Appendix 9-A

Case Example Audited Financial Statement

Combined Financial Statements

Harris Memorial Hospital and Harris Community Foundation

Years Ended December 31, 20X7 and 20X6

Contents

Report of Independent Auditors—Pennypacker & Vandelay, LLC

The Board of Trustees
Harris Memorial Hospital and
Harris Community Foundation

We have audited the accompanying combined balance sheets of Harris Memorial Hospital and Harris Community Foundation and subsidiaries (the Foundation) as of December 31, 20X7 and 20X6, and the related combined statements of operations, changes in net assets, and cash flows for the years then ended.

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

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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 our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making this risk assessment, we consider internal control relevant to the Foundation'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 Foundation'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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Harris Memorial Hospital and Harris Community Foundation and subsidiaries at December 31, 20X7 and 20X6, and the combined changes in their net assets and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

TABLE 9A-1 Harris Memorial Hospital and Harris Community Foundation Combined Balance Sheets (in Thousands)

	December 31, 20X7	December 31, 20X6
Assets		
Current assets		
Cash and cash equivalents	**$82,815**	$59,696
Assets limited as to use, current portion	**5,327**	5,088
Accounts receivable		
Patients, less allowance for doubtful accounts ($25,302 in 20X7 and $23,014 in 20X6)	**70,025**	59,939
Other	**28,990**	24,995
Supplies	**7,078**	6,663
Total current assets	**194,235**	156,381
Assets limited as to use		
For donor-restricted purposes	**84,440**	67,826
Board designated for specific purposes	**382,835**	378,413
Held by trustees under bond agreements	**51,038**	25,937
	518,313	472,176
Less current portion	**5,327**	5,088
	512,986	467,088
Property and equipment, net	**563,349**	458,829
Other assets	**34,476**	34,302
Total assets	**$1,305,046**	$1,116,600
Liabilities and net assets		
Current liabilities		

Accounts payable	**$32,572**	$24,631
Accrued expenses and other liabilities	**58,878**	53,725
Due to third-party payers	**7,380**	12,633
Current maturities of long-term debt	**4,692**	5,908
Total current liabilities	**103,522**	96,897
Long-term debt, less current maturities	**439,597**	332,354
Contingent professional liabilities	**33,260**	48,487
Due to broker	**15,128**	19,608
Other liabilities	**20,713**	5,298
Postretirement benefit obligation, other than pensions	**8,207**	7,694
Total liabilities	**620,427**	510,338
Net assets		
Unrestricted	**600,179**	538,436
Temporarily restricted	**55,213**	40,393
Permanently restricted	**29,227**	27,433
Total net assets	**684,619**	606,262
Total liabilities and net assets	**$1,305,046**	$1,116,600

TABLE 9A-2 Harris Memorial Hospital and Harris Community Foundation Combined Statements of Operations (in Thousands)

	December 31, 20X7	December 31, 20X6
Operating revenues and other support		
Net patient service revenue	**$829,005**	$774,662
Provision for doubtful accounts	**(55,851)**	(57,975)
Net patient service revenue less provision for doubtful accounts	**773,154**	716,687
Other operating revenue	**27,055**	29,334
Total operating revenue	**800,209**	746,021

(continues)

TABLE 9A-2 Harris Memorial Hospital and Harris Community Foundation Combined Statements of Operations (in Thousands) *(continued)*

Operating expenses		
Salaries and wages	**$371,449**	$329,668
Employee benefits	**81,532**	77,231
Supplies and purchased services	**228,244**	225,497
Advertising	**3,072**	2,376
Staff enrichment	**10,767**	8,591
Occupancy cost	**14,346**	13,442
Depreciation	**44,392**	41,627
Interest	**10,974**	6,145
Operating expenses	**764,776**	704,577
Excess of revenue over expenses	**35,433**	41,444
Nonoperating gains (losses)		
Contributions, gifts, and bequests	**3,189**	1,318
Net assets released from restrictions for research expenditures	**14,070**	14,474
Research, education, and other nonoperating expenses	**(22,980)**	(24,773)
Change in interest rate swap value and put agreements	**1,578**	9,397
Investment income	**30,453**	18,402
	26,310	18,818
Excess of revenues and gains over expenses and losses	**$61,743**	$60,262

TABLE 9A-3 Harris Memorial Hospital and Harris Community Foundation Combined Statements of Changes in Net Assets (in Thousands)

	December 31, 20X7	December 31, 20X6
Unrestricted net assets		
Excess of revenues and gains over expenses and losses	**$61,743**	$60,262
Net assets released from restrictions for capital expenditures	—	119

Cumulative effect of change in accounting principle	—	(3,943)
Increase in unrestricted net assets	**61,743**	56,438
Temporarily restricted net assets		
Contributions, gifts, and bequests	**20,435**	15,512
Investment income	**8,455**	3,972
Net assets released from restrictions for research expenditures	**(14,070)**	(14,474)
Net assets released from restrictions for capital expenditures	—	(119)
Increase in temporarily restricted net assets	**14,820**	4,891
Permanently restricted net assets		
Contributions, gifts, and bequests	**1,794**	3,218
Increase in permanently restricted net assets	**1,794**	3,218
Net assets at beginning of year	**606,262**	541,715
Net assets at end of year	**$684,619**	$606,262

TABLE 9A-4 Harris Memorial Hospital and Harris Community Foundation Combined Statements of Cash Flows (in Thousands)

	December 31, 20X7	December 31, 20X6
Operating activities		
Increase in net assets	**$78,357**	$64,547
Adjustments to reconcile increase in net assets to net cash provided by operating activities		
Change in net unrealized gains and losses on investment securities	**(26,358)**	11,432
Cumulative effect of change in accounting principle	—	(3,943)
Depreciation	**44,392**	41,627
Gain on sale or disposal of assets, net	**(6,119)**	—
Provision for bad debts	**55,851**	57,975
Change in interest rate swap value and put agreements	**(1,578)**	(9,397)

(continues)

TABLE 9A-4 Harris Memorial Hospital and Harris Community Foundation Combined Statements of Cash Flows (in Thousands) *(continued)*

	December 31, 20X7	December 31, 20X6
Changes in operating assets and liabilities		
Assets limited as to use	(19,779)	(14,274)
Accounts receivable	(65,937)	(51,251)
Other assets	(7,071)	(43)
Supplies	(415)	840
Accounts payable	7,941	10,613
Accrued expenses and other liabilities	20,568	8,430
Due to third-party payers	(5,253)	(4,877)
Contingent professional liabilities	(15,227)	3,743
Postretirement benefit obligation, other than pensions	513	456
Net cash provided by operating activities	59,885	115,878
Investing activities		
Property and equipment acquired	(142,793)	(159,943)
Cash used in investing activities	(142,793)	(159,943)
Financing activities		
Repayment of long-term debt	(177,294)	(5,545)
Proceeds from borrowing	283,321	57,614
Net cash provided by financing activities	106,027	52,069
Net increase in cash and cash equivalents	23,119	8,004
Cash and cash equivalents at beginning of year	59,696	51,692
Cash and cash equivalents at end of year	$82,815	$59,696

Harris Memorial Hospital and Harris Community Foundation

Notes to Combined Financial Statements
December 31, 20X7

1. Organization and Significant Accounting Policies

Organization and Basis of Combination

Harris Memorial Hospital (the Hospital) and Harris Community Foundation (the Foundation) are a hospital and charitable foundation located in Jersey, Ohio. The Hospital and Foundation are exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (IRC). The Hospital and Foundation are collectively referred to herein as the Foundation.

The Foundation owns and operates the Renee Center, which has 27 skilled nursing beds; Harris Assurance, Ltd. (Assurance), a for-profit, wholly owned insurance subsidiary; and Harris Properties (Condit Inn), a for-profit, wholly owned subsidiary. During 20X6, the Foundation formed the Harris Community Hospital Corporation (dba Harris Hospital) located in Oldstone, Ohio and the Harris Long Term Acute Care Hospital Corporation (dba Harris Continuing Care Hospital) located in Jersey, Ohio. The 60-bed Harris Continuing Care Hospital opened in May 20X7. Harris Hospital, with 92 beds, opened in late July 20X7. At December 31, 20X7, the Foundation has remaining commitments totaling approximately $7,360,000 under construction contracts for these and other capital projects.

The Foundation is affiliated with the Harris Health Plan (the Health Plan). The Health Plan's financial statements are not included in these combined financial statements. The Foundation provides healthcare services in the central Ohio region. All appropriate intercompany accounts have been eliminated in combination.

Cash Equivalents

The Foundation considers all undesignated highly liquid investments with maturities of 3 months or less when purchased to be cash equivalents.

Supplies

Supplies are stated at cost (first-in, first-out method), which is not in excess of market value.

Patient Accounts Receivable

Patient accounts receivable are stated at estimated net realizable value. Significant concentrations of patient accounts receivable were 20% and 19% at December 31, 20X7 and 20X6, respectively, from government-related programs. Patient accounts receivable from the Health Plan were 25% and 29% at December 31, 20X7 and 20X6, respectively.

The Foundation maintains allowances for uncollectable accounts for estimated losses resulting from a payer's inability to make payments on accounts. The Foundation uses a balance sheet approach to value the allowance account based on historical write-offs, payer type, and the aging of the accounts. Accounts are written off when collection efforts have been exhausted. Management continually monitors and adjusts, as necessary, allowances associated with its receivables. The majority of uncollectable accounts are from uninsured and the patient portion of accounts receivable.

Assets Limited as to Use

Assets limited as to use at December 31, 20X7, include 76% and 9% held under master trust agreements with Liberty Eagle Trust and Highbanks, respectively, and 15% held in government-insured time deposits and other financial instruments. Assets limited as to use at December 31, 20X6, include 78% and 5% held under master trust agreements with Liberty Eagle Trust and Highbanks, respectively, and 17% held in government-insured time deposits and other financial instruments. The investments held under the master trust agreements are diversified among equity, debt, and money market instruments and are reported at estimated fair value. The fair value of these investments is generally based on quoted market prices on national exchanges.

Property and Equipment

Property and equipment are recorded at cost at the date of acquisition or estimated fair value at the date of donation. Depreciation is computed on the straight-line method using the estimated economic lives of the depreciable assets, generally ranging from 3 to 40 years. Expenditures that materially increase values, change capacities, or extend useful lives are capitalized. Routine maintenance and repair items are charged to operating expenses.

The Foundation evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the remaining balance of an asset may not be recoverable. The assessment of possible impairment is based on whether the carrying amount of the asset exceeds the expected total undiscounted value of cash flows expected to result from the use of the assets and their eventual disposition. No amounts were recognized in 20X6.

In 20X7, the Foundation recorded a charge of $4,000,000, net of reimbursement, for unrecoverable costs incurred in connection with repair and maintenance costs of the Condit Inn.

Derivative Financial Instruments

The Foundation accounts for its derivatives under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities,* or SFAS No. 133. SFAS No. 133 requires that all derivative financial instruments that qualify for hedge accounting be recognized in the financial statements and measured at fair value regardless of the purpose or intent for holding them. Changes in the fair value of derivative financial instruments are recognized periodically either in operations or in changes in unrestricted net assets. The Foundation's policy is to not hold or issue derivatives for trading purposes and to avoid derivatives with leverage features.

Restricted Support

The Foundation records unconditional promises of cash or other assets at estimated fair value on the date the promises are received. The Foundation reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or a purpose of restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the combined statements of operations or combined statements of changes in net assets (based on nature of restriction) as net assets released from restrictions.

The Foundation reports gifts of land, buildings, and equipment as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. The Foundation reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

Permanently restricted net assets have been restricted by donors to be maintained by the Foundation in perpetuity. The income from permanently restricted net assets is recorded as unrestricted unless explicitly restricted by donors. Donor-restricted income on permanently restricted net assets is generally available to support research and education and is reported as temporarily restricted.

The Foundation's temporarily restricted net assets are restricted primarily for research, education, capital projects, and medical care programs and its permanently restricted net assets are primarily restricted for endowment purposes.

Net Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payers, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Charity Care

The Foundation provides care without charge or at amounts less than its established rates to patients who meet certain criteria under its charity policy. Because the Foundation does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Hospital charges foregone for charity care, based on established rates, were approximately $35,200,000 in 20X7, prior to application of disproportionate share funds of approximately $4,800,000 received from the State of Ohio, and $35,300,000 in 20X6, prior to application of disproportionate share funds of approximately $5,800,000 received from the State of Ohio. Clinic charges forgone for charity care, based on established rates, were $12,525,000 and $10,216,000 in 20X7 and 20X6, respectively.

Health Insurance Program Reimbursement

Revenue from the Medicare and Medicaid programs accounted for approximately 45% and 8%, respectively, of the Foundation's net patient service revenue for the year ended December

31, 20X7, and 51% and 11%, respectively, for the year ended December 31, 20X6. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and are subject to interpretation. Federal regulations require the submission of annual cost reports covering medical costs and expenses associated with services provided to program beneficiaries. Medicare and Medicaid cost report settlements are estimated in the period services are provided to beneficiaries. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 20X7 and 20X6 net patient service revenue increased (decreased) approximately $10,340,000 and $(1,332,000), respectively, due to changes in allowances previously estimated as a result of the final settlements for years that are no longer subject to audits, reviews, and investigations. The Foundation believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing.

Medicare cost reports filed by the Hospital for all years before 20X4 have been audited and settled as of December 31, 20X7. Medicare cost reports filed by the Clinic for all years before 20X0 have been audited and settled as of December 31, 20X7. Amounts due to the Medicare and Medicaid programs totaled approximately $7,380,000 and $12,633,000 at December 31, 20X7 and 20X6, respectively, and are included in due to third-party payers in the accompanying combined balance sheets.

Nonoperating Gains and Losses

Nonoperating gains and losses include unrestricted contributions, gifts and bequests, interest earnings on investments, net assets released from restrictions for research and education expenditures (net of contributions for such expenditures), change in interest rate swap value and put agreements, and other gains and losses unrelated to the Foundation's primary operations.

Excess of Revenues and Gains over Expenses and Losses

Included in excess of revenues and gains over expenses and losses in the accompanying combined statements of operations are all changes in unrestricted net assets other than net assets released from restrictions for capital expenditures, unrealized gains and losses on investments other than trading investment securities, and investment returns restricted by donors.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the combined financial statements and accompanying notes. Actual results could differ from those estimates.

Other

Certain reclassifications of donor trust liabilities, previously included in assets limited as to use, were made to the 20X6 combined financial statements to conform to the 20X7 presentation.

Additionally, in previous years, the Foundation's investment portfolio (see Note 7) was classified as other than trading. As such, unrealized gains and losses that were considered temporary were excluded from excess of revenues and gains over expenses and losses. During fiscal year 20X7, the Foundation determined that substantially all of its investment portfolio was more accurately classified as trading with unrealized gains and losses included in excess of revenues and gains over expenses and losses. Therefore, a reclassification was made in the accompanying 20X6 combined financial statements to reflect this change in classification. A net unrealized loss of approximately $9,183,000 was reclassified from change in net unrealized gains and losses on investment securities to investment income.

2. **Contingent Professional Liabilities**

The Foundation self-insures substantially all of its professional liability risk through its wholly owned insurance subsidiary. A commercial insurance policy is maintained to insure claims exceeding $7,000,000 individually or $35,000,000 in the aggregate in 20X7 on a claims-made basis. Contingent professional liabilities are recorded for incurred but not reported claims and reported claims based on estimates by independent actuaries. Management established a fund for the purpose of setting aside assets based on estimates made by independent actuaries, and these funds are reported in the combined balance sheets as assets limited as to use.

3. **Property and Equipment**

TABLE 9A-5 Property and Equipment and Related Accumulated Depreciation (in Thousands)

	December 31, 20X7	December 31, 20X6
Land and improvements	**$26,945**	$26,610
Buildings and improvements expenditures	**447,897**	265,965
Fixed and movable equipment	**469,441**	427,882
Construction-in-progress	**112,880**	189,807
	1,057,163	910,264
Less accumulated depreciation	**493,814**	451,435
	$563,349	$458,829

4. **Long-Term Debt**

In July 20X7, the Foundation issued the Series 20X7 LTACH Revenue Bonds totaling $15,700,000. The Series 20X7 LTACH Revenue Bonds are due July 20X2 with principal and interest payments due monthly. Interest accrues at 65% of LIBOR plus 100 basis points. Effective with the issuance of the bonds, the Foundation entered into a fixed rate swap agreement for the amount of the bonds by which the Foundation pays a fixed rate of interest of 4.55%. The change in fair value for the period ended December 31, 20X7 was not significant to the increase in net assets.

In November 20X6, the Foundation issued Series 20X6 Revenue Bonds with a par amount of $233,350,000. Proceeds were used to advance refund $31,280,000 of the Series 20X0A Revenue Bonds, current refund $58,410,000 of the Series 20X1 Revenue Bonds, and finance and/or refinance expansion projects. The Series 20X6 Bonds were issued as Auction Rate Securities and generally bear interest for successive 7-day auction periods at interest rates determined through Dutch auctions on the business day preceding the auction period. Any series or subseries of the Series 20X6 Revenue Bonds may be converted at the option of the Foundation, subject to certain restrictions, to bonds that bear interest in different rate periods, including daily, weekly, flexible, term, or fixed rate periods. The Series 20X6 Revenue Bonds contain certain restrictive covenants, including minimum levels of debt service coverage. Management believes the Foundation is in compliance with all covenants.

TABLE 9A-6 Long-Term Debt (in Thousands)

	December 31, 20X7	December 31, 20X6
Revenue bonds, LTACH Series 20X7; interest at 65% of LIBOR plus100 basis points (4.647% at December 31, 20X7); principal and interest payable monthly through July 20X2	**$15,679**	$—
Revenue bonds, Series 20X6A-1; interest accrues for successive 7-day auction periods at interest rates determined through Dutch auctions (3.800% at December 31, 20X7)	**42,375**	—
Revenue bonds, Series 20X6A-2; interest accrues for successive 7-day auction periods at interest rates determined through Dutch auctions (3.800% at December 31, 20X7)	**42,400**	—

Revenue bonds, Series 20X6B; interest accrues for successive 7-day auction periods at interest rates determined through Dutch auctions (3.850% at December 31, 20X7)	**56,550**	—
Revenue bonds, Series 20X6C; interest accrues for successive 7-day auction periods at interest rates determined through Dutch auctions (3.850% at December 31, 20X7)	**55,275**	—
Revenue bonds, Series 20X6D; interest accrues for successive 7-day auction periods at interest rates determined through Dutch auctions (3.900% at December 31, 20X7)	**36,750**	—
Revenue bonds, Series 20X1; interest accrues at a daily rate determined by the remarketing agent (3.960% at December 31, 20X7); interest and principal payable annually through 20X1 (principal payments began in 20X6)	**90,360**	151,800
Revenue bonds, Series 20X0A; interest at 5.375%; interest and principal payable annually through 20X9	**2,700**	35,230
Revenue bonds, Series 20X0B; interest accrues at a daily rate determined by the remarketing agent (3.960% at December 31, 20X7); interest and principal payable annually through 20X9	**83,200**	84,500
Line of credit	**19,000**	46,686
Interim construction loan	**—**	7,000
Other	**—**	13,046
	444,289	338,262
Less current maturities	**4,692**	5,908
	$439,597	$332,354

In January 20X6, the Foundation entered into a revolving line of credit with Bank of Central Ohio to fund interim construction costs and provide for liquidity and other short-term needs. In accordance with terms of the loan agreement, the total available for borrowing was decreased from $70,000,000 to $30,000,000 30 days following the issuance of the Series 20X6 Revenue Bonds. The total amount drawn as of December 31, 20X7 was $19,000,000. Interest is payable quarterly at a rate equal to the lesser of the maximum lawful rate or LIBOR plus 15 basis points (5.71% at December 31, 20X7). Amounts drawn are due in full June 25, 20X9.

The Foundation issued Series 20X1 Revenue Bonds with a par amount of $158,000,000 that were partially refunded in November 20X6. The net proceeds were used to fund expansion projects.

The Foundation issued Series 20X0A Revenue Bonds with a par amount of $42,025,000 that were partially refunded in November 20X6 and Series 20X0B Revenue Bonds with a par amount of $91,200,000. The majority of the proceeds from the Series 20X0A and Series 20X0B Revenue Bonds were used to refund the current Series 19X8 Revenue Bonds with an outstanding balance of $19,147,000 and a note payable with an outstanding par amount of $88,000,000.

The Series 20X0A and Series 20X0B Revenue Bonds and the Series 20X1 Revenue Bonds contain certain restrictive covenants, including minimum levels of debt service coverage. Management believes the Foundation is in compliance with all covenants.

The Series 20X0B Revenue Bonds and the Series 20X1 Revenue Bonds are variable rate bonds in a daily mode and can be tendered by holders upon demand. A remarketing agent selected by the Foundation determines the interest rates and remarkets both series of bonds. The Series 20X0B Revenue Bonds and the Series 20X1 Revenue Bonds are supported by Standby Bond Purchase Agreements (the Agreements) with liquidity providers pursuant to which the providers will purchase any bonds the remarketing agent is unable to market. The termination date of the two Agreements related to the Series 20X0B Revenue Bonds was December 6, 20X7. On October 18, 20X7, these Agreements were extended to December 4, 20X8. There are also two Agreements associated with the Series 20X1 Revenue Bonds. The termination date of the first Agreement related to the Series 20X1 Revenue Bonds was December 6, 20X7, and on October 18, 20X7, was extended to December 4, 20X8. The termination date of the second Agreement related to the Series 20X1 Revenue Bonds is December 15, 20X5, as extended in November 20X4. All Agreements include covenants that are customary in credit agreements of this nature. Repayment of bonds purchased under the Agreements is subject to a 5-year payout beginning July 20X6, if other liquidity facilities, as defined in the bond agreements, are not executed. The maturities of long-term debt, net of unamortized premium, as of December 31, 20X7, are shown below (in thousands):

20X8	$4,692
20X9	23,902
20X0	5,136
20X1	5,353
20X2	19,896
Thereafter	385,310
	$444,289

Total interest costs incurred during fiscal 20X7 and 20X6 were $16,779,140 and $9,339,000 respectively, including $5,805,140 and $3,194,000 of capitalized interest costs in 20X7 and 20X6, respectively. Interest paid during fiscal 20X7 and 20X6 was $16,937,249 and $9,084,500, respectively, net of amounts capitalized.

5. **Concentrations of Credit Risk**

Harris Memorial grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payer agreements. The mix of receivables from patients and third-party payers was as follows:

TABLE 9A-7 Mix of Receivables

	December 31, 20X7	December 31, 20X6
Medicare	**21%**	19%
Medicaid	**2**	2
Major payer 1	**15**	15
Major payer 2	**11**	11
Major payer 3	**11**	13
Other third-party payers	**28**	28
Private pay	**12**	12
Total	**100%**	100%

6. **Interest Rate Swap Agreements**

Effective December 20X1, the Foundation entered into an interest rate swap agreement with an initial notional amount of $150,000,000. The interest rate swap agreement converts a notional amount of $150,000,000 of floating rate borrowings to fixed rate borrowings. The Foundation pays a fixed rate of interest (5.17%) and receives, from the counterparty, a variable rate of interest based on the SIFMA Municipal Swap Index (SIFMA Index) on the outstanding principal balance of the Series 20X1 Revenue Bonds until 2031. The Foundation has elected not to apply hedge accounting; therefore, the change in fair value is included in nonoperating (gains) losses. The fair value of the interest rate swap at December 31, 20X7 and 20X6, is a liability of approximately $9,498,000 and $16,530,000, respectively, and is included in due to broker in the accompanying combined balance sheets. The change in the fair value of the interest rate swap is included in nonoperating gains (losses) and totaled approximately $(7,032,000) and $(6,885,000) for the years ended December 31, 20X7 and 20X6, respectively. The change in fair value for the year ended December 31, 20X7 includes the amendment fee paid to the counterparty of $7,037,000, realized as a part of the Series 20X1 Revenue Bond refunding.

Simultaneous with entering into the interest rate swap agreement, the Foundation also entered into a put agreement with the counterparty. The counterparty may exercise this put agreement if the daily weighted average of the SIFMA Index is greater than 7.00% for the 180-day period ending on the day the counterparty exercises the put option. Under this agreement, the Foundation pays a variable rate of interest, based on the SIFMA Index, on the outstanding principal balance of the proposed bonds until 2031. For this put agreement, the counterparty pays the Foundation an annual premium of 77.30 basis points on an initial notional amount of $150,000,000 over the term of the put agreement, for a net effective combined annual payment by the Foundation to the counterparty for the swap agreement and the put agreement of approximately 4.39%. The premium payment, however, will cease upon exercise of the put agreement. This put agreement, if exercised, will offset the cash flows of the interest rate swap agreement noted above. The fair value of the put agreement at December 31, 20X7 and 20X6, is an asset of $4,200,000 and $7,016,000, respectively, and has been included in other assets. The change in the fair value of $(2,816,000) and $(552,000) for the years ended December 31, 20X7 and 20X6, respectively, has been included in nonoperating gains (losses) since the put agreement is not a hedge and must be adjusted to fair value through the performance indicator. A portion of the change in fair value for the year ended December 31, 20X7 includes the amount related to the partial refunding of the Series 20X1 Revenue Bonds. The amendment fee received from the counterparty was $2,005,000.

On October 30, 20X2, the Foundation entered into an interest rate swap agreement with an initial notional amount of $96,400,000 ($88,400,000 Series 20X0A and Series 20X0B and $8,000,000 Series 20X1). The interest rate swap agreement converts a notional amount of $96,400,000 of floating rate borrowings to fixed rate borrowings. The Foundation pays a fixed rate of interest (4.34)% and receives, from the counterparty, a variable rate of interest based on the SIFMA Index on the outstanding principal balance of the Revenue Bonds until 2031. The Foundation has elected not to apply hedge accounting; therefore, the change in fair value is included in nonoperating (gains) losses. The fair value of the interest rate swap at December 31, 20X7 and 20X6, is a liability of approximately $3,020,000 and $3,078,000, respectively, and is included in due to broker in the accompanying combined balance sheets. The change in the fair value of the interest rate swap is included in nonoperating gains (losses) and totaled approximately $(58,000) and $(3,639,000) for the years ended December 31, 20X7 and 20X6, respectively. The change in fair value includes the amendment fee of $176,000 paid to the counterparty to terminate the portion of the interest rate swap agreement associated with the Series 20X1 Revenue Bonds. Simultaneous with entering into the interest rate swap agreement, the Foundation also entered into a put agreement with the counterparty. The counterparty may exercise this put agreement if the daily weighted-average of the SIFMA Index is greater than 6.00% for the 180-day period ending on the day the counterparty exercises the put option. Under this agreement, the Foundation pays a variable rate of interest, based on the SIFMA Index, on the outstanding principal balance of the related bonds until 2031. For this put agreement, the counterparty pays the Foundation an annual premium of 110.10 basis points on an initial notional amount $96,400,000 over the term of the put agreement, for a net effective combined annual payment by the Foundation to the counterparty for the swap agreement and the put agreement of approximately 3.24%. The premium payment, however, will cease upon exercise of the put agreement. This put agreement, if exercised, will offset the cash flows of the interest rate swap agreement noted above. The fair value of the put agreement at December 31, 20X7 and 20X6, is an asset of approximately $4,970,000 and $5,056,000, respectively, and has been included in other assets. This change in fair value of $(86,000) and $(575,000) for the years ended December 31, 20X7 and 20X6, respectively, has been included in nonoperating gains (losses) since the put agreement is not a hedge and must be adjusted to fair value through the performance indicator. The change in fair value includes the amendment fee of $198,000 received from the counterparty to terminate the portion of the put agreement associated with the Series 20X1 Revenue Bonds.

In anticipation of the issuance of the Series 20X6 Bonds, the Foundation entered into five interest rate swap transactions in October 20X6 with an initial notional amount totaling $233,350,000.

The swap transactions serve to substantially fix the expected net interest expense associated with the Series 20X6 Bonds by converting floating rate borrowings with a notional amount of $233,350,000 to fixed rate borrowings. For the swaps related to the Series 20X6A and 20X6B Bonds, the Foundation pays a fixed rate of 3.502% per annum, and the counterparty pays a variable rate of interest at a rate equal to 57.4% of the 1-month LIBOR rate plus a spread of 0.33%. For the swaps related to the Series 20X6C Bonds and 20X6D Bonds, the Foundation pays a fixed rate of 3.496% per annum, and the counterparty pays a variable rate of interest at a rate equal to 57.4% of the 1-month LIBOR rate plus a spread of 0.33%.

The Foundation has elected not to apply hedge accounting; therefore, the change in fair value is included in nonoperating (gains) losses. The fair value of the interest rate swaps at December 31, 20X7 is a liability of approximately $2,610,000, which equates to the change in fair value from inception of the swaps through the year ended December 31, 20X7.

The Foundation can terminate any of these agreements at any time at current market value. The Foundation would make or receive a payment depending on market value on the date of termination.

The Foundation is exposed to credit losses in the event of nonperformance by the counterparty to the agreements. The counterparty is a creditworthy financial institution, and the Foundation anticipates that the counterparty will be able to fully satisfy its obligation under the agreements.

7. Pension Plans

The Foundation implemented a 401(a) defined contribution plan and a 403(b) voluntary savings plan covering substantially all employees. The Foundation contributes from 6% to 13% of participating employees' compensation. Prior to January 1, 20X6, the Foundation's contributions were based on participating employees' age. The plan was amended January 1, 20X6 and these contributions are now based on years of service. The Foundation's contribution expense was approximately $28,495,000 and $26,121,000 in 20X7 and 20X6, respectively.

The Foundation sponsors a defined benefit postretirement plan that provides medical and dental benefits to retirees who meet specific eligibility requirements upon termination of active service. The plan is unfunded and requires covered retirees to contribute a portion of the cost of benefits. The Foundation uses an incremental cost approach in estimating the annual accrued cost related to postretirement benefits other than pensions, which is based on estimates by independent actuaries. Such an approach is considered appropriate since substantially all of the healthcare benefits are provided by the Foundation to retirees, using the Health Plan to manage the care provided. Plan expenses incurred by the Foundation were $880,000 and $822,000 for the years ended December 31, 20X7 and 20X6, respectively.

8. Assets Limited as to Use

Certain cash and investments, where their use is limited due to board designations or other purposes as set forth below, are reported as assets limited as to use. The carrying values (in thousands) are at estimated fair values, which are summarized in **TABLE 9A-8**.

TABLE 9A-8 Assets Limited as to Use

	December 31, 20X7	December 31, 20X6
Assets limited as to use and long-term investments		
For donor-restricted purposes, such as research, lectureships, and capital projects	**$84,440**	$67,826
Board designated for specific purposes		
Funded depreciation	**133,028**	118,618

Contingent professional liabilities	**33,357**	46,566
Institutional research	**18,072**	16,241
Investments held by subsidiary	**19,925**	16,019
Other board designated	**178,453**	180,969
	382,835	378,413
Held by trustees under bond agreements	**51,038**	25,937
	518,313	472,176
Less current portion of assets limited as to use	**5,327**	5,088
	$512,986	$467,088

Investment income or loss is included in the excess of revenues and gains over expenses and losses, and includes realized and unrealized gains and losses, interest, and dividends.

TABLE 9A-9 The Foundation's Assets Limited as to Use at December 31 (in Thousands)

	December 31, 20X7	December 31, 20X6
Carried at fair value		
Money market accounts	**$83,900**	$58,833
Certificates of deposit	**1,651**	2,151
U.S. Treasury securities	**74,896**	75,195
Corporate debt securities	**53,412**	82,657
Equity securities	**304,454**	253,340
	518,313	472,176
Less current portion of assets limited as to use	**5,327**	5,088
	$512,986	$467,088

9. Commitments and Contingencies

The Foundation leases equipment and a medical office building under operating leases. These payments are due monthly through December 2012. Rent expense totaled approximately $7,426,000 and $8,715,000 in 20X7 and 20X6, respectively.

Future minimum lease commitments under operating leases that have initial or remaining lease terms in excess of 1 year are as follows as of December 31, 20X7 (in thousands):

20X8	$3,410
20X9	3,544
20X0	3,252
20X1	2,886
20X2	2,287
	$15,379

Sale of Medical Office Building

On December 29, 20X7, the Foundation sold a medical office building to Ross Acquisition of Alexandria (RA) for approximately $22,200,000. The building had a book value of approximately $10,900,000. The transaction included a ground lease with a term of 50 years and HR prepaid the rent totaling approximately $900,000. The Foundation entered into lease-back agreements for space within the building. The Foundation recognized an immediate gain of approximately $6,100,000 and a deferred gain of approximately $4,300,000 to be recognized over a period equal to the operating lease term.

Other

The Foundation is a defendant in various legal proceedings arising in the ordinary course of business. Although the results of litigation cannot be predicted with certainty, management believes the outcome of pending litigation will not have a material adverse effect on the Foundation's combined financial statements.

On February 21, 20X3, the Foundation entered into a 10-year Master Customer Agreement with COTC, for the provision of services, supplies, and equipment. The agreement provides a platform for the development of the Zuber Center as a fully integrated, all-digital facility. COTC will support the Foundation in five core areas: healthcare information technology applications and infrastructure, medical equipment, telecommunications power, and "smart" building technologies. The agreement provides for a commitment of approximately $200,000,000 from the Foundation to purchase certain goods and services at favorable prices. The Foundation has certain minimum yearly purchase commitments ranging from $10,000,000 to $25,000,000 over the 10-year term of the agreement. For the years ended December 31, 20X7 and 20X6, the Foundation purchased approximately $22,353,000 and $26,372,000, respectively, in goods and services from Siemens and affiliated companies, which exceeded the purchase commitments in those years. Goods and services purchased under the contract total approximately $137,400,000.

The Foundation invests in short-term instruments as part of its money management program. These instruments include short-term government securities and investment grade commercial paper. Generally, an investment firm on behalf of the Foundation manages these investments, and the Foundation has invested in a number of short-term investment grade commercial papers over the years. On October 29, 20X1, the Foundation sold approximately $10,000,000 in MGMTMatrix commercial paper prior to maturity. MGMTMatrix filed a voluntary petition for relief under Chapter 11 on February 17, 20X1. On October 6, 20X3, the Foundation learned that the bankruptcy counsel for MGMTMatrix filed, in U.S. Bankruptcy Court in the District of New York, an attempt to nullify the redemption of certain MGMTMatrix commercial paper including that divested by the Foundation. The case was settled in December 20X7 for approximately $3,900,000 and is included in accrued expenses and other liabilities in the accompanying combined balance sheets. The Foundation paid the settlement amount in October 20X7.

10. Fair Values of Financial Instruments

Generally accepted accounting principles established a framework for measuring fair value that provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

The three levels of the fair value hierarchy under Accounting Standards Codification (ASC) 820-10-50, Fair Value Measurement—Overall, are described here:

- Level 1: Valuation is based on quoted prices for identical instruments traded in active markets. Level 1 securities include primarily overnight repurchase agreements, money market funds, and mutual funds.
- Level 2: Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. At Level 2 securities include an unregistered mutual fund.
- Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Hospital's estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of discounted cash flow models and similar techniques. Level 3 securities include an equity fund limited partnership.

Fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Hospital maximizes the use of observable inputs and minimizes the use of unobservable inputs when developing fair value measurements.

Fair value measurements for assets and liabilities where there is limited or no observable market data and, therefore, are based primarily on estimates calculated by the Hospital, are based on the economic and competitive environment, the characteristics of the asset or liability and other factors. Therefore, the results cannot be determined with precision and may not be realized upon an actual settlement of the asset or liability. There may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows that could significantly affect the results of the current or future values.

The following methods and assumptions were used by the Foundation in estimating the fair value of its financial instruments:

Cash and cash equivalents: The carrying amount reported in the combined balance sheet for cash and cash equivalents approximates its fair value.

Investments: Fair values, which are the amounts reported in the combined balance sheet, are based on quoted market prices.

Interest rate swap agreements: Fair values, which are the amounts reported in the combined balance sheet as due to broker and other assets, are based on market rates.

Long-term debt: The carrying amount of the Foundation's borrowings under its revolving line of credit and auction rate security bond issues approximates fair value. The fair value of the Foundation's other long-term debt is estimated using discounted cash flow analyses, based on the Foundation's current incremental borrowing rates for similar types of borrowing arrangements.

11. Functional Expenses

The Foundation provides healthcare services to residents within its geographical service area.

TABLE 9A-10 The Carrying Amounts and Fair Values of the Foundation's Financial Instruments in the Combined Balance Sheets at December 31 (in Thousands)

	Carrying Amount	Fair Value
20X7		
Cash and cash equivalents	**$82,815**	$82,815
Assets limited as to use	**518,313**	518,313
Due to broker	**15,128**	15,128
Long-term debt	**444,289**	444,349
20X6		
Cash and cash equivalents	**$59,696**	$59,696
Assets limited as to use	**472,176**	472,176
Due to broker	**19,608**	19,608
Long-term debt	**338,262**	340,809

TABLE 9A-11 Expenses Related to Providing These Services for the Years Ended December 31, 20X7 and 20X6 (in Thousands)

	December 31, 20X7	December 31, 20X6
Healthcare services	**$619,596**	562,186
General and administrative	**143,293**	140,546
Fundraising	**1,887**	1,845
Total operating expenses	**$764,776**	704,577