Queen's Health Systems Pension Plan (the Plan), which is a noncontributory defined benefit pension plan. Pension benefits are provided to participants under several types of retirement options based upon years of continuous service, age, and compensation. Retirement benefits are paid to pensioners or beneficiaries in various forms of joint and survivor annuities, including a lump-sum payment option. The funding policy is to contribute amounts as deemed necessary on an actuarial basis to provide assets sufficient to meet the benefits to be paid to Plan members.

QHS has three unfunded postretirement welfare plans, covering substantially all of its employees, that provide medical benefits (until age 65), drug and vision benefits, and life insurance benefits. The postretirement medical and drug and vision plans are contributory and also contain other cost-sharing features, such as deductibles and coinsurance.

The changes in benefit obligations, changes in plan assets, and funded status of the pension and postretirement plans with the amounts recognized in the consolidated balance sheets as of June 30, 2017 and 2016 were as follows:

	Pension benefits		Other postretirement benefits	
	2017	**2016**	**2017**	**2016**
Change in benefit obligations:				
Benefit obligations – beginning of year	$ 468,287	430,598	43,271	37,385
Service cost	19,081	17,743	1,720	1,415
Interest cost	14,972	20,006	1,421	1,735
Actuarial (gain) loss	(21,055)	32,222	(1,349)	3,626
Benefits paid	(14,431)	(32,282)	(912)	(890)
Benefit obligation – end of year	466,854	468,287	44,151	43,271

(Dollars in thousands)

		Pension benefits		Other postretirement benefits	
		2017	2016	2017	2016
Change in plan assets:					
Fair value of plan assets – beginning of year	$	262,439	294,237	—	—
Actual return on plan assets		23,713	484	—	—
Employer contributions		18,230	—	912	890
Benefits paid		(14,431)	(32,282)	(912)	(890)
Fair value of plan assets – end of year		289,951	262,439	—	—
Funded status	$	(176,903)	(205,848)	(44,151)	(43,271)
Amounts recognized in the consolidated balance sheets consisted of:					
Other current liabilities	$	—	—	(1,211)	(1,091)
Pension and other postretirement benefits		(176,903)	(205,848)	(42,940)	(42,180)
Net amounts recognized	$	(176,903)	(205,848)	(44,151)	(43,271)

Amounts recognized in unrestricted net assets at June 30, 2017 and 2016 were as follows:

		Pension benefits		Other postretirement benefits	
		2017	2016	2017	2016
Prior service (credit) cost	$	(7,951)	(8,894)	162	303
Net loss		137,518	176,375	7,049	8,730
Total	$	129,567	167,481	7,211	9,033

(Dollars in thousands)

Amounts recognized in unrestricted net assets at June 30, 2017, that are expected to be recognized as components of benefit cost in the year ending June 30, 2018, are as follows:

		Pension benefits	Other postretirement benefits
Prior service (credit) cost	$	(943)	91
Net loss		9,269	198
Total	$	8,326	289

Components of net periodic pension cost and amounts recognized in other changes in unrestricted net assets, but not yet included in net periodic benefit costs were as follows:

		Pension benefits		Other postretirement benefits	
		2017	2016	2017	2016
Net periodic pension costs:					
Service cost	$	19,081	17,743	1,720	1,415
Interest cost		14,972	20,006	1,421	1,735
Expected return on plan assets		(18,513)	(20,002)	—	—
Amortization of prior service cost		(943)	(943)	141	330
Recognized net actuarial loss		12,602	8,651	332	112
Net periodic pension costs	$	27,199	25,455	3,614	3,592

(Dollars in thousands)

		Pension benefits		Other postretirement benefits	
		2017	2016	2017	2016
Other changes in plan assets and benefit obligations recognized in other changes in unrestricted net assets:					
Net actuarial (gain) loss	$	(26,255)	51,739	(1,349)	3,625
Prior service cost		943	943	(141)	(330)
Recognized loss		(12,602)	(8,651)	(332)	(112)
Total recognized in other changes in unrestricted net assets	$	(37,914)	44,031	(1,822)	3,183

Weighted average assumptions used to determine benefit obligations and net periodic benefit cost at June 30, 2017 and 2016 were as follows:

	Pension benefits		Other postretirement benefits	
	2017	2016	2017	2016
Benefit obligation:				
Discount rate	4.07 %	4.02 %	4.07 %	4.01 %
Rate of compensation increase	3.25	3.25	—	—
Net periodic benefit cost:				
Discount rate	4.02	4.74	4.01	4.71
Expected return on plan assets	7.00	7.00	—	—
Rate of compensation increase	3.25	4.00	—	—

The accumulated benefit obligation for the Plan was $421,354 and $416,021 at June 30, 2017 and 2016, respectively.

The long-term rate of return of the Plan is management's estimate of the return on the plan assets over a long-time horizon. Based upon the current policy allocations and historical returns, the expected long-term rate of return for fiscal year 2017 was 7.0%.

(Dollars in thousands)

The annual rate of increase in the per capita cost of medical benefits (i.e., health care cost trend rate) was assumed to be 7% in 2017, declining by 0.25% to 0.50% per year through 2025, and then remaining at 4.5% thereafter. A one-percentage point increase or decrease in this rate would increase or decrease the Plan's accumulated postretirement benefit obligation by $501 and $441, respectively, as of June 30, 2017, and the Plan's service cost and interest cost component of net periodic postretirement benefit cost for the year ended June 30, 2017, by $72 and $62, respectively. QHS anticipates making contributions of $45,200 to the pension plan and $1,219 to the postretirement benefit plan during fiscal year 2018. The future estimated benefit payments for each plan are as follows:

	Pension benefits	Other postretirement benefits
Year ending June 30:		
2018	$ 20,068	1,219
2019	21,406	1,415
2020	23,140	1,613
2021	24,611	1,804
2022	25,482	1,995
2023–2027	140,272	12,593

The primary objective of the Plan investments is to prudently fund the liabilities for benefits under the Plan. The Plan's investment strategy is to structure an investment program that most efficiently matches investment risks and return characteristics with the Plan's objectives. Volatility and uncertainty of investment results are managed through asset allocation and diversification. The Plan's investment policy permits investments in cash and cash equivalents, fixed income securities, equity securities, real return assets, tactical assets, hedge funds, and private equities. The Plan's asset allocation at June 30, 2017 and 2016, and the target allocations were as follows:

	Target range	2017 actual	2016 actual
Cash and cash equivalents	— %	3.4 %	0.6 %
Fixed income securities(a)	26–36	29.0	30.7
Domestic equities(b)	15–33	25.1	24.4
Real return investments(c)	3–12	8.8	9.9
Hedge fund investments(d)	6–14	9.3	10.7
Private equity investments(e)	3–11	4.1	2.8
International equities(f)	16–24	20.3	20.9
Total		100.0 %	100.0 %

(Dollars in thousands)

(a) This category includes investments in U.S. government and corporate bond securities, mortgage and other asset-backed securities, U.S. dollar and non-U.S. dollar-denominated securities, and money market instruments.

(b) This category includes investments primarily in domestic equity securities of large-cap and mid-cap companies.

(c) This category includes investments in real estate, inflation protected bonds, global equities, and commodities.

(d) This category includes investments in direct hedge funds or hedge funds of funds that employ various strategies, consisting of, but not limited to, long/short equity, opportunistic/macro, distressed securities, merger arbitrage/event driven, short selling, credit investing, real estate, restructuring, and value strategies.

(e) This category includes, but is not limited to, equity securities and equity-related investments, purchase or provision of subordinated debt securities/loans, and mezzanine investments.

(f) This category includes investments in non-U.S. companies.

The following tables present information about the fair value of the QHS pension plan assets as of June 30, 2017 and 2016, according to the valuation techniques QHS used to determine their fair values:

		Fair value measurements at June 30, 2017			
Asset category		**Level 1**	**Level 2**	**Level 3**	**Total**
Cash and cash equivalents, primarily money market funds	$	6,445	—	—	6,445
Mutual funds:					
Fixed income		1,810	—	—	1,810
Domestic equities		10,371	—	—	10,371
Real assets		11,960	—	—	11,960
Domestic debt securities		25,318	27,623	—	52,941
Domestic equity securities		10,275	—	—	10,275
Limited liability entities and other		—	—	196,149	196,149
Total	$	66,179	27,623	196,149	289,951

(Dollars in thousands)

	Fair value measurements at June 30, 2016			
Asset category	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash and cash equivalents, primarily money market funds	$ 1,719	—	—	1,719
Mutual funds:				
Fixed income	2,133	—	—	2,133
Domestic equities	10,208	—	—	10,208
Real assets	10,793	—	—	10,793
Domestic debt securities	18,935	37,986	—	56,921
Domestic equity securities	10,719	—	—	10,719
Limited liability entities and other	—	—	169,946	169,946
Total	$ 54,507	37,986	169,946	262,439

There were no reclassifications between Level 1 and Level 2 investments in 2017 and 2016.

See note 2 for the definition of the three levels within the fair value hierarchy and the methods and assumptions used to estimate the fair value of cash and cash equivalents, money market funds, mutual funds, equity securities, and debt securities. Real return, hedge funds, and private equity investments are valued at estimated fair values using certain factors, including their proportionate share of the respective entities' fair value as recorded in the respective entities' financial statements.

The table below presents a reconciliation of the beginning and ending balances of the fair value measurements using significant unobservable inputs (Level 3) for the years ended June 30, 2017 and 2016, respectively:

Ending balance – June 30, 2015	$ 197,176
Realized gains	1,711
Unrealized losses	(772)
Purchases	3,172
Sales	(31,341)
Ending balance – June 30, 2016	169,946
Realized gains	830
Unrealized gains	21,355
Purchases	14,128
Sales	(10,110)
Ending balance – June 30, 2017	$ 196,149

(Dollars in thousands)

Certain executives participate in a nonqualified, unfunded pension plan. At June 30, 2017 and 2016, the benefit liability related to this plan was $924 and $878, respectively. Benefit expense related to this plan was $162 and $204 for the years ended June 30, 2017 and 2016, respectively.

Certain key executives are covered by a nonqualified, unfunded supplemental executive retirement plan. At June 30, 2017 and 2016, the benefit liability related to this plan was $3,747 and $4,036, respectively. Benefit expense related to this plan was $179 and $226 for the years ended June 30, 2017 and 2016, respectively.

QHS has defined contribution retirement plans (the Retirement Plans) that cover substantially all employees and provide participants the ability to make pretax deduction contributions for deposit into retirement savings accounts. The participants' contributions are matched at a percentage of their total contributions and up to annual dollar limits per participant as defined by the Retirement Plans. The QHS expense relating to the above Retirement Plans was approximately $16,370 and $14,599 for the years ended June 30, 2017 and 2016, respectively.

(8) Income Taxes

QIE, QDC, and DLS are subject to federal and state income taxes. At June 30, 2017, these companies had operating loss carryforwards for income tax purposes of approximately $14,453 that expire through 2027. At June 30, 2017, QHS had net operating loss carryforwards of $2,745 related to its unrelated business income. The net operating loss carryforwards expire through 2036.

The components of income tax expense for the years ended June 30, 2017 and 2016 were as follows:

		2017	2016
Current income tax expense	$	3,660	4,751
Deferred income tax benefit		(209)	(1,222)
Total	$	3,451	3,529

For the years ended June 30, 2017 and 2016, the effective tax rate differed from the statutory rate primarily due to tax credits and a valuation allowance established for net operating losses and foreign tax credits of QDC.

(Dollars in thousands)

At June 30, 2017 and 2016, deferred income tax assets and liabilities resulted principally from operating loss carryforwards and from temporary differences for fixed assets, intangible assets, allowance for uncollectible accounts, pension costs, and accrued vacation. Deferred income tax assets and liabilities as of June 30, 2017 and 2016 were as follows:

		2017	2016
Deferred income tax assets	$	19,848	20,256
Deferred income tax liabilities		(1,827)	(1,730)
		18,021	18,526
Less valuation allowance		(6,739)	(6,597)
		11,282	11,929
Less current		(1,783)	(1,832)
Noncurrent	$	9,499	10,097

In assessing the deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax-planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the benefits of these deductible differences will be realized, net of the existing valuation allowances at June 30, 2017. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

(9) Operating Leases

(a) As Lessor

Rental revenues are received from operating leases. The lease terms range from monthly tenancy to 73 remaining years and provide for periodic rent escalation and renegotiation, reimbursement of certain operating costs, and contingent rents based on the lessee's sales or production. Contingent rental revenues of $14,569 and $8,627 were recognized in 2017 and 2016, respectively.

Office space in buildings owned by QHS is leased to physicians and other tenants under operating leases. QHS also maintains operating leases for land and leasehold interests. At June 30, 2017 and 2016, the basis for land, leasehold interests, and buildings under operating leases was approximately $217,255 and $218,032, respectively, and the related accumulated depreciation was approximately $90,882 and $84,747, respectively.

(Dollars in thousands)

Future minimum rental income under noncancelable operating leases at June 30, 2017 is as follows:

Year ending June 30:		
2018	$	49,101
2019		47,032
2020		44,733
2021		44,780
2022		44,584
Thereafter		1,155,376
	$	1,385,606

(b) As Lessee

QHS leases office space, land, and equipment under operating leases expiring through 2042. Future minimum lease payments under noncancelable operating leases at June 30, 2017 are as follows:

Year ending June 30:		
2018	$	3,969
2019		3,587
2020		3,081
2021		2,438
2022		1,713
Thereafter		5,886
	$	20,674

QHS also pays additional amounts for common area maintenance charges, real property taxes, and certain building operating costs. Rent expense during 2017 and 2016 under these leases was approximately $9,244 and $7,741, respectively.

(10) Commitments and Contingencies

At June 30, 2017, there were several legal and compliance actions pending against QHS that arose in the normal course of business. The ultimate resolution of such actions cannot presently be determined. In the opinion of management, based upon current facts and circumstances, the resolution of these matters is not expected to have a material adverse effect on the consolidated financial statements. There were also certain actions alleging malpractice. These actions are covered under the QHS self-insurance program for general and professional liability exposure (note 5).

At June 30, 2017, QHS had commitments for facilities construction and equipment purchases for approximately $53,058.

QMC has collective bargaining agreements with the Hawaii Nurses Association (HNA) and the Teamsters Union. The HNA agreement covers approximately 1,800 employees and expires in February 2018. The Teamsters Union agreement covers approximately 800 employees and expires in June 2019.

MGH and NHCH have collective bargaining agreements with United Public Workers and HNA, respectively. These agreements cover a total of approximately 100 employees and expires in July 2018 and March 2019, respectively.

(11) Subsequent Events

QHS has evaluated subsequent events from the balance sheet date through October 19, 2017, the date at which the consolidated financial statements were issued, and determined that there are no items to disclose.

Schedule 1

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Balance Sheet Information
for the Members of The Queen's Health Systems Credit Group

June 30, 2017

(In thousands)

Assets

Current assets:		
Cash and cash equivalents	$	51,562
Receivables – net		221,372
Due from affiliates		6,138
Inventories		19,965
Investments		812,922
Assets whose use is limited or restricted – current		14,116
Deferred income tax asset – current		1,783
Prepaid expenses and other current assets		14,236
Total current assets		1,142,094
Investments – less current portion		50,413
Assets whose use is limited or restricted – less current portion		63,577
Land, buildings, and equipment – net		532,539
Investments in affiliates		7,163
Goodwill		7,619
Deferred income tax asset – less current portion		9,499
Due from affiliates – noncurrent		14,568
Beneficial interests in trusts		108,821
Other assets		16,941
Total	$	1,953,234

(Continued)

Schedule 1

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Balance Sheet Information
for the Members of The Queen's Health Systems Credit Group

June 30, 2017

(In thousands)

Liabilities and Net Assets

Current liabilities:		
Accounts payable and other accrued liabilities	$	97,335
Accrued salaries and benefits		64,775
Other current liabilities		16,562
Due to government reimbursement programs – current		6,037
Short-term and long-term debt – current		9,386
Long-term debt subject to short-term remarketing arrangements		103,380
Due to affiliates		24,812
Total current liabilities		322,287
Long-term debt – less current portion		372,893
Pension and postretirement liabilities		223,099
Due to government reimbursement programs – less current portion		14,952
Other long-term liabilities		40,644
Total liabilities		973,875
Net assets:		
Unrestricted		836,179
Temporarily restricted		28,712
Permanently restricted		114,468
Total net assets		979,359
Total	$	1,953,234

This balance sheet information of the Members of The Queen's Health Systems Credit Group (Credit Group) include the accounts of The Queen's Health Systems (Parent), The Queen's Medical Center, Queen's Development Corporation, Diagnostic Laboratory Services, Inc., Molokai General Hospital, and North Hawaii Community Hospital, each of which are members of the Credit Group, as defined in the Master Trust Indenture executed in 2015. Pursuant to the Master Trust Indenture and related agreements, the combined Credit Group financial statement information is presented as of and for the year ended June 30, 2017. Certain organizations controlled by the Parent are not members of the Credit Group. This combined balance sheet information does not include the accounts of these nonobligated, controlled affiliates and, accordingly, is not presented in accordance with U.S. generally accepted accounting principles. This combined balance sheet information is included for additional analysis and is not a required part of the basic 2017 consolidated financial statements. It should be read in conjunction with the 2017 consolidated financial statements of The Queen's Health Systems and subsidiaries.

See accompanying independent auditors' report.

Schedule 2

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Statement of Operations and Changes in Net Assets Information
for the Members of The Queen's Health Systems Credit Group

Year ended June 30, 2017

(In thousands)

Unrestricted operating revenues:	
Net patient service revenues	$ 1,142,464
Rental revenues	15,643
Other	48,201
Total unrestricted operating revenues	1,206,308
Net assets released from restrictions	12,056
Total unrestricted operating revenues and other support	1,218,364
Unrestricted operating expenses:	
Salaries, wages, and employee benefits	712,811
Supplies	222,920
Purchased services	108,110
Professional fees	62,544
Depreciation and amortization	55,756
Rent and utilities	30,743
Sustainability fees and taxes – other than income taxes	26,808
Interest	19,617
Other	38,697
Total unrestricted operating expenses	1,278,006
Operating loss	(59,642)
Nonoperating income (expense):	
Investment income, net	88,958
Income tax expense	(3,444)
Gain on interest rate swap	9,568
Net assets released from restrictions	375
Other expense	347
Total nonoperating income, net	95,804
Excess of revenues over expenses, carried forward	36,162

(Continued)

Schedule 2

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Statement of Operations and Changes in Net Assets Information
for the Members of The Queen's Health Systems Credit Group

Year ended June 30, 2017

(In thousands)

Excess of revenues over expenses, brought forward	$	36,162
Other changes:		
Net assets released from restrictions for capital expenditures		380
Net unrealized gain on investments		11,806
Pension related changes other than net periodic pension cost		38,438
Transfers from affiliates and other changes, net		29,905
Total other changes		80,529
Increase in unrestricted net assets		116,691
Temporarily restricted net assets:		
Gifts and grants		7,693
Investment gains, net		2,355
Net assets released from restrictions used for operating expenses		(11,760)
Net assets released from restrictions used for nonoperating and capital expenditures		(755)
Transfers from affiliates, net		7,164
Other changes, net		29
Increase in temporarily restricted net assets		4,726
Permanently restricted net assets:		
Cash distributions from perpetual trusts		(296)
Other changes, net		233
Decrease in permanently restricted net assets		(63)
Increase in net assets		121,354
Net assets – beginning of year		858,005
Net assets – end of year	$	979,359

This combined statement of operations and changes in net assets information of the Members of The Queen's Health Systems Credit Group (Credit Group) include the accounts of The Queen's Health Systems (Parent), The Queen's Medical Center, Queen's Development Corporation, Diagnostic Laboratory Services, Inc., Molokai General Hospital, and North Hawaii Community Hospital, each of which are members of the Credit Group, as defined in the Master Trust Indenture executed in 2015. Pursuant to the Master Trust Indenture and related agreements, the combined Credit Group financial statement information is presented as of and for the year ended June 30, 2017. Certain organizations controlled by the Parent are not members of the Credit Group. This combined statement of operations and changes in net assets information does not include the accounts of these nonobligated, controlled affiliates and, accordingly, is not presented in accordance with U.S. generally accepted accounting principles. This combined statement of operations and changes in net assets information is included for additional analysis and is not a required part of the basic 2017 consolidated financial statements. It should be read in conjunction with the 2017 consolidated financial statements of The Queen's Health Systems and subsidiaries.

See accompanying independent auditors' report.

SCHEDULE 2

List of Obligated Persons

The Queen's Health Systems
The Queen's Medical Center
Molokai General Hospital
North Hawaii Community Hospital