



# KDHD

**King's Daughters' Health**

**CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 31, 2016 AND 2015**

*CPAs / ADVISORS*



**KING'S DAUGHTERS' HEALTH AND  
AFFILIATED ORGANIZATION**

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DECEMBER 31, 2016 AND 2015

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## REPORT OF INDEPENDENT AUDITORS

Board of Managers  
King's Daughters' Health  
and Affiliated Organization  
Madison, Indiana

### **Report on the Consolidated Financial Statements**

We have audited the accompanying consolidated financial statements of King's Daughters' Health and its affiliated organization (the "Hospital")(a nonprofit organization), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### **Management's Responsibility for the Consolidated Financial Statements**

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

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the 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 auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal 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.

Board of Managers  
King's Daughters' Health  
and Affiliated Organization  
Madison, Indiana

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 Hospital as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Blue & Co., LLC*

Louisville, Kentucky  
May 17, 2017

**KING'S DAUGHTERS' HEALTH AND  
AFFILIATED ORGANIZATION**

CONSOLIDATED BALANCE SHEETS  
DECEMBER 31, 2016 AND 2015

<b>ASSETS</b>	<u>2016</u>	<u>2015</u>
<b>Current assets</b>		
Cash and cash equivalents	\$ 20,980,469	\$ 16,607,672
Patient accounts receivable, net of allowance for doubtful accounts of \$8,244,223 in 2016 and \$7,957,642 in 2015	12,121,632	12,214,616
Inventories	2,464,740	2,580,826
Prepaid expenses and other current assets	1,954,972	1,649,618
Estimated third-party payor settlements	80,000	-0-
Other assets - current portion	<u>333,512</u>	<u>424,309</u>
Total current assets	37,935,325	33,477,041
<b>Assets whose use is limited</b>	97,587,760	85,108,293
<b>Property and equipment, net</b>	115,550,461	124,956,955
<b>Other assets, net of current portion</b>	<u>7,463,899</u>	<u>7,111,820</u>
Total assets	<u>\$ 258,537,445</u>	<u>\$ 250,654,109</u>
<b>LIABILITIES AND NET ASSETS</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 1,919,074	\$ 2,507,682
Accrued personnel costs	6,885,365	6,874,654
Accrued expenses	2,306,195	2,147,539
Estimated third-party payor settlements	-0-	765,000
Current portion of obligations under capital leases	478,049	343,719
Current portion of long-term debt	<u>1,495,000</u>	<u>1,430,000</u>
Total current liabilities	13,083,683	14,068,594
<b>Long-term liabilities</b>		
Obligations under capital leases, net of current portion	939,388	300,605
Long-term debt, net of current portion	93,823,589	95,261,235
Life insurance policies	371,637	947,484
Deferred compensation liabilities	<u>47,021</u>	<u>59,556</u>
Total long-term liabilities	<u>95,181,635</u>	<u>96,568,880</u>
Total liabilities	108,265,318	110,637,474
<b>Net assets</b>		
Unrestricted	148,817,535	138,237,617
Temporarily restricted	1,434,592	1,759,018
Permanently restricted	<u>20,000</u>	<u>20,000</u>
Total net assets	<u>150,272,127</u>	<u>140,016,635</u>
Total liabilities and net assets	<u>\$ 258,537,445</u>	<u>\$ 250,654,109</u>

*See accompanying notes to consolidated financial statements.*

**KING'S DAUGHTERS' HEALTH AND  
AFFILIATED ORGANIZATION**

CONSOLIDATED STATEMENTS OF OPERATIONS  
YEARS ENDED DECEMBER 31, 2016 AND 2015

	2016	2015
<b>Changes in unrestricted net assets</b>		
<b>Operating revenues</b>		
Net patient service revenue	\$ 137,618,531	\$ 145,539,402
Less: Provision for bad debts	(12,305,614)	(12,702,335)
Net patient service revenue less provision for bad debts	125,312,917	132,837,067
Other revenue	2,206,862	792,895
Net assets released from restrictions	574,018	594,283
Total operating revenues	128,093,797	134,224,245
<b>Operating expenses</b>		
Salaries and wages	51,057,970	50,599,102
Employee benefits and payroll taxes	12,113,132	12,258,407
Professional medical fees	1,152,250	1,341,473
Medical supplies	8,373,465	7,134,919
Other supplies	1,083,893	1,212,986
Drugs	9,314,422	8,386,368
Purchased services	10,489,761	10,662,453
Utilities	2,018,012	1,777,775
Insurance	1,434,777	1,478,716
Depreciation and amortization	12,203,311	12,607,511
Interest	5,412,700	5,445,574
Hospital assessment fee	2,323,666	1,586,599
Other operating expenses	5,687,556	6,491,877
Total operating expenses	122,664,915	120,983,760
Income from operations	5,428,882	13,240,485
<b>Nonoperating gains (losses)</b>	5,151,036	(1,327,559)
Excess revenues (expenses) and change in unrestricted net assets	10,579,918	11,912,926
<b>Changes in temporarily restricted net assets</b>		
Contributions	249,592	248,782
Net assets released from restrictions	(574,018)	(594,283)
Change in temporarily restricted net assets	(324,426)	(345,501)
Change in net assets	\$ 10,255,492	\$ 11,567,425

*See accompanying notes to consolidated financial statements.*

**KING'S DAUGHTERS' HEALTH AND  
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CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS  
YEARS ENDED DECEMBER 31, 2016 AND 2015

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**Unrestricted Net Assets**

Balance, December 31, 2014	\$ 126,324,691
Change in unrestricted net assets	<u>11,912,926</u>
Balance, December 31, 2015	\$ 138,237,617
Change in unrestricted net assets	<u>10,579,918</u>
Balance, December 31, 2016	<u><u>\$ 148,817,535</u></u>

**Temporarily Restricted Net Assets**

Balance, December 31, 2014	\$ 2,104,519
Change in temporarily restricted net assets	<u>(345,501)</u>
Balance, December 31, 2015	\$ 1,759,018
Change in temporarily restricted net assets	<u>(324,426)</u>
Balance, December 31, 2016	<u><u>\$ 1,434,592</u></u>

**Permanently Restricted Net Assets**

Balance, December 31, 2014	\$ 20,000
Change in permanently restricted net assets	<u>-0-</u>
Balance, December 31, 2015	\$ 20,000
Change in permanently restricted net assets	<u>-0-</u>
Balance, December 31, 2016	<u><u>\$ 20,000</u></u>

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*See accompanying notes to consolidated financial statements.*

**KING'S DAUGHTERS' HEALTH AND  
AFFILIATED ORGANIZATION**

CONSOLIDATED STATEMENTS OF CASH FLOWS  
YEARS ENDED DECEMBER 31, 2016 AND 2015

	2016	2015
<b>Cash flows from operating activities</b>		
Change in net assets	\$ 10,255,492	\$ 11,567,425
Adjustments to reconcile total change in net assets to net cash from operating activities		
Depreciation	12,149,839	12,554,036
Amortization	53,472	53,475
Provision for bad debts	12,305,614	12,702,335
Loss on disposal of capital assets	455,810	10,879
Amortization of bond discount	57,354	45,467
Net realized gains and losses and unrealized gains and losses on assets whose use is limited	(3,842,125)	2,974,912
Changes in operating assets and liabilities		
Patient accounts receivable	(12,212,630)	(12,870,443)
Inventories	116,086	86,597
Prepaid expenses and other current assets	(305,354)	2,291,271
Accounts payable	(602,195)	(1,786,653)
Accrued personnel costs	10,711	632,217
Accrued expenses	158,656	(140,984)
Estimated third-party payor settlements	(845,000)	(1,535,000)
Net cash from operating activities	17,755,730	26,585,534
<b>Cash flows from investing activities</b>		
Purchases of property and equipment	(1,855,234)	(3,699,323)
Proceeds from sale of capital assets	9,000	14,415
Change in assets whose use is limited	(8,637,342)	(22,945,771)
Change in other assets	(314,754)	(300,360)
Change in life insurance policies	(575,847)	147,635
Change in deferred compensation liabilities	(12,535)	(28,546)
Net cash from investing activities	(11,386,712)	(26,811,950)
<b>Cash flows from financing activities</b>		
Principal payments on obligations under capital leases	(566,221)	(353,474)
Principal payments on long-term debt	(1,430,000)	(1,370,000)
Net cash from financing activities	(1,996,221)	(1,723,474)
Net change in cash and cash equivalents	4,372,797	(1,949,890)
<b>Cash and cash equivalents, beginning of year</b>	16,607,672	18,557,562
<b>Cash and cash equivalents, end of year</b>	\$ 20,980,469	\$ 16,607,672

*See accompanying notes to consolidated financial statements.*



**KING'S DAUGHTERS' HEALTH AND  
AFFILIATED ORGANIZATION**

CONSOLIDATED STATEMENTS OF CASH FLOWS  
YEARS ENDED DECEMBER 31, 2016 AND 2015

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	2016	2015
<b>Supplemental disclosure of cash flow information</b>		
Cash paid during the year for interest	\$ 5,436,831	\$ 5,468,693
<b>Supplemental disclosure of noncash operating and investing activities</b>		
Property and equipment acquired under accounts payable	\$ 13,587	\$ 172,161
<b>Supplemental disclosure of noncash investing and financing activities</b>		
Property and equipment acquired under capital leases	\$ 1,339,334	\$ 28,705

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*See accompanying notes to consolidated financial statements.*

# KING'S DAUGHTERS' HEALTH AND AFFILIATED ORGANIZATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2016 AND 2015

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## 1. NATURE OF OPERATIONS

King's Daughters' Health ("KDH") is a not-for-profit, acute care hospital owned by the Bethany Circle of King's Daughters' of Madison, Indiana, Inc., located in Madison, Indiana. KDH is organized for the purpose of providing healthcare services to the residents of Jefferson County, Indiana and the surrounding area. KDH's primary sources of support are from patient revenues. Patient revenues include funds received from Medicare, state agencies, insurance companies, and the patients themselves.

The King's Daughters' Hospital Foundation, Inc. (the "Foundation") is a not-for-profit organization created in 2005 and located in Madison, Indiana. The Foundation operates for the benefit of KDH. The Foundation's main sources of revenue are earnings on investments and contributions received.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies followed by KDH and the Foundation (collectively the "Hospital") in the preparation of the consolidated financial statements are summarized below:

### Reporting Entity and Consolidation Policy

The accompanying consolidated financial statements include the accounts of KDH and the Foundation. Intercompany transactions and balances have been eliminated in consolidation.

### Management's Estimates

Management uses estimates and assumptions in preparing the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, if any, and the reported revenues and expenses. Actual results could vary from the estimates that were used.

### Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less excluding amounts included in assets whose use is limited.

### Patient Accounts Receivable and Net Patient Service Revenue

The Hospital recognizes net patient service revenues on the accrual basis of accounting in the reporting period in which services are performed based on the current gross charge structure, less actual adjustments and estimated discounts for contractual allowances, principally for patients covered by Medicare, Medicaid, managed care, and other health plans. Gross patient service revenue is recorded in the accounting records using the established rates for the types of service provided to the patient. The

**KING'S DAUGHTERS' HEALTH AND  
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Hospital recognizes an estimated contractual allowance to reduce gross patient charges to the estimated net realizable amount for service rendered based upon previously agreed-to rates with a payor. The Hospital utilizes the patient accounting system to calculate contractual allowances on a payor-by-payor basis based on the rates in effect for each primary third-party payor. Another factor that is considered and could further influence the level of the contractual reserves includes the status of accounts receivable balances as inpatient or outpatient. The Hospital's management continually reviews the contractual estimation process to consider and incorporate updated laws and regulations and the frequent changes in managed care contractual terms that result from contract negotiations and renewals.

Payors include federal and state agencies, including Medicare and Medicaid, managed care health plans, commercial insurance companies, and patients. These third-party payors provide payments to the Hospital at amounts different from its established rates based on negotiated reimbursement agreements. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and fee schedule payments. Retroactive adjustments under reimbursement agreements with third-party payors are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Allowance for Doubtful Accounts

Accounts receivable are reduced by an allowance for doubtful accounts based on the Hospital's evaluation of its major payor sources of revenue, the aging of the accounts, historical losses, current economic conditions, and other factors unique to the service area and the healthcare industry. Management regularly reviews data about the major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party payor coverage, the Hospital analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulty that make the realization of amounts due unlikely). For receivables associated with self-pay payments, which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill, the Hospital records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible.

**KING'S DAUGHTERS' HEALTH AND  
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The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. The December 31, 2016 and 2015 allowance for doubtful accounts balances were comprised of the following:

	<u>2016</u>	<u>2015</u>
Reserve for third-party payor balances	\$ 1,729,256	\$ 2,292,889
Reserve for self-pay balances	<u>6,514,967</u>	<u>5,664,753</u>
Total allowance for doubtful accounts	<u>\$ 8,244,223</u>	<u>\$ 7,957,642</u>

Inventories

Inventories consist of medical supplies, pharmaceuticals, and office supplies and are valued at the lower-of-cost or market, with cost being determined on the first-in, first-out (FIFO) method.

Assets Whose Use is Limited

Assets whose use is limited include assets set aside by the Hospital's Board of Managers for future capital improvements and other long-term uses, over which the Board retains control and may at its discretion subsequently use for other purposes; assets held by trustees under indenture agreements; temporarily restricted assets whose use by the Hospital has been limited by donors to a specific time period or purpose; permanently restricted net assets whose use by the Hospital has been restricted by donors in perpetuity; and deferred compensation assets related to certain deferred compensation agreements.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair market value in the consolidated balance sheets. Investment income or loss, including unrealized gains and losses on trading securities, interest, and dividends is included in nonoperating gains of unrestricted net assets, unless the income is restricted by donor or law.

Property and Equipment

Property and equipment are recorded at cost, except for donations, which are recorded at the fair market value at the date of the donation.

Property and equipment include expenditures for additions and repairs which substantially increase the useful lives of existing property and equipment. Maintenance, repairs, and minor improvements are expensed as incurred.

The property and equipment of the Hospital are being depreciated using the straight-line method of depreciation over their estimated useful lives based upon the American Hospital Association's *Estimated Useful Lives of Depreciable Hospital Assets*.

**KING'S DAUGHTERS' HEALTH AND  
AFFILIATED ORGANIZATION**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2016 AND 2015

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Cost of Borrowing

Interest costs incurred on borrowed funds during the period of construction of capital assets, if any, are capitalized as a component of the cost of acquiring those assets. For the years ended December 31, 2016 and 2015, interest costs incurred were as follows:

	<u>2016</u>	<u>2015</u>
Interest costs capitalized	\$ -0-	\$ -0-
Interest costs expensed	<u>5,412,700</u>	<u>5,445,574</u>
Interest costs incurred	<u>\$ 5,412,700</u>	<u>\$ 5,445,574</u>

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Hospital in perpetuity.

Consolidated Statements of Operations

For purposes of display, transactions deemed by management to be ongoing, major, or central to the provision of healthcare services are reported as operating revenues and expenses and included within the line *income (loss) from operations* in the consolidated statements of operations. Peripheral and incidental transactions are reported as nonoperating gains (losses). Nonoperating gains (losses) which are excluded from *income (loss) from operations* include contributions and donations, investment income or loss, goodwill impairment, and gain or loss on disposal of capital assets.

Performance Indicator

The consolidated statements of operations include *excess revenues (expenses)*. Consistent with industry practice, changes in net assets which are excluded from *excess revenues (expenses)* include, if any, unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

Advertising

The Hospital expenses advertising costs as incurred. Advertising expenses were \$172,846 and \$169,376 for the years ending December 31, 2016 and 2015, respectively.

**KING'S DAUGHTERS' HEALTH AND  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Charity Care

The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are reported as deductions from revenue.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the Hospital are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give, if any, are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted revenue if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

Income Taxes

KDH and the Foundation are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code and are exempt from federal income taxes on related income pursuant to Section 501(a) of the Code. As such, KDH and the Foundation are generally exempt from income taxes. However, KDH and the Foundation are required to file Federal Form 990 – Return of Organization Exempt from Income Tax which is an informational return only.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Hospital and recognize a tax liability if the Hospital has taken an uncertain tax position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the Hospital, and has concluded that as of December 31, 2016 and 2015, there are no uncertain tax positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying consolidated financial statements. The Hospital is subject to routine audits by taxing jurisdictions. However, as of the date the financial statements were issued, there were no audits for any tax periods in progress.

Going Concern Evaluations

Management evaluates whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a period of one year from the date the financial statements are issued.

**KING'S DAUGHTERS' HEALTH AND  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Risk Management

The Hospital is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The Hospital is insured for medical malpractice claims and judgments.

Reclassifications

Certain 2015 amounts have been reclassified to provide for consistency with reporting of 2016 information. These reclassifications have no effect on the previously reported total change in net assets or net assets.

Subsequent Events

The Hospital has evaluated events or transactions occurring subsequent to the consolidated balance sheet date for recognition and disclosure in the accompanying consolidated financial statements through the date the consolidated financial statements are issued, which is May 17, 2017.

**3. CHANGE IN ACCOUNTING PRINCIPLE**

During 2016, the Hospital adopted Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements – Going Concern (Topic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. ASU No. 2014-15 requires management to evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a period of one year from the date the financial statements are issued. When conditions or events that raise substantial doubt exist, additional disclosures will be required to enable financial statement users to understand those conditions or events, management's evaluation of them and management's plans that either alleviated substantial doubt or are intended to mitigate the conditions or events that raise substantial doubt. The adoption of ASU No. 2014-15 did not have a material effect on the accompanying consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2016 AND 2015

**4. ASSETS WHOSE USE IS LIMITED**

Assets whose use is limited are reported at market value and include the following at December 31, 2016 and 2015:

	2016	%	2015	%
Cash	\$ 1,273,733	1.3 %	\$ 6,532,152	7.7 %
Money market mutual funds	18,621,335	19.1	17,513,392	20.6
Common stocks	16,922,779	17.3	14,900,671	17.5
Mutual funds	53,350,517	54.7	39,171,653	46.0
Certificates of deposit	10,576	0.0	10,510	0.0
Corporate bonds	1,393,187	1.4	1,178,759	1.4
U.S. Government securities	6,015,633	6.2	5,801,156	6.8
	<u>\$ 97,587,760</u>	<u>100.0 %</u>	<u>\$ 85,108,293</u>	<u>100.0 %</u>
	2016	%	2015	%
Board-Designated Funds	\$ 89,601,564	91.8 %	\$ 77,128,196	90.6 %
Trustee-Held Funds	6,759,126	6.9	6,758,726	7.9
Donor-Restricted Funds	1,180,049	1.2	1,161,815	1.4
Deferred Compensation	47,021	0.1	59,556	0.1
	<u>\$ 97,587,760</u>	<u>100.0 %</u>	<u>\$ 85,108,293</u>	<u>100.0 %</u>

Investment income is comprised of the following for the years ended December 31, 2016 and 2015:

	2016	2015
Dividends and interest income	\$ 2,103,393	\$ 1,837,538
Realized gains (losses) on investments	82,473	599,391
Change in net unrealized gains (losses) on investments	3,759,652	(3,574,303)
Investment fees	(344,974)	(292,473)
	<u>\$ 5,600,544</u>	<u>\$ (1,429,847)</u>

Board-Designated Funds

The Hospital's Board of Managers approved the funding of depreciation expense to meet the capital asset replacement needs of the facility. Depreciation is funded totally with expenditures for capital assets reducing the funded depreciation balance. All income amounts earned by the Board-designated funds are left to accumulate as additions to the funds.



# **KING'S DAUGHTERS' HEALTH AND AFFILIATED ORGANIZATION**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2016 AND 2015

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### Trustee-Held Funds

The trustee-held funds are restricted for the payments of principal, interest, and construction costs related to certain long-term debt agreements.

### Donor-Restricted Funds

Donor-restricted funds represent contributions that have been restricted by the donors for a specific purpose.

### Deferred Compensation Funds

The deferred compensation funds represent assets that have accumulated under separate deferred compensation plans. The Hospital simply maintains the funds for the participants until they are withdrawn according to the specific terms of each separate deferred compensation agreement. The Hospital records liabilities equal to the deferred compensation assets.

### Fair Value Measurements and Disclosures

The framework for measuring fair value 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) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Hospital has the ability to access.
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

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Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2016 and 2015.

- *Money market mutual funds:* Generally transact subscription and redemption activity at a \$1 stable net asset value (NAV); however, on a daily basis the funds are valued at their daily NAV calculated using the amortized cost of the securities held in the fund.
- *Common stocks:* Valued at the closing price reported on the active market on which the individual securities are traded.
- *Mutual funds:* Valued at the daily closing price as reported by the fund. Mutual funds held by the Hospital are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value and to transact at that price. The mutual funds held by the Hospital are deemed to be actively traded.
- *Corporate bonds:* Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.
- *U.S. government securities:* Valued using pricing models maximizing the use of observable inputs for similar securities.

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The following table sets forth by level, within the hierarchy, the Hospital's assets measured at fair value on a recurring basis as of December 31, 2016 are as follows:

	Level 1	Level 2	Level 3	Total
Assets whose use is limited				
Money market mutual funds	\$ -0-	\$ 18,621,335	\$ -0-	\$ 18,621,335
Common stocks				
Basic materials	1,875,708	-0-	-0-	1,875,708
Consumer goods	1,664,602	-0-	-0-	1,664,602
Consumer services	2,429,863	-0-	-0-	2,429,863
Financials	2,909,607	-0-	-0-	2,909,607
Healthcare	2,392,129	-0-	-0-	2,392,129
Industrials	1,681,868	-0-	-0-	1,681,868
Technology	3,584,567	-0-	-0-	3,584,567
Utilities	384,435	-0-	-0-	384,435
	<u>16,922,779</u>	<u>-0-</u>	<u>-0-</u>	<u>16,922,779</u>
Mutual funds				
High yield	2,295,929	-0-	-0-	2,295,929
Short term	4,178	-0-	-0-	4,178
World blend	3,802,888	-0-	-0-	3,802,888
Inflation protected	2,076,374	-0-	-0-	2,076,374
Intermediate term	9,021,116	-0-	-0-	9,021,116
Foreign large blend	4,948,649	-0-	-0-	4,948,649
Domestic small cap growth	14,589	-0-	-0-	14,589
Real estate	813,113	-0-	-0-	813,113
Diversified emerging markets	3,858,290	-0-	-0-	3,858,290
Commodities	565,525	-0-	-0-	565,525
Large value growth	8,733,814	-0-	-0-	8,733,814
Domestic mid cap blend	3,896,806	-0-	-0-	3,896,806
Domestic large blend	6,994,245	-0-	-0-	6,994,245
Foreign large growth	3,824,058	-0-	-0-	3,824,058
European stock	303,577	-0-	-0-	303,577
Multisector bond	2,197,366	-0-	-0-	2,197,366
	<u>53,350,517</u>	<u>-0-</u>	<u>-0-</u>	<u>53,350,517</u>
Corporate bonds				
Consumer goods	-0-	111,620	-0-	111,620
Financials	-0-	490,901	-0-	490,901
Healthcare	-0-	246,255	-0-	246,255
Information technology	-0-	230,815	-0-	230,815
Materials	-0-	125,441	-0-	125,441
Utilities	-0-	188,155	-0-	188,155
	<u>-0-</u>	<u>1,393,187</u>	<u>-0-</u>	<u>1,393,187</u>
U.S. Government Securities				
U.S. Treasury notes	-0-	2,987,796	-0-	2,987,796
U.S. Treasury bonds	-0-	309,111	-0-	309,111
Federal National Mortgage Association	-0-	1,526,486	-0-	1,526,486
Federal Home Loan Mortgage Corp.	-0-	1,192,240	-0-	1,192,240
	<u>-0-</u>	<u>6,015,633</u>	<u>-0-</u>	<u>6,015,633</u>
Total assets at fair value	<u>\$ 70,273,296</u>	<u>\$ 26,030,155</u>	<u>\$ -0-</u>	<u>96,303,451</u>
Cash				1,273,733
Certificates of deposit				10,576
Total assets whose use is limited				<u>\$ 97,587,760</u>

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	Level 1	Level 2	Level 3	Total
Assets whose use is limited				
Money market mutual funds	\$ -0-	\$ 17,513,392	\$ -0-	\$ 17,513,392
Common stocks				
Basic materials	1,018,983	-0-	-0-	1,018,983
Consumer goods	1,709,634	-0-	-0-	1,709,634
Consumer services	2,722,400	-0-	-0-	2,722,400
Financials	2,360,082	-0-	-0-	2,360,082
Healthcare	2,476,611	-0-	-0-	2,476,611
Industrials	1,154,618	-0-	-0-	1,154,618
Technology	3,131,319	-0-	-0-	3,131,319
Utilities	327,024	-0-	-0-	327,024
	<u>14,900,671</u>	<u>-0-</u>	<u>-0-</u>	<u>14,900,671</u>
Mutual funds				
Fixed income	2,120,197	-0-	-0-	2,120,197
High yield	1,891,447	-0-	-0-	1,891,447
World blend	3,050,264	-0-	-0-	3,050,264
Inflation protected	1,536,372	-0-	-0-	1,536,372
Intermediate term	5,751,959	-0-	-0-	5,751,959
Foreign large blend	4,243,826	-0-	-0-	4,243,826
Domestic small cap growth	2,040	-0-	-0-	2,040
Real estate	764,883	-0-	-0-	764,883
Diversified emerging markets	547,272	-0-	-0-	547,272
Commodities	508,544	-0-	-0-	508,544
Large value growth	2,831,085	-0-	-0-	2,831,085
Small cap blend	10,392	-0-	-0-	10,392
Domestic mid cap blend	5,076,794	-0-	-0-	5,076,794
Domestic large blend	7,330,374	-0-	-0-	7,330,374
Foreign large growth	3,196,916	-0-	-0-	3,196,916
European stock	309,288	-0-	-0-	309,288
	<u>39,171,653</u>	<u>-0-</u>	<u>-0-</u>	<u>39,171,653</u>
Corporate bonds				
Consumer goods	-0-	193,050	-0-	193,050
Financials	-0-	583,847	-0-	583,847
Healthcare	-0-	103,242	-0-	103,242
Information technology	-0-	156,712	-0-	156,712
Materials	-0-	91,375	-0-	91,375
Utilities	-0-	50,533	-0-	50,533
	<u>-0-</u>	<u>1,178,759</u>	<u>-0-</u>	<u>1,178,759</u>
U.S. Government Securities				
U.S. Treasury notes	-0-	3,427,859	-0-	3,427,859
U.S. Treasury bonds	-0-	307,675	-0-	307,675
Federal National Mortgage Association	-0-	1,177,249	-0-	1,177,249
Federal Home Loan Mortgage Corp.	-0-	888,373	-0-	888,373
	<u>-0-</u>	<u>5,801,156</u>	<u>-0-</u>	<u>5,801,156</u>
Total assets at fair value	<u>\$ 54,072,324</u>	<u>\$ 24,493,307</u>	<u>\$ -0-</u>	<u>78,565,631</u>
Cash				6,532,152
Certificates of deposit				10,510
Total assets whose use is limited				<u>\$ 85,108,293</u>

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The Hospital's policy is to recognize transfers between levels as of the end of the reporting period. There were no significant transfers between levels 1 and 2 during 2016 and 2015.

Risks and Uncertainties

The Hospital holds investments in common stocks, mutual funds, corporate bonds, and U.S. Government Securities. Such investments are exposed to various risks such as interest rate, market, and credit. Due to the level of risk associated with these securities and the level of uncertainty related to changes in value, it is at least reasonably possible that changes in the various risk factors will occur in the near term that could affect the amounts reported in the accompanying consolidated financial statements. The Hospital's management is currently unable to determine the effect, if any, the decline in market conditions may ultimately have on the Hospital's investment portfolio and ability to fund certain projects.

**5. PROPERTY AND EQUIPMENT, NET**

Property and equipment, net consists of the following at December 31, 2016 and 2015:

	2016	2015
	<u>                    </u>	<u>                    </u>
Land	\$ 4,937,784	\$ 4,937,784
Buildings and improvements	119,252,475	119,123,429
Fixtures and equipment	<u>64,213,779</u>	<u>62,831,096</u>
	188,404,038	186,892,309
Less accumulated depreciation	<u>(73,018,343)</u>	<u>(61,995,327)</u>
	115,385,695	124,896,982
Construction in progress	<u>164,766</u>	<u>59,973</u>
Property and equipment, net	<u>\$ 115,550,461</u>	<u>\$ 124,956,955</u>

Impairment of Property and Equipment

The Hospital evaluates the recoverability of the carrying value of long-lived assets whenever events or circumstances indicate the carrying amount may not be recoverable. If a long-lived asset is tested for recoverability and the undiscounted estimate future cash flows expected to result from the use and eventual disposition of the asset is less than the carrying amount of the asset, the asset cost is adjusted to fair value and an impairment loss is recognized as the amount by which the carrying amount of a long-lived asset exceeds its fair value. The Hospital did not recognize a loss on impairment of property and equipment for the years ended December 31, 2016 and 2015, respectively.

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Conditional Asset Retirement Obligation

FASB Accounting Standards Codification Topic 410 (Topic 410) clarified when an entity is required to recognize a liability for a conditional asset retirement obligation. Management has considered Topic 410, specifically as it relates to its legal obligation to perform asset retirement activities, such as asbestos removal, on its existing properties. Management believes there is an indeterminate settlement date for the asset retirement obligations because the range of time over which the Hospital may settle the obligations is unknown and cannot be estimated. As a result, as of December 31, 2016 and 2015, the Hospital cannot reasonably estimate a liability related to these potential asset retirement activities.

**6. OTHER ASSETS**

Other assets consist of the following at December 31, 2016 and 2015:

	2016	2015
Bond issue costs, net of accumulated amortization	\$ 1,532,827	\$ 1,586,299
Investment in captive insurance company	335,311	335,311
Captive insurance company subscriber savings	1,284,878	1,107,789
Executive Benefit Plan notes receivable	3,422,030	2,396,711
Life insurance policies	371,637	947,484
Physician recruiting notes receivable	576,185	545,332
Pledges receivable	274,543	617,203
Total other assets	7,797,411	7,536,129
Less: current portion of other assets	(333,512)	(424,309)
Other assets, net of current portion	\$ 7,463,899	\$ 7,111,820

Bond issue costs are being amortized over the 35-year life of the bonds beginning in 2010.

The Hospital is a 12.5 percent owner of Indiana Healthcare Reciprocal Risk Retention Group (the "Captive"), a risk retention company created to purchase professional liability and general liability insurance for its members. The Hospital accounts for this investment using the cost method. In addition, the Captive retains a subscriber savings account for each of its members based upon the premiums paid in and the resulting claims paid out, plus other factors. Members are paid the balance of their subscriber savings account once they leave the Captive in accordance with the terms of the Captive agreement.

See Note 7 for a description of the Executive Benefit Plan.

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The Hospital is the holder of life insurance policies for several different physicians and key management members. The Hospital has a liability outstanding for the expected payout that will be paid out on the insured's behalf.

Physician recruiting notes receivable are forgiven if the physicians meet the period of service requirement. If the physicians do not meet the period-of-service requirement, the notes are immediately due in full. Other physician notes receivable are paid back over the terms of the notes. All physician notes receivable are in varying amounts maturing through July 2021 and carry interest rates ranging from 3.25 percent to 4.25 percent.

Pledges receivable represent pledges made by donors for the construction of the cancer center at the Hospital. Pledges receivable are recorded at their estimated net realizable value and discounted to their estimated net present value. The Hospital's management uses historical losses, economic climate, and other factors when estimating the allowance for uncollectible pledges amount. The allowance for uncollectible pledges was \$-0- at both December 31, 2016 and 2015. Pledges receivable consist of the following at December 31, 2016 and 2015:

	2016	2015
Pledges receivable	\$ 312,925	\$ 683,222
Less: discounts to present value (4.5%)	(38,382)	(66,019)
Pledges receivable, net of discount	\$ 274,543	\$ 617,203

The maturity of pledges receivable at December 31, 2016 is as follows:

Due in less than 1 year	111,449
Due in 1 to 5 years	201,476
Unamortized discounts	(38,382)
Total	\$ 274,543

The current portion of other assets represents the amount of notes receivable from physicians expected to be repaid or forgiven in the next fiscal year, according to individual employment contracts and the amount of pledges receivable due in one year.

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**7. EXECUTIVE BENEFIT PLAN**

The Hospital entered into collateral assignment split-dollar life insurance arrangements, referred to as the Executive Benefit Plan, for eight of its executives. Under the Executive Benefit Plan, the Hospital shall pay the planned periodic premiums set forth in the policies for each participant during their employment with the Hospital. The premium payments made by the Hospital shall be treated as a series of loans (notes) by the Hospital to the participants that are secured by the death benefit of the policy.

Death benefits under the policy subject to a collateral assignment are as follows:

1. The employer shall receive an amount equal to the recoverable amount, determined as of the date the death benefit is paid, which amount shall be paid before any other amounts, and
2. The balance of the death benefit shall be payable to the beneficiary under the policy.

The recoverable amount is determined as follows:

1. The pre-effective date premium amount plus the premium accretion amount, using the applicable interest rate, plus
2. The cumulative premiums that have been paid by the employer plus the premium accretion amount for each premium payment using the interest factor.

The balance of the Executive Benefit Plan notes receivable as of December 31, 2016 and 2015 was \$3,422,030 and \$2,396,711, respectively. The notes bear interest at the applicable Federal rate for a term loan, as defined in Internal Revenue Code Section 1274(d), at the date the note is made. The Federal rates for the notes outstanding at December 31, 2016 range from 2.54% to 3.39%.

**8. OBLIGATIONS UNDER CAPITAL LEASES**

The Hospital is the lessee of certain equipment under capital leases expiring in various years through 2021. The assets and liabilities under capital leases are initially recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. Amortization of assets held under capital leases is included in depreciation expense and was \$357,456 and \$345,232 for the years ended December 31, 2016 and 2015, respectively.

Following is a summary of property held under capital leases:

	2016	2015
Equipment	\$ 1,534,378	\$ 1,720,922
Less: accumulated amortization	<u>678,608</u>	<u>1,032,790</u>
	<u>\$ 855,770</u>	<u>\$ 688,132</u>



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Minimum future lease payments under capital leases as of December 31, 2016 are as follows:

Year Ending December 31,	Amount
2017	\$ 531,559
2018	368,492
2019	305,993
2020	302,904
2021	26,584
	1,535,532
Less: amount representing interest	118,095
Present value of minimum lease payments	\$ 1,417,437

**9. LONG-TERM DEBT**

At December 31, 2016 and 2015, the Hospital was obligated for long-term debt agreements as follows:

	2016	2015
Indiana Finance Authority Hospital Revenue Bonds, dated October 2010, payable in annual principal installments commencing August 2015 through August 2045, in amounts ranging from \$1,370,000 to \$6,400,000. Serial remaining fixed interest rates ranging from 4.5% to 5.5%. Secured by gross revenues.	\$ 97,235,000	\$ 98,665,000
Less unamortized bond discounts	(1,916,411)	(1,973,765)
Less current portion	(1,495,000)	(1,430,000)
Long-term debt, net of current portion	\$ 93,823,589	\$ 95,261,235

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Maturities of long-term debt for each of the five years subsequent to December 31, 2016, are as follows:

Year Ending December 31,	Principal Amount
2017	\$ 1,495,000
2018	1,570,000
2019	1,645,000
2020	1,730,000
2021	1,815,000
Thereafter	88,980,000
Unamortized bond discounts	(1,916,411)
Total	\$ 95,318,589

Under the terms of the Series 2010 Bonds, the Hospital is required to maintain certain deposits with a trustee. Such deposits are reported in the consolidated financial statements as assets whose use is limited. These agreements also place limits on the occurrence of additional borrowings and require that the Hospital satisfy certain covenants, including debt service coverage ratio, days cash on hand, and submission of audited financial statements. Management believes the Hospital is in compliance with all restrictive covenants.

**10. TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS**

Temporarily restricted net assets are donor-restricted for a specific use or by the passage of time. Permanently restricted net assets are donor-restricted assets whereby the principal amount is never to be expended. Income earned from these principal amounts includes both temporarily restricted and unrestricted amounts. Temporarily and permanently restricted net assets include the following at December 31, 2016 and 2015:

	2016	2015
Temporarily restricted		
Prenatal/Postnatal Education Program Fund	\$ 1,846	\$ 1,846
Teen Event Fund	-0-	6,751
May Library Fund	4,641	4,639
Fit Kids	-0-	963
National Nurses Week	39	138
Patient Scales	219	362
Nicotine Replacement Therapy	-0-	3,481

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Coalition Against Substance Abuse (CASA)	-0-	76
Indiana Hospital Association	1,217	-0-
HIP 2.0 Premium Assistance	2,231	-0-
Art Work (New Hospital)	2,350	2,350
Bill Zink Scholarship Fund	22,633	24,583
Board Discretionary Fund	7,886	-0-
Building	5,135	5,135
Building/Technology (Cancer Center)	24,460	19,679
Cardio Pulmonary Rehab	-0-	230
Cardiology	-0-	26
Caring and Responding to Employees (CARE)	2,875	8,099
CEO Discretionary Fund	-0-	7,672
Community Benefit Initiative (Jefferson Co. Fdn)	-0-	45,430
Dialysis	-0-	50
E. Pendleton Fund	14,492	14,492
E. Pendleton Interest Earned (Hospice)	1,188	1,122
Education	246	1,496
EMS Development	1,548	1,398
Girls on the Run	5,133	3,615
Hearing Aids for Diabetic Patients	10,000	10,000
Home Health/Hospice	79,222	19,124
Hospice	-0-	63,017
Immediate Response Fund	-0-	31,660
Oncology	19,692	16,153
Hope and Healing Campaign	973,826	1,298,146
Pediatrics	46,171	41,727
Pet Therapy	325	325
Physician Wall	3,993	3,732
Prostate Health	1,711	2,277
Quilt	150	350
Radiology	1,370	1,227
Raffle	215	-0-
Rehab	1,725	30
Ripley County	1,100	1,100
Run the Falls Event	-0-	1,010
Scholarship Fund - W. Wright	-0-	9,360
Scholarship Fund	27,610	6,782
Taustine	1,000	1,000

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Tranquility Trail	-0-	12,756
We Care About Our Patients	29,382	359
Wellness	70,618	16,908
Women's Health	<u>68,343</u>	<u>68,342</u>
 Total temporarily restricted net assets	 <u>\$ 1,434,592</u>	 <u>\$ 1,759,018</u>
 Permanently restricted		
Heberhart Endowment	\$ 10,000	\$ 10,000
E. Pendleton Hospice Endowment	<u>10,000</u>	<u>10,000</u>
 Total permanently restricted net assets	 <u>\$ 20,000</u>	 <u>\$ 20,000</u>

**11. ENDOWMENTS**

The Hospital's endowments consist of individual donor-restricted funds established by the donors to function as endowments. As required by accounting principles generally accepted in the United States of America, net assets associated with endowment funds, including funds designated by the Board of Managers to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The Board of Managers has interpreted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Hospital classifies as permanently restricted net assets (a) the original value of the gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund.

The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets, if any, is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the Hospital in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the Hospital considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds.

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

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The Hospital has adopted investment and spending policies for endowment assets that attempt to balance the mission of building capital for future use with the corresponding obligation to support current and future needs of the Hospital. Endowment assets include those assets of donor-restricted funds that the organization must hold in perpetuity or for a donor-specified period. Under this policy, as approved by the Board of Managers, the endowment assets are invested in a manner that is intended to produce long-term growth of capital without undue exposure to risk.

To satisfy its long-term rate of return objectives, the Hospital relies on a total return strategy in which investment decisions shall be made with the intent of maximizing the long-term total return of the portfolio through market value changes (realized and unrealized) and through earned income (dividends and interest).

On balances of endowed funds, as of the beginning of each fiscal year, an amount as determined by the Hospital Board will be distributed for the intended purposes of the endowment annually. Growth of the endowment will come from the annual earnings of investments in excess of distributions plus contributions made to the endowment.

Endowment net asset composition by type of fund as of December 31, 2016 is as follows:

	Temporarily Restricted	Permanently Restricted	Total
Donor restricted endowment funds	\$ 1,188	\$ 20,000	\$ 21,188

Changes in Endowment Net Assets for the year ended December 31, 2016 is as follows:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 1,122	\$ 20,000	\$ 21,122
Investment income	66	-0-	66
Endowment net assets, end of year	\$ 1,188	\$ 20,000	\$ 21,188

Endowment net asset composition by type of fund as of December 31, 2015 is as follows:

	Temporarily Restricted	Permanently Restricted	Total
Donor restricted endowment funds	\$ 1,122	\$ 20,000	\$ 21,122

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Changes in Endowment Net Assets for the year ended December 31, 2015 is as follows:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 612	\$ 20,000	\$ 20,612
Investment income	510	-0-	510
Endowment net assets, end of year	\$ 1,122	\$ 20,000	\$ 21,122
Permanently restricted net assets		2016	2015
The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or UPMIFA		\$ 20,000	\$ 20,000

**12. NET PATIENT SERVICE REVENUE**

For the years ended December 31, 2016 and 2015, net patient service revenue was as follows:

	2016	2015
Gross patient service revenue		
Inpatient revenue	\$ 91,003,450	\$ 93,774,919
Outpatient revenue	269,242,819	258,324,866
Total gross patient service revenue	360,246,269	352,099,785
Deductions from revenue		
Contractual allowances	(223,404,664)	(210,037,349)
Charity care	(1,601,743)	(2,129,004)
Medicaid DSH recognized	2,378,669	5,605,970
Provision for bad debts	(12,305,614)	(12,702,335)
Total deductions from revenue	(234,933,352)	(219,262,718)
Total net patient service revenue	\$ 125,312,917	\$ 132,837,067

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For the years ended December 31, 2016 and 2015, net patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), by major payor source was as follows:

	2016	2015
Patient service revenue (net of contractual allowances and discounts):		
Third party payors	\$ 129,058,257	\$ 108,234,296
Patients	8,560,274	11,900,436
Total	\$ 137,618,531	\$ 120,134,732

The Hospital grants credit without collateral to its patients, most of who are local residents and insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31, 2016 and 2015 is as follows:

	2016		2015	
	Revenue	Receivables	Revenue	Receivables
Medicare	45 %	40 %	48 %	32 %
Medicaid	17	14	15	19
Blue Cross	20	13	20	15
Other Commercial	16	19	14	21
Self-Pay	2	14	3	13
	100 %	100 %	100 %	100 %

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

- **Medicare.** The Hospital is a provider of services to patients entitled to coverage under Title XVIII (Medicare) of the Health Insurance Act. The Hospital is reimbursed for Medicare inpatient services based on a fixed price per discharge for each diagnosis related grouping (DRG) and Medicare outpatient services based on a fixed price per clinical unit of service. Differences between the total program billed charges and the payments received are reflected as deductions from revenue. At the Hospital's year end, a cost report is filed with the Medicare program computing reimbursement amounts related to Medicare patients. The difference between computed reimbursement and interim reimbursement is reflected as a receivable from or payable to the third-party program. The Hospital's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization under contract with the Hospital. As of December 31, 2016, the Hospital's submitted Medicare cost reports have been final settled with the Fiscal Intermediary through December 31, 2013.

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- **Medicaid.** The Hospital is a provider of services to patients entitled to coverage under Title XIX (Medicaid) of the Health Insurance Act. The Hospital is reimbursed for Medicaid inpatient services under a prospectively determined rate-per-discharge and Medicaid outpatient services based on a fixed price per clinical unit of service. Differences between the total program billed charges and the payments received are reflected as deductions from revenue. There is no cost settlement for either of the inpatient or outpatient programs.
- **Other.** The Hospital has also entered into preferred provider agreements with certain commercial insurance carriers. The basis for payment to the Hospital under these arrangements is a discount from established charges and fee schedule payments.
- **Charity Care and Uninsured Discounts.** The Hospital provides care without charge or at less than its established rates to patients who meet certain criteria under its charity care policy. Because the Hospital does not collect amounts deemed to be charity care, they are not reported as revenue. The estimated costs of providing charity services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associating with providing care to charity patients. The ratio of cost to charges is calculated based on the Hospital's total operating expenses divided by gross patient service revenue. For the years ended December 31, 2016 and 2015, the Hospital incurred estimated charity costs of \$545,398 and \$731,540, respectively.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to investigation and/or allegations concerning possible violations of fraud and abuse statutes and/or regulations by health care providers. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Final determination of compliance with such laws and regulations is subject to future government review and interpretation. Violations may result in significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. The Hospital believes that it is in compliance with all applicable laws and regulations.

The Centers for Medicare and Medicaid Services ("CMS") has been granted authority to suspend payments, in whole or in part, to Medicare providers if CMS possess reliable information on overpayment, fraud or if willful misrepresentation exists. If CMS suspects payments are being made as the result of fraud or misrepresentation, CMS may suspend payment at any time without providing prior notice to the Hospital. The initial suspension period is limited to 180 days. However, the payment suspension period can be extended indefinitely if the matter is under investigation by the United States Department of Health and Human Services Office of Inspector General or the United States Department of Justice. Therefore, the Hospital is unable to predict if or when it may be subject to a suspension of payments by the Medicare and/or Medicaid programs, the possible length of the suspension period, or the potential cash flow impact



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of a payment suspension. Any such suspension would adversely impact the Hospital's financial position, results of operations, and cash flows.

**13. ELECTRONIC HEALTH RECORDS (EHR) INCENTIVE PAYMENTS**

The Hospital receives EHR incentive payments under the Medicare and Medicaid programs. To qualify for EHR incentive payments, the Hospital must meet "meaningful use" criteria that become more stringent over time. The Hospital periodically submits and attests to its use of certified EHR technology, satisfaction of meaningful use objectives, and various patient data. These submissions generally include performance measures for each annual EHR reporting period (Federal fiscal year ending on September 30th). The related EHR incentive payments are paid out over a four year transition schedule and are based upon data that is captured in the Hospital's cost reports. The payment calculation is based upon an initial amount as adjusted for discharges, program utilization using inpatient days multiplied by a factor of total charges excluding charity care to total charges, and a transitional factor that ranges from 100% in first payment year and thereby decreasing by 25% each payment year until it is completely phased out in the fifth year.

The Hospital recognizes EHR incentive payments as grant income when there is reasonable assurance that the Hospital will comply with the conditions of the meaningful use objectives and any other specific grant requirements. In addition, the financial statement effects of the grants must be both recognizable and measurable. During 2016, the Hospital recognized \$1,038,181 in EHR incentive payments as grant income using the cliff recognition method. During 2015, the Hospital recognized an expense for an overpayment of EHR incentive payments of approximately \$64,904. Under the cliff recognition method, the Hospital records income at the end of the EHR reporting period in which compliance is achieved. EHR incentive income/expense is included in other revenue in the consolidated statements of operations. EHR incentive income recognized is based on management's estimate and amounts are subject to change, with such changes impacting operations in the period the changes occur. Receipt of these funds is subject to the fulfillment of certain obligations by the Hospital as prescribed by the program, subject to future audits and may be subject to repayment upon a determination of noncompliance.

**14. PENSION PLAN**

The Hospital sponsors a defined contribution pension plan that covers all eligible employees who work over 1,000 hours a year. All employees are eligible for enrollment on the first day of the month following their hire date. The Hospital contributes 2 percent for each eligible employee. The employee may contribute up to 15 percent with a maximum of 6 percent being matched at a rate of 50 percent. For the years ended December 31, 2016 and 2015, the amount of pension expense was \$1,661,657 and \$1,702,855, respectively.

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**15. DEFERRED COMPENSATION AGREEMENTS**

Previously, the Hospital maintained a deferred compensation plan for a select group of key management employees. Under the terms of the plan, the Hospital contributed 4 percent of a participant's compensation, as defined in the agreement, each calendar quarter. The Hospital no longer offers this plan, but still records a liability for any amounts that were unpaid at year-end. The deferred compensation asset and liability amounts under this agreement were both \$47,021 and \$59,556 at December 31, 2016 and 2015, respectively.

**16. PROFESSIONAL LIABILITY INSURANCE**

The Indiana Medical Malpractice Act (the "Act"), IC 34-18, provides a maximum recovery of \$250,000 for an occurrence of malpractice and \$1,250,000 for an injury or death of a patient due to an act of malpractice. The Act requires physicians to maintain medical malpractice liability insurance in the minimum amount of \$250,000 per occurrence and \$750,000 in the annual aggregate and hospitals to maintain medical malpractice liability insurance in the minimum amount of \$250,000 per occurrence and \$5,000,000 for hospitals with less than 100 occupied beds. The Hospital's insurance policies conform to the Act. The Act also requires the Hospital to pay a surcharge to the State Patient's Compensation Fund. This fund may be used to pay medical malpractice claims in excess of the annual aggregate amount noted above, under certain terms and conditions.

The Hospital maintains professional liability insurance through a multi-provider reciprocal risk retention group (the "Group"), in which premiums are accrued based on the Group's experience to date. This provides protection from liability in amounts not to exceed as follows:

	2016	2015
Hospital per occurrence	\$ <u>250,000</u>	\$ <u>250,000</u>
Hospital aggregate	\$ <u>5,000,000</u>	\$ <u>5,000,000</u>
Group umbrella aggregate	\$ 10,000,000	\$ 10,000,000
Group first additional umbrella aggregate	10,000,000	10,000,000
Group second additional umbrella aggregate	<u>10,000,000</u>	<u>10,000,000</u>
Total Group umbrella aggregate	<u>\$ 30,000,000</u>	<u>\$ 30,000,000</u>

Liabilities for incurred but not reported losses at December 31, 2016 and 2015 are not determinable; however, in management's opinion, such liabilities, if any, will not have a material effect on the Hospital's financial position and its malpractice and general liability insurance is adequate to cover losses, if any. Should the policies not be renewed or replaced with appropriate insurance coverage, claims based upon

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occurrences during these terms, but reported subsequently, will be uninsured. The Hospital intends to continue carrying such insurance.

**17. HOSPITAL ASSESSMENT FEE**

The purpose of the Hospital Assessment Fee ("HAF") Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share ("DSH") payments for Indiana hospitals as reflected in the hospital assessment fee reported in the consolidated statements of operations. Previously, the State share was funded by government entities through intergovernmental transfers. The Medicaid enhanced payments relate to both fee for service and managed care claims. The Medicaid enhanced payments are designed to follow the patients and result in increased Medicaid rates. The Hospital recognized HAF program expense of \$2,323,666 and \$1,586,599 at December 31, 2016 and 2015, respectively.

**18. OPERATING LEASES**

The Hospital leases certain equipment under noncancelable operating leases expiring in various years through 2020. Minimum future rental payments under these noncancelable operating leases as of December 31, 2016, are as follows:

<u>Year Ending December 31,</u>	<u>Amount</u>
2017	\$ 272,367
2018	162,533
2019	162,533
2020	<u>8,053</u>
Total	<u>\$ 605,486</u>

The Hospital incurred \$230,295 and \$259,953 in total rent expense for the years ended December 31, 2016 and 2015, respectively, under both cancelable and noncancelable leases.

**19. CONCENTRATIONS OF CREDIT RISK**

The Hospital maintains its cash in bank deposit accounts, which at times, may exceed federally insured limits. The Hospital has not experienced any losses on such accounts. The Hospital believes it is not exposed to any significant credit risk on cash.

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**20. FUNCTIONAL EXPENSES**

The Hospital provides general healthcare services to residents within its geographic area. Expenses related to providing these services are broken down as follows for the years ended December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Healthcare services	\$ 105,192,460	\$ 103,495,696
General and administrative	<u>17,472,455</u>	<u>17,488,064</u>
	<u>\$ 122,664,915</u>	<u>\$ 120,983,760</u>

**21. FAIR VALUE OF FINANCIAL INSTRUMENTS**

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

Cash and Cash Equivalents

The carrying amount reported in the consolidated balance sheets for cash and cash equivalents approximates its fair value based on short term maturities of those items.

Assets Whose Use is Limited

These assets are reported in the consolidated balance sheets at fair value. The fair value amounts are based on quoted market prices, if available, or are estimated using quoted market prices for similar securities.

Accounts Payable, Accrued Personnel Costs, and Accrued Expenses

The carrying amounts reported in the consolidated balance sheets for accounts payable, accrued personnel costs, and accrued expenses approximate their fair value based upon short maturities of those items.

Estimated Third-Party Payor Settlements

The carrying amount reported in the consolidated balance sheets for estimated third-party payor settlements approximates its fair value because they are expected to be settled in the near future.

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Long-Term Debt and Obligations Under Capital Leases

The carrying amount and fair value reported in the consolidated balance sheets for the combined amounts of long-term debt and obligations under capital leases were based on incremental borrowing rates available to similar entities with similar credit ratings. The combined carrying amounts and fair value of long-term debt and obligations under capital leases were \$96,736,026 and \$128,120,816, respectively, for 2016 and \$97,335,559 and \$126,057,775, respectively, for 2015.

Deferred Compensation Liabilities and Life Insurance Policies

The carrying amount reported in the consolidated balance sheets for deferred compensation liabilities approximates its fair value based on quoted market prices, if available, or is estimated using quoted market prices for similar securities. The carrying amount reported in the consolidated balance sheets for life insurance policies approximates its fair value based on the cash surrender value of the insurance policies.

**22. CONTINGENCIES**

The Hospital is susceptible to a variety of legal proceedings and claims by others against the Hospital in a variety of matters arising out of the conduct of the Hospital's business. The ultimate resolution of such claims would not, in the opinion of management, have a material adverse effect on the financial statements.

Current Economic Conditions

The current economic situation continues to present hospitals with unprecedented circumstances and challenges, which in some cases have resulted in large declines in the fair value of investments and other assets, large declines in contributions, constraints on liquidity, and difficulty obtaining financing. The financial statements have been prepared using values and information currently available to the Hospital.

Current economic conditions and employer benefit trends have made it difficult for certain patients to pay for services rendered. As employers make adjustments to health insurance plans or more patients become unemployed, services provided to self-pay and other payers may significantly impact net patient service revenue, which has had an adverse impact on the Hospital's operating results. Further, the effect of economic conditions on the state may have an adverse effect on cash flows related to the Medicaid program.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the financial statements could change rapidly, resulting in material future adjustments in asset values and allowances for accounts receivable that could negatively impact the Hospital's ability to improve its financial position and results of operations.

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HIPAA

Management continues to implement policies, procedures, and a compliance-monitoring organizational structure to enforce and monitor compliance with the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") and other government statutes and regulations. The Hospital's compliance with such laws and regulations is subject to future government review and interpretations, as well as regulatory actions which are unknown or unasserted at this time.

Health Care Reform Legislation

In March 2010, Congress adopted comprehensive health care insurance legislation, the Patient Care Protection and Affordable Care Act and the Health Care and Education Reconciliation Act (collectively, the "Health Care Reform Legislation" or "HCRL"). The HCRL, among other matters, is designed to expand access to health care coverage to substantially all citizens through a combination of public program expansion and private industry health insurance. Provision of the HCRL become effective at various dates over the next several years and a number of additional steps are required to implement these requirements.

Starting in 2014, the legislation required the establishment of health insurance exchanges, which provide individuals without employer provided health care coverage the opportunity to purchase insurance. Some employers currently offering insurance to employees have opted to have employees seek insurance coverage through the insurance exchanges. In some cases, reimbursement rates paid by insurers participating in the insurance exchanges may be substantially different than rates paid under current health insurance products. Another significant component of the HCRL is the expansion of the Medicaid program to a wide range of newly eligible individuals. In anticipation of this expansion, payments under certain existing programs, such as Medicare disproportionate share, substantially decreased. Each state's participation in an expanded Medicaid program is optional. The state of Indiana is currently participating in the expansion of the Medicaid program.

Due to the complexity of the HCRL, reconciliation and implementation of the legislation continues to be under consideration by lawmakers, and it is not certain as to what changes may be made in the future regarding health care policies. Changes to existing Medicaid coverage and payments are also expected to occur as a result of this legislation. While the full impact of HCRL is not yet fully known, changes to policies regarding reimbursement, universal health insurance, and managed competition may materially impact the Hospital's operations. Additionally, it is possible the Hospital will experience payment delays and other operational challenges during implementation.

Currently, the new administration is reviewing options to develop and pass legislation for a new health care bill. It is unknown what impact new legislation could have on the Hospital.

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**23. COMMITMENTS**

As of December 31, 2016, the Hospital has construction and renovation project commitments as follows:

Project	Expected Date of Completion	Estimated Total Cost of Project	Costs Incurred as of December 31, 2016
2-RS8OA Ultrasound System	1/1/2017	\$ 295,698	\$ 147,849
All others	Various	315,012	16,917
		<u>\$ 610,710</u>	<u>\$ 164,766</u>

**24. RELATED PARTY TRANSACTIONS**

German American Bank

A Hospital Board member is the spouse of the Regional Chairman of German American Bank. At December 31, 2016 and 2015, the Hospital had the following related party transactions with German American Bank:

	2016	2015
Deposits	\$ 18,129,217	\$ 13,678,825
Interest income	\$ 137,527	\$ 126,896
Interest expense	\$ 6,798	\$ 8,102

**25. NEW ACCOUNTING STANDARDS**

On May 28, 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The core principle of this new guidance is that "an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services". On August 12, 2015, the FASB further amended this guidance and issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606), which deferred the effective date for all entities by one year. These new standards, which the Hospital is not required to adopt until its year ending December 31, 2018, deal with the timing of reporting revenues from contracts with customers, and disclosures related thereto.

On February 25, 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This new standard, which the Hospital is not required to adopt until its year ending December 31, 2019, is intended to improve financial reporting about leasing transactions by requiring entities that lease assets to recognize on their balance sheet the assets and liabilities for the rights and obligations created by those leases, and to provide

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additional disclosures regarding the leases. Leases with terms (as defined in the ASU) of twelve months or less are not required to be reflected on an entity's balance sheet.

On August 18, 2016, FASB issued ASU No. 2016-14 Presentation of Financial Statements of Not-for-Profit Entities (Topic 958) that amends how a not-for-profit organization classifies its net assets, as well as the information it presents in financial statements and notes about its liquidity, financial performance, and cash flows. This new standard, which the Hospital is not required to adopt until its year ending December 31, 2018, requires improved presentation and disclosures to help not-for-profits provide more relevant information about their resources (and the changes in those resources) to donor, grantor, creditors, and other users. This ASU completes the first phase of a two-phase project to amend non-for-profit financial reporting requirements.

The Hospital is presently evaluating the effects that these ASUs will have on its future financial statements, including related disclosures.