



Memorial Hermann Health System

(UNAUDITED)

**QUARTERLY REPORT ON FINANCIAL INFORMATION
AND OPERATING DATA**

Fiscal Quarter Ended

December 31, 2018

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CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Memorial Hermann Health System
Six Months Ended December 31, 2018 and 2017
With Report of Independent Auditors

Memorial Hermann Health System
Consolidated Financial Statements (Unaudited)
December 31, 2018

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Review Report of Independent Auditors

The Board of Directors
Memorial Hermann Health System

We have reviewed the consolidated financial information of Memorial Hermann Health System (the Health System), which comprise the consolidated balance sheet as of December 31, 2018, and the related consolidated statements of operations and changes in net assets and cash flows for the six-month periods ended December 31, 2018 and 2017.

Management's Responsibility for the Financial Information

Management is responsible for the preparation and fair presentation of the interim financial information in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in conformity with U.S. generally accepted accounting principles.

Auditor's Responsibility

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information. Accordingly, we do not express such an opinion.

Conclusion

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial information referred to above for it to be in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

February 14, 2018

Memorial Hermann Health System

Consolidated Balance Sheets

	December 31, 2018 (unaudited)	June 30, 2018 (audited)
	<i>(In Thousands)</i>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 307,453	\$ 371,026
Patient accounts receivable, net of allowances for bad debt (June 30, 2018 – \$561,415)	593,517	665,617
Other current assets	318,230	215,710
Total current assets	<u>1,219,200</u>	<u>1,252,353</u>
Investments	2,336,575	2,354,526
Assets limited as to use, less current portion	239,881	250,275
Property, plant, and equipment, net	3,120,180	3,029,293
Other assets	212,887	217,777
Total assets	<u><u>\$ 7,128,723</u></u>	<u><u>\$ 7,104,224</u></u>
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 223,141	\$ 298,593
Accrued payroll and related expenses	210,336	223,090
Other accrued expenses	213,369	206,472
Current portion of long-term debt, including capital lease obligations	55,650	52,475
Long-term debt subject to liquidity agreements	455,033	454,966
Total current liabilities	<u>1,157,529</u>	<u>1,235,596</u>
Long-term debt, including capital lease obligations	1,818,138	1,799,296
Other long-term obligations	605,469	490,932
Total liabilities	<u>3,581,136</u>	<u>3,525,824</u>
Net assets, including noncontrolling interest of \$139,278 and \$130,928 as of December 31 and June 30, 2018, respectively	<u>3,547,587</u>	<u>3,578,400</u>
Total liabilities and net assets	<u><u>\$ 7,128,723</u></u>	<u><u>\$ 7,104,224</u></u>

See accompanying notes.

Memorial Hermann Health System

Consolidated Statements of Operations and Changes in Net Assets (Unaudited)

	Six Months Ended December 31,	
	2018	2017
	<i>(In Thousands)</i>	
Revenues, gains, and other support:		
Net patient service revenue before bad debt provision		\$ 2,879,156
Provision for bad debt		(482,346)
Net patient service revenue	\$2,545,741	2,396,810
Premium revenue, net	53,519	81,236
Other revenue	123,405	126,416
Total revenues, gains, and other support	2,722,665	2,604,462
Expenses:		
Salaries, benefits, and related personnel costs	1,192,126	1,150,866
Services and other	714,212	745,613
Supplies and medicines	498,001	453,756
Outside medical claims	31,906	57,086
Depreciation and amortization	148,220	140,868
Interest	46,938	46,400
Total expenses	2,631,403	2,594,589
Operating income	91,262	9,873
Nonoperating activities:		
Investment (loss) gains, net and other	(101,458)	136,387
Interest rate swap agreements	(19,312)	499
Revenues in (deficit) excess of expenses	(29,508)	146,759
Revenues in excess of expenses attributable to noncontrolling interests	(40,144)	(35,059)
Revenues in (deficit) excess of expenses attributable to the Health System	(69,652)	111,700
Other changes in net assets:		
Contributions and grants received and other changes in net assets, net	30,489	9,694
Change in noncontrolling interests	8,350	8,716
Change in net assets	(30,813)	130,110
Net assets at beginning of year	3,578,400	3,260,145
Net assets at end of period	\$ 3,547,587	\$ 3,390,255

See accompanying notes.

Memorial Hermann Health System

Consolidated Statements of Cash Flows (Unaudited)

	Six Months Ended December 31,	
	2018	2017
	<i>(In Thousands)</i>	
Operating activities		
Cash received for patient services	\$ 2,543,354	\$ 2,307,366
Cash paid to or on behalf of employees	(1,189,300)	(1,158,192)
Cash paid for supplies and services	(1,281,966)	(1,260,465)
Other receipts from operations, including premiums	156,199	224,378
Investment gains realized	51,447	35,007
Interest paid	(48,652)	(48,749)
Net cash provided by operating activities	231,082	99,345
Investing activities		
Capital expenditures, net	(225,074)	(164,615)
Change in assets limited as to use	5,657	76,818
Change in investments	(153,982)	(13,877)
Proceeds from sale of investment in medical office building	112,082	—
Net cash used in investing activities	(261,317)	(101,674)
Financing activities		
Payment on long-term debt and note payable	(7,114)	(11,000)
Restricted contributions	5,570	5,941
Noncontrolling interest	(31,794)	(25,064)
Net cash used in financing activities	(33,338)	(30,123)
Net decrease in cash and cash equivalents	(63,573)	(32,452)
Cash and cash equivalents at beginning of year	371,026	337,551
Cash and cash equivalents at end of period	\$ 307,453	\$ 305,099
Supplemental information – reconciliation of change in net assets to net cash provided by operating activities		
Change in net assets	\$ (30,813)	\$ 130,110
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	148,220	140,868
Unrealized net loss (gain) on investments and interest swap agreements	189,259	(96,033)
Other changes in net assets	22,900	20,311
Change in patient accounts receivable, net of provision for bad debt	72,102	(45,887)
Change in other assets	(113,304)	(44,653)
Change in accounts payable, accrued payroll, and other accrued expenses	(59,162)	(26,982)
Change in other long-term obligations	1,880	21,611
Net cash provided by operating activities	\$ 231,082	\$ 99,345

See accompanying notes.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited)

December 31, 2018

1. Mission and Organization

Memorial Hermann Health System (the Health System), a Texas nonprofit membership corporation, controls and coordinates the activities of certain other affiliates. The Health System Board of Directors exercises governance control for the Health System and retains significant reserved powers regarding its affiliates. The Health System is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code (IRC). The Health System owns and operates 13 nonsectarian general acute care hospitals (including Memorial Hermann – Texas Medical Center, the primary teaching hospital for The McGovern Medical School of The University of Texas Health Science Center at Houston), a research and rehabilitation hospital (TIRR) in the Texas Medical Center, a Medicare-certified home health agency, and a comprehensive ambulatory care network of facilities and services — all serving to position Memorial Hermann Health System as the market leader in the greater Houston, Texas, area. The Health System includes one of the nation’s largest Independent Practice Association models, through which more than 5,500 physicians are clinically integrated and affiliated with the Health System for clinical practice standards, two insurance companies that underwrite group health coverage for employers and the Medicare Advantage program, a captive casualty and liability insurance company, and an accountable care organization. Additionally, the Health System is supported by the Memorial Hermann Foundation (the Foundation). The consolidated financial statements include the accounts of the Health System and its controlled affiliates. All significant intercompany accounts and transactions have been eliminated.

On September 28, 2018, the Health System executed a letter of intent with Baylor Scott & White Holdings and Its Controlled Affiliates to pursue merging the operations of the two health systems through the creation of a new nonprofit, tax-exempt parent corporation. On February 5, 2019, The Health System and Baylor Scott & White Holdings announced merger discussions have been discontinued.

2. Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial reporting, applied on a basis substantially consistent with that of the 2018 audited financial statements of the Health System. They do not include all the information and footnotes required by GAAP for annual financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature. Operating results for

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

the six months ended December 31, 2018 are not necessarily indicative of the results expected for the year ending June 30, 2019. For more information, refer to the consolidated financial statements and notes thereto as of and for the year ended June 30, 2018.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and disclosure of contingent assets and liabilities, at the date of the financial statements. Because of the subjectivity inherent in this process, actual results may differ from those estimates.

Subsequent Events

The Health System evaluates the impact of subsequent events, events that occur after the balance sheet date but before the financial statements are issued, for potential recognition in the consolidated financial statements as of the consolidated balance sheets' date or disclosure in the notes to the consolidated financial statements. The Health System evaluated events occurring subsequent to December 31, 2018 through February 14, 2019, the date on which the accompanying consolidated financial statements were issued.

Net Assets and Contributions

To ensure compliance with restrictions placed on the resources available to the Health System, the Health System's accounts are maintained in accordance with the existence or absence of donor-imposed restrictions. This is the procedure by which resources are classified for accounting and reporting into funds established according to their nature and purposes. In the consolidated financial statements, funds that have similar characteristics have been consolidated into three net asset categories: permanently restricted, temporarily restricted, and unrestricted.

- Permanently restricted net assets contain donor-imposed restrictions that stipulate the resources be maintained permanently, but permit the Health System to use the income derived from the donated assets for donor-specified purposes.
- Temporarily restricted net assets contain donor-imposed restrictions that permit the Health System to use or expend the assets as specified. The restrictions are satisfied either by the passage of time or by actions of the Health System.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

- Unrestricted net assets are not restricted by donors, or the donor-imposed restrictions have expired or been met. When a donor restriction expires, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions.

At December 31, 2018 and June 30, 2018, the Health System had \$131,937,000 and \$129,321,000, respectively, in restricted net assets.

Unrestricted and restricted donations are recognized when received. Unrestricted and restricted pledges are reported as revenue in the period the pledge is made at the present value of estimated future cash flows. Amortization of the discount is included in contribution income. Pledges are recorded net of an allowance for uncollectibles. This allowance is determined based upon historical collection and write-off experience. Donor-restricted pledges and donations are recorded in the appropriate donor-restricted fund until restrictions are met, at which time they are contributed to the affiliate beneficiary. Gifts of property other than cash are recorded at fair market value at the dates the gifts are received.

The Health System holds donor-restricted endowment funds established primarily to fund specified activities for and within the Health System and the medical community as a whole. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

Contributions are recorded as revenue at the present value of estimated future cash flows when an unconditional promise is received. At December 31, 2018 and June 30, 2018, the Health System had \$30,213,000 and \$30,245,000, respectively, in pledges receivable, net of discount and allowance for uncollectibles of \$2,807,000 for both periods. Pledges receivable are recorded as assets limited as to use in the accompanying consolidated balance sheets and are due, based on gross pledges, as follows:

	<u>Pledges</u>
December 31, 2019	\$ 7,098,000
December 31, 2020	5,758,000
December 31, 2021	5,599,000
December 31, 2022	3,890,000
December 31, 2023	3,675,000
Thereafter	7,000,000

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

Net Patient Service Revenue and Patient Accounts Receivable

Net Patient Service Revenue

Effective July 1, 2018 the Health System used a modified retrospective method of application to adopt Accounting Standards Updates (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The core principle of ASU 2014-09 is that an entity should recognize revenue based on performance obligations 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.

Revenues generally relate to contracts with patients in which performance obligations are to provide health care services to the patients. Revenues are recorded during the period that obligations to provide health care services are satisfied. Performance obligations for inpatient services are generally satisfied over periods that average approximately five days, and revenues are recognized based on charges incurred in relation to total expected charges. Performance obligations for outpatient services are generally satisfied over a period of less than one day. The contractual relationships with patients, in most cases, also involve a third-party payer (Medicare, Medicaid, managed care health plans and commercial insurance companies and the transaction prices for the services provided are dependent upon the terms provided by (Medicare and Medicaid) or negotiated with (managed care companies) the third-party payers. The payment arrangements with third-party payers for the services the Health System provides to the related patients typically specify payments at amounts less than the Health System's standard charges. Medicare generally pays for inpatient and outpatient services at prospectively determined rates based on clinical, diagnostic and other factors. Services provided to patients having Medicaid coverage are generally paid at prospectively determined rates per discharge, per identified service or per covered member. Agreements with managed care companies generally provide for payments based upon predetermined rates per diagnosis, per diem rates or discounted fee-for-service rates. Management continually reviews the contractual estimation process to consider and incorporate updates to laws and regulations and the frequent changes in managed care contractual terms resulting from contract renegotiations and renewals.

The transaction price is determined based on gross charges for services provided, reduced by contractual adjustments provided to third-party payers, discounts provided to uninsured patients, and implicit price concessions provided primarily to uninsured patients. The Health System determined the estimates of contractual adjustments and discounts based on contractual agreements, discount policies and historical experience. The estimate of implicit price

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

concessions are based on the Health System's historical collection experience with these classes of patients using a portfolio approach as a practical expedient to account for patient contracts as collective groups rather than individually. The financial statement effects of using this practical expedient are not materially different from an individual contract approach.

The adoption of ASU 2014-09 resulted in changes to the presentation and disclosure of revenue primarily related to uninsured or underinsured patients. Prior to adoption of ASU 2014-09, a significant portion of the provision for doubtful accounts related to self-pay patients. Under ASU 2014-09, the estimated uncollectable amounts due from these patients are generally considered implicit price concessions that are a direct reduction to net patient revenue.

There was no material impact of the new standard on various reimbursement programs that represent variable consideration. The accounting for these programs under ASU 2014-09 is substantially consistent with the Health System's historical accounting. These include supplemental state Medicaid programs, disproportionate share payments and settlements with third party payers. While the adoption of ASU 2014-09 had a material effect on the presentation of net patient service revenue in the Health System's consolidated statements of operations and on certain disclosures, it did not materially impact the consolidated results of operations or cash flows.

The Health System's net patient service revenue for the six month period ended December 31, 2018 and net patient service revenue before bad debt by payor for the six month period ended December 31, 2017, and approximate percentages of total, were as follows (in thousands):

	2018		2017	
	Amount	Ratio	Amount	Ratio
Managed care	\$ 1,357,723	53%	\$ 1,340,382	47%
Medicare	749,260	29	675,730	23
Medicaid	288,569	11	331,620	12
Self-pay	39,497	2	445,637	15
Other	110,692	5	85,787	3
	\$ 2,545,741	100%	\$ 2,879,156	100%
Provision for bad debt	–	–	(482,346)	–
Total	\$ 2,545,741		\$ 2,396,810	

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

The Health System's accounts receivable by payor as a percentage of net accounts receivable were as follows at December 31, 2018 and June 30, 2018:

	December 31, 2018	June 30, 2018
Managed care	51%	49%
Medicare	22	22
Medicaid	9	10
Self-pay	4	4
Other	14	15
Total	100%	100%

Medicare and Medicaid Programs

While laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation, the Health System intends to be in compliance with all applicable laws and regulations and, to that end, has implemented a comprehensive organization-wide corporate compliance policy.

Annual retroactive settlements with the Medicare and Medicaid programs are subject to review by appropriate governmental authorities or their agents. Settlements are accrued on an estimated basis in the period the related services are rendered, and adjusted in future periods as final settlements are determined. Accruals for possible settlements are calculated based on historical experience.

The Health System's Medicare and Medicaid cost reports have been audited by the applicable fiscal intermediary through June 30, 2014, for all hospitals and up to 2016 for certain entities. However, certain prior cost reports have been reopened by the fiscal intermediary for further review. Additionally, from time to time, the Health System appeals decisions of the fiscal intermediary in order to recover funds it believes are appropriately due to the Health System for services rendered to Medicare and/or Medicaid beneficiaries. Processes related to recovering these funds are often long and complex. The Health System's policy is to record any funds received from appeals as income in the year in which the notice of cost report settlement is received.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

At December 31, 2018 and June 30, 2018, aggregate accruals and allowances for possible settlements, and pending reviews, as discussed above, of \$28,808,000 and \$34,907,000, respectively, are included in the accompanying consolidated balance sheets in other accrued expenses. It is reasonably possible that these estimates could differ from actual settlements and, thus, change in the near term by material amounts.

During the six-month periods ended December 31, 2018 and 2017, the Health System recognized \$6,504,000 and \$9,984,000, respectively, in net patient service revenue from differences between estimated and actual cost report settlements and appeals.

Medicaid Supplemental Payments

During fiscal years 2018 and 2017, the Health System participated in the Medicaid Disproportionate Share hospital funding program, established by the state of Texas and administered by the Texas Health and Human Services Commission (HHSC), which created additional federal matching funds to increase access to health care by Texas' indigent patients and defray the cost of treating indigent patients. Funds are distributed to hospitals providing a high volume of services to Medicaid and uninsured patients. During fiscal year 2012, a new Medicaid supplemental payment program was established in Texas under an 1115 Waiver (Waiver). The Waiver program was initially a five-year federally approved program designed to supplement the unreimbursed costs of providing care to Medicaid and uninsured patients, as discussed in Note 3. This program has been extended until December 2022. There are two pools of funds established under the Waiver program: an uncompensated care (UC) pool and a delivery system reform incentive payment (DSRIP) pool.

To receive payments from the UC pool, a hospital must submit an application (referred to as the Waiver tool) estimating its uncompensated costs for services provided to Medicaid and uninsured patients. In March 2018, an additional Medicaid supplemental fund program, the Uniform Hospital Rate Increase Program (UHRIP) was implemented. As part of this program, hospital providers receive an additional payment for Medicaid managed care patients from the plans for which the hospital is the participant. The funding of these programs are dependent on intergovernmental transfers from state-owned and local governmental entities to draw down federal funds to finance both pools. Medicaid supplemental funds, which include Medicaid Disproportionate Share, DSRIP, UC, and UHRIP payments, of approximately \$147,612,000 and \$127,114,000 were recorded for the six-month periods ended December 31, 2018 and 2017, respectively. Net patient service revenue includes UC, UHRIP, and Disproportionate Share supplemental funds as a reduction of contractual adjustment. DSRIP is recorded as other

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

revenue. At December 31 and June 30, 2018, the Health System has receivables recorded of \$79,180,000 and \$40,588,000, respectively, for Medicaid supplemental payments. These amounts are included in other current assets in the accompanying consolidated balance sheets. Medicaid supplemental payments have been recognized based on the most recent information available, but it is reasonably possible that the recorded estimates may change by a material amount in the near term.

Premium Revenues, Claims Payable, and Medical Claims Expenses

Premium revenues are recognized in the month in which members are entitled to health care services. Premiums collected in advance are recorded as unearned premiums and are included in accrued liabilities on the accompanying consolidated balance sheets.

The estimated cost of all health services rendered to members through December 31 and June 30, 2018 but not yet paid as of that date is included in other accrued expenses. This claims expense estimate is developed using actuarial assumptions based on historical experience with respect to the timing of payments in relation to the dates of service. Subsequent changes to prior period estimates are reflected in the current period.

Cash Equivalents

Liquid investments with an original maturity of three months or less are reported as cash equivalents, except for those held for long-term investing purpose or subject to restrictions, which are reported as investments or assets limited to use.

Investments, Assets Limited to Use, and Investment Income

Investments are reflected as investments or assets limited as to use in the consolidated balance sheets and include fixed income, equity securities, master limited partnerships (MLPs), and alternative investments. Investments in equity securities and all debt securities are carried at fair value. Fixed income includes U.S. government securities, mortgage-backed securities, asset-backed securities and other securitized credit, corporate obligations, and non-U.S. sovereign and corporate securities, in pooled funds and separate accounts. Equity securities include domestic and international equities in pooled funds and separate accounts. Pooled funds are professionally managed and include institutional mutual funds, fixed income funds, equity funds, and commingled accounts. MLPs include domestic MLPs in pooled funds and separate accounts and

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

represent limited partnerships that are typically publicly traded. Other characteristics often associated with these MLPs include the requirement that the partnerships must generate most of their cash flows from particular businesses (including commodities).

Alternative investments include ownership interests in hedge funds and limited partnerships that may employ various investment strategies through the use of publicly traded securities, market neutral arbitrage, floating rate loans and debt securities, fixed income swaps, private real assets, and private equity. The Health System's alternative investments include certain investments whose reported values had been estimated by fund managers in the absence of readily available market values or cannot otherwise be substantiated. Because of the inherent uncertainty of valuations, fund managers' estimates of fair value may differ from the values that would have been used had a ready market for the securities existed, and the differences could be material. Additionally, risks in certain of the Health System's alternative investments include limited transparency where funds are not required to disclose the holdings in their portfolios to the Health System and limitations on liquidity as funds may impose lockup periods or holdback provisions that limit the Health System's ability to redeem those investments. The Health System records its alternative investments at estimated fair value. As of December 31, 2018, management has utilized the best available data for reported investment values, which in some instances are valuations as of September 30, 2018. As of December 31, 2018, the unfunded commitment related to alternative investments is approximately \$386,530,000.

Investments are classified as noncurrent assets, regardless of their maturity date due to the Health System's primary intent not to utilize these assets to meet current obligations, capital, and other cash flow needs, and the investments have exposure to asset classes with longer term investment horizons. Assets limited as to use are funds legally restricted by bond indentures, internally restricted in connection with self-insurance programs, externally restricted by donor specifications, restricted by resident agreements, or internally restricted for charity care or other purposes. Assets limited as to use are classified as noncurrent assets, except for assets limited as to use that are required to meet current liabilities, which are classified as current assets.

Substantially all of the Health System's investments are designated as trading investments. Investment income, including realized and unrealized gains and losses on investments, interest and dividend income, and equity in earnings of alternative investments, is recorded as a nonoperating activity and included in revenues in excess of expenses in the accompanying consolidated statements of operations and changes in net assets, unless the income or loss is restricted by donor or law. Net purchases and sales of investments are reported as a component of net cash used in investing activities in the accompanying consolidated statements of cash

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

flows, as the net proceeds were used primarily to fund the Health System's acquisition of capital assets.

The Health System maintains investments with various financial institutions and investment management firms, and its policy is designed to limit exposure to any one institution or investment, therefore reducing overall risk.

Property, Plant, and Equipment

Property, plant, and equipment are carried at cost or fair value at the time of donation and include expenditures for new facilities and equipment and those expenditures that substantially increase the useful life of existing facilities and equipment. Ordinary maintenance and repairs are charged to expense when incurred. Depreciation is provided using the straight-line method over 20 to 40 years for buildings, 5 to 10 years for improvements (limited to the term of the related lease, if applicable), and 3 to 12 years for equipment. Assets accounted for as capital leases are amortized over the terms of the respective leases, and such amortization is included in depreciation and amortization expense.

When events, circumstances, or operating results indicate that the carrying values of certain long-lived assets might be impaired, the Health System prepares undiscounted projections of cash flows expected to result from the use of the assets and their eventual disposition.

If the projections indicate that the recorded amounts are not expected to be recoverable, the related asset's carrying value is reduced to estimated fair value. Fair value may be estimated based upon internal evaluations that include quantitative analyses of revenues and cash flows, reviews of recent sales of similar assets, and independent appraisals. Property and equipment to be disposed of are reported at the lower of the carrying amounts or fair value less costs to sell or close. The estimates of fair value are usually based upon recent sales of similar assets and market responses based upon discussions with and offers received from potential buyers.

Interest Rate Swap Agreements

The Health System records its interest rate swap agreements at fair value in the consolidated balance sheets and the change in the fair values and net interest payments under swaps as a component of interest rate swap agreements on the consolidated statements of operations and changes in net assets.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

Investments in Joint Ventures

The Health System has entered into multiple joint venture and partnership arrangements for the provision of medical services to patients. For those ventures where the Health System has a controlling interest through majority ownership, management control, or both, the ventures' assets, liabilities, and operating results have been included in the consolidated financial statements of the Health System. At December 31 and June 30, 2018, the Health System has recognized net assets attributable to noncontrolling interest of \$139,278,000 and \$130,928,000, respectively, representing the venture partners' interest in the equity and undistributed earnings of the consolidated ventures. For those ventures where the Health System does not maintain a controlling interest, the Health System accounts for its investment under the equity method of accounting.

Goodwill

The Health System records goodwill arising from a business combination as the excess of the purchase price and related costs over the fair value of the identifiable tangible and intangible assets acquired and liabilities assumed. At December 31 and June 30, 2018, the Health System had goodwill of \$197,246,000 and \$195,996,000, respectively, which relates to the purchase of several entities from 2010 to 2018, including purchases made by consolidated joint ventures. Goodwill is reflected in other long-term assets.

Goodwill is tested at least annually for impairment at the reporting unit level. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Additional impairment assessments may be performed on an interim basis if the Health System encounters events or changes in circumstances that would indicate that it is more likely than not that the carrying value of goodwill has been impaired. The Health System has determined that its reporting units are geographic or service-line-based depending on the nature of operations. The first step in the impairment process is to determine the fair value of the reporting unit and then compare it to the carrying value, including goodwill. If the fair value exceeds the carrying value, no further action is required and no impairment loss is recognized. The Health System applied the optional provisions of ASU No. 2011-08, *Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, which provides for a qualitative impairment analysis. A qualitative impairment analysis concluded that it was more likely than not that the fair value exceeded the carrying value of the applicable reporting units. Therefore, the two-step impairment analysis was not required and no impairment charges were recorded for fiscal year 2018 or 2017.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

Taxes

The Health System and certain other affiliates are Texas nonprofit corporations and have been recognized as tax-exempt pursuant to Section 501(c)(3) of the IRC. The Health System owns certain taxable subsidiaries and engages in certain activities that are unrelated to its exempt purpose and, therefore, subject to tax.

Management annually reviews its tax positions and has determined that there are no material uncertain tax positions that require recognition in the accompanying consolidated balance sheets. The tax returns are subject to Internal Revenue Service review for three years subsequent to the dates they are filed. The Health System has net operating losses (NOL) tax carryforwards that will expire between 2022 and 2037. Due to the age of these NOLs and the fact that management is uncertain that the full amount of the NOLs will be realized in the future, no deferred tax asset has been recorded.

The Tax Cuts and Jobs Act (the Act) was enacted on December 22, 2017. The provisions of the Act do not have a material tax effect on the Health System's consolidated financial statements. Certain regulatory guidance provides for a measurement period of up to one year during which accounting for the tax effects of the Act may be completed. The Health System will continue to evaluate the impact of the Act and may record adjustments as additional information and guidance is released by the IRS.

Pension and Postretirement Benefit Cost

On July 1, 2018, the Health System adopted ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The amendments in ASU 2017-07 require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. It also requires the other components of net periodic pension cost and net periodic postretirement benefit cost to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. The adoption of ASU 2017-07 resulted in an increase in the amount reported as salaries, benefits, and related personnel costs for the six months ended December 31, 2018 by \$5,400,000 and an increase in investment income and other by a corresponding amount. ASU 2017-07 requires retrospective adoption, and for the six months ended December 31, 2017, salaries, benefits, and related personnel costs was increased by \$6,000,000 and investment income was increased by a corresponding amount.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

2. Significant Accounting Policies (continued)

Performance Indicator

The Health System's consolidated statements of operations and changes in net assets contain a performance indicator titled revenues in excess of expenses. Revenues in excess of expenses include the Health System's results from operations and nonoperating activities, and exclude changes in noncontrolling interest, changes in unfunded pension obligations, restricted contributions and grants received, and certain other changes in net assets. Health System activities directly related to the furtherance of the Health System's purpose, as discussed in Note 1, are considered to be operating activities. Other activities that result in gains or losses are considered to be nonoperating and primarily include investment earnings, losses on extinguishment of debt, and other nonoperating gains/losses, including unusual or infrequent recoveries or costs not directly related to operating activities.

Pending Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU 2016-02 requires companies that lease assets to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in their balance sheets. The pronouncement will also require additional disclosures about the amount, timing and uncertainty of cash flows arising from leases. The provisions of ASU 2016-02 are effective for the Health System starting July 1, 2019, including interim periods within that reporting period, and early adoption is permitted. Management is currently evaluating the impact of this pronouncement on the Health System's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958) Presentation of Financial Statements of Not-for-Profit Entities*. ASU 2016-14 sets forth the FASB's improvements to net asset classification requirements and the information presented about a not-for-profit entity's liquidity, financial performance, and cash flows. The provisions of ASU 2016-14 are effective for the Health System's annual financial statements for the fiscal year starting July 1, 2018, and early adoption is permitted. Application to interim financial statements is permitted but not required in the initial year of application, but is required starting July 1, 2019. Management anticipates adopting in the Health System's annual reporting period ending June 30, 2019 and is currently evaluating the impact of this pronouncement on the Health System's consolidated financial statements.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

3. Community Service

In accordance with its purpose and values, the Health System is committed to providing high-quality, cost-effective health services to the community, including such underserved groups as the indigent and the elderly. Self-pay revenues are derived primarily from patients who do not have any form of health coverage. The revenues associated with self-pay patients are generally reported at the Health System's gross charges. The Health System evaluates these patients, after the patient's medical condition is determined to be stable, for their ability to pay based upon federal and state poverty guidelines, or qualifications for Medicaid or other governmental assistance programs, as well as the Health System's policy for charity care. The Health System provides care without charge to certain patients who qualify under the local charity care policy. The Health System's gross charity care charges include only services provided to patients who are unable to pay and qualify under the Health System's charity care policies. The Health System does not report a charity care patient's charges in revenues or in the provision for doubtful accounts, as it is the Health System's policy not to pursue collection of amounts related to these patients.

In addition, the Health System contributes to Harris County Clinical Services, Inc. (HCCS), which provides health care services to low-income and needy residents in the community.

The Health System's management estimates its costs of care provided under its charity care programs utilizing a calculated ratio of costs to gross charges multiplied by the Health System's gross charges provided.

These costs are as follows for the six-month periods ended:

	December 31,	
	2018	2017
	<i>(In Thousands)</i>	
Charity care costs	\$ 136,577	\$ 113,793
HCCS costs	57,000	75,475
	<u>\$ 193,577</u>	<u>\$ 189,268</u>

The Health System operates emergency rooms at its hospitals that are open to the public 24 hours a day, 7 days a week. The Health System also operates Life Flight, an air ambulance service based at the Memorial Hermann Texas Medical Center (Level I trauma center); a burn unit; a transplant center; a Level II trauma center in the Woodlands, and one Level IV and one Level III neonatal intensive care units that provide services to many infants whose mothers have not had

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

3. Community Service (continued)

access to appropriate prenatal care. Furthermore, the Health System provides various community screenings for the detection of diseases and disorders, as well as a forum for various wellness activities and community health education classes.

In addition to the uncompensated care provided to patients, the Health System funds various community projects as part of its ongoing community benefit plan. These projects are developed in response to specific community needs in the Health System's service area identified through community needs assessments. Examples of projects funded include ten school-based health centers and three mobile dental vans serving 72 schools in five school districts, an ER Navigator program educating primary care patients about the importance of finding an appropriate medical home other than the emergency room; two neighborhood health centers serving the primary care needs of uninsured and underinsured patients; a nurse help-line providing nurse triage to greater Houston to educate and assist on the appropriate use of health resources; and providing financial support to primary care clinics and social service agencies that support Memorial Hermann Community Benefit Corporation's four driving pillars of access, emotional health, food and exercise. Additionally, the Health System supports various community and city-wide task forces committed to building toward a healthier and more vital Houston community.

As a part of its approval of the 1997 merger between Memorial Hospital System and Hermann Hospital Estate, a Harris County District Court entered an Agreed Order stipulating that the Memorial Hermann – Texas Medical Center will continue providing charity care and community service in the amount of 6% of net revenue or \$22,500,000, whichever is greater. This amount is an additional 1% above the percentage required of all Texas nonprofit hospitals under the charity care provision of the Texas Health & Safety Code. During fiscal years 2018 and 2017, the Health System believes it has met all stipulations of the agreement. Revenues of the other Health System entities are not obligated under the agreement.

4. Investments and Assets Limited as to Use

Investments

The Health System maintains investments with various financial institutions and investment management firms, and its policy is designed to limit exposure to any one institution or investment, therefore reducing overall investment risks. The following is a summary of unrestricted investments by classification:

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

4. Investments and Assets Limited as to Use (continued)

	December 31, 2018	June 30, 2018
	<i>(In Thousands)</i>	
Cash and cash equivalents	\$ 8,757	\$ 12,896
Fixed income	345,242	340,085
Equity securities	880,281	993,614
Alternative investments	1,102,295	1,007,931
Total investments	<u>\$ 2,336,575</u>	<u>\$ 2,354,526</u>

Assets Limited as to Use

The following table sets forth the restricted purpose of the Health System's assets limited as to use:

	December 31, 2018	June 30, 2018
	<i>(In Thousands)</i>	
Self-insurance programs and insurance companies restricted deposits	\$ 113,419	\$ 120,095
Donor restrictions	128,812	132,676
Charity care and depreciation funds	4,306	4,160
	<u>246,537</u>	<u>256,931</u>
Less current portion required for current liabilities reflected in cash	(6,656)	(6,656)
	<u>\$ 239,881</u>	<u>\$ 250,275</u>

Investment Income

Investment income related to unrestricted net assets comprises the following for the six-month periods ended:

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

4. Investments and Assets Limited as to Use (continued)

	December 31,	
	2018	2017
	<i>(In Thousands)</i>	
Interest and dividend income	\$ 36,128	\$ 17,001
Realized gains, net	32,467	25,901
Unrealized (losses) gains, net	(175,453)	87,485
	<u>\$ (106,858)</u>	<u>\$ 130,387</u>

5. Property, Plant, and Equipment

Property, plant, and equipment consist of the following:

	December 31,	June 30,
	2018	2018
	<i>(In Thousands)</i>	
Buildings and leasehold improvements	\$ 3,201,189	\$ 3,180,266
Building and equipment under capital lease	819,080	804,965
Equipment	2,149,510	2,119,350
Less accumulated depreciation	(3,781,124)	(3,643,870)
	<u>2,388,655</u>	<u>2,460,711</u>
Land	144,929	144,009
Construction-in-progress	586,596	424,573
	<u>\$ 3,120,180</u>	<u>\$ 3,029,293</u>

At December 31 and June 30, 2018, the Health System had leasehold improvements net of accumulated depreciation totaling \$244,949,000 and \$242,358,000.

At December 31 and June 30, 2018, the Health System had building and equipment under capital lease net of accumulated depreciation totaling \$580,387,000 and \$577,659,000.

At December 31, 2018, the Health System had remaining commitments for planned construction of approximately \$350,507,000. In 2016, the Health System purchased a previously leased 255-licensed-bed general acute care hospital in north Houston for \$55,000,000. As part of the purchase agreement, the Health System has an obligation to operate the hospital for at least 10 years and to construct a new hospital tower with an expected cost of approximately \$70,000,000.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

5. Property, Plant, and Equipment (continued)

with the Northeast Hospital Authority contributing \$10,000,000 toward the cost. The new hospital tower was opened on November 26, 2018 and as of December 31, 2018 the Health System had incurred costs totaling \$62,200,000 and have additional commitments for \$12,700,000.

Under the provisions of ASC 840-40, *Leases – Sale-Leaseback Transactions*, the Health System is required to continue to capitalize medical office buildings sold and leased back and to recognize an obligation for the sales proceeds received. A prior year gain on the sale of approximately \$128,272,000 has been deferred until specified forms of continuing involvement have ceased. These medical office buildings are depreciated over the economic lives when placed in service. As of December 31, the following amounts are recorded in property, plant, and equipment, net and other long-term obligations:

	Property, Plant, and Equipment		Other Long-term Obligations	
	December 31,	June 30,	December 31,	June 30,
	2018	2018	2018	2018
Medical office buildings and improvements	\$ 59,219,000	\$ 62,442,000	\$ 215,013,000	\$ 218,708,000

In July 2018, a partnership in which the Health System had an equity method investment sold a medical office building in the Texas Medical Center, and the Health System received its share of the net sale proceeds of approximately \$115,000,000. Under the provisions of ASC 840-40, *Leases – Sale-Leaseback Transactions* a gain on the sale of approximately \$11,500,000 has been recognized and \$96,500,000 has been deferred in conjunction with the sale. This gain will be recognized over the life of the Health System's leases in the building. For the six month period ended December 31, 2018, \$1,408,000 of the deferred gain was recognized as a reduction to rent expense. The consolidated balance sheet as of December 31, 2018 includes approximately \$95,114,000 in deferred gains in other long-term obligations and other accrued expenses related to this transaction.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

6. Indebtedness

Long-term debt consisted of the following (in thousands):

	December 31, 2018	June 30, 2018
	<i>(In Thousands)</i>	
Obligations issued under the Memorial Hermann Health Master Trust Indenture:		
Revenue bonds, in variable rate demand mode, with interest rates ranging from 1.69% to 2.11% at December 31, 2018, due in varying installments through June 1, 2046:		
Series 2014C and D	\$ 70,400	\$ 70,400
Series 2015A, B and C	247,700	247,700
Series 2016B, C, D and E	315,305	315,305
Revenue bonds, in variable rate mode, with interest rate ranging from 1.71% to 2.29% at December 31, 2018, due in annual installments through December 1, 2042:		
Series 2013B	67,210	67,210
Series 2014B	70,425	70,425
Revenue bonds, in fixed rate mode, bearing interest from 2.40% to 5.30%, due in annual installments through July 1, 2046:		
Series 2010A	36,135	36,135
Series 2013A	294,705	301,945
Series 2014A	135,185	139,775
Series 2016A	132,900	132,900
Other long-term debt obligations:		
Capital lease obligations	857,472	826,096
Line of credit and other notes	72,305	67,888
	2,299,742	2,275,779
Premiums on long-term debt, net	37,065	39,230
Less deferred financing fees	(7,986)	(8,272)
	2,328,821	2,306,737
Less current portion, including amounts subject to self-liquidity	(510,683)	(507,441)
	\$ 1,818,138	\$ 1,799,296

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

6. Indebtedness (continued)

Debt Obligations

The Health System has issued revenue bonds through the Harris County Health Facilities Development Corporation and the Harris County Education Facilities Finance Corporation. Payments to the bondholders are funded by the issuing affiliates under a master trust indenture with the trustees of the respective bond issues. The Health System and substantially all operating affiliates have agreed to arrangements and indentures related to the bonds to abide by guidelines regarding repayment, financial performance, organizational changes, reporting, and additional borrowing. Certain variable rate demand bonds were issued under the Health System's self-liquidity program, and therefore, have been classified as current liabilities. The Health System will provide its own liquidity to purchase any tendered bonds that cannot be successfully remarketed.

In February 2017, the Health System renewed a syndicated revolving line of credit agreement for a term of five years with a maximum amount available of \$300,000,000. The purpose of this line of credit facility is to provide a source of liquidity in the case of emergency or disaster, or to provide a means of bridge financing in advance of any permanent debt financing transaction. As of June 30 and December 31, 2018, \$36,500,000 was outstanding.

On December 15, 2015, the Health System refinanced its Series 2010B (\$162,400,000) variable rate demand bonds by issuing the Series 2015A (\$81,200,000) and Series 2015B (\$81,200,000) refunding bonds. The Series 2008A-1 (\$107,800,000) variable rate demand bonds were refinanced by issuing the Series 2015C (\$107,800,000) refunding bonds.

In May 2018, the Health System converted the modes of the Series 2015A, Series 2015B, and Series 2015C bonds. The Series 2015A and Series 2015B bonds (\$162,400,000) were converted to privately placed floating rate notes for a term of three years. The Series 2015C bonds (\$93,200,000) were converted to variable rate demand bonds under the Health System's self-liquidity program and, therefore, are classified as current liabilities. The amortization and final maturity of the bonds remained unchanged.

The bank notes associated with the Series 2015A and Series 2015B bonds contain certain criteria under which the respective banks can call for the repayment of the debt in advance of the stated maturities. Management has evaluated these criteria and believes the debt is appropriately classified as long-term.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

6. Indebtedness (continued)

On June 8, 2016, the Health System issued the Series 2016A fixed rate bonds in the amount of \$132,900,000 due on July 1, 2046. The Series 2016A bonds were sold at a net premium of \$18,306,215.

On June 8, 2016, the Health System issued the Series 2016B variable rate demand bonds in commercial paper mode in the amount of \$150,000,000. On June 8, 2016, the Health System refinanced the 2013C and 2013D bonds by issuing the Series 2016C (\$62,370,000) and 2016D (\$41,605,000), which are variable rate demand bonds.

On June 8, 2016, the Health System restructured the Series 2008A-2 into 2016E Series (\$72,300,000) variable rate demand refunding bonds.

The 2014C and D and 2016B, C, D, and E Series bonds were issued under the Health System's self-liquidity program and, therefore, have been classified as current liabilities.

Other notes consist of secured loans by financial institutions to finance the equipment purchases of the Health System's joint venture partnerships.

The estimated fair value of the Health System's serial and term fixed rate bonds at December 31, 2018 and June 30, 2018 was approximately \$641,712,000 and \$659,348,000, respectively. The valuation of the bonds is based on a combination of quoted market prices for identical securities when available, a Level 1 input, and quoted market prices for similarly rated health care revenue bond issues, a Level 2 input. The Health System considers the carrying value of its variable rate long-term debt to approximate fair value at December 31, 2018 and June 30, 2018, due to the variable nature of the interest rate.

Leases

The Health System leases certain health facilities located in the Houston metropolitan area. One such leasing arrangement, which is reflected as a capital lease in the accompanying consolidated financial statements, consists of a 520-licensed-bed general acute care hospital and rehabilitation care facility located in west Houston. All revenues and income from the operation of the leased facilities during the lease term accrue to the Health System. The Health System is responsible under the lease for ad valorem taxes, normal maintenance, utilities, and other operating costs.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

6. Indebtedness (continued)

The Health System leases certain land, buildings, and medical offices near the west Houston location. These agreements are recorded as operating leases with rental payments reflected in the accompanying consolidated statements of operations and changes in net assets.

7. Interest Rate Swap Agreements

The Health System utilizes interest rate swap agreements to manage its capital costs and interest rate risk. The following table summarizes the Health System's swap portfolio, the fair values at December 31, 2018 and June 30, 2018, the change in value, and the net amounts paid and received for the six-month periods ended December 31, in thousands:

Swap Description	Term Date	Interest Rate Agreements	Aggregate Notional Amount	Fair Value Liability		Change in Fair Value	
				December 31, 2018	June 30, 2018	December 31, 2018	December 31, 2017
LIBOR-based to fixed (5.343%)	2032	1	\$ 113,120	\$ (30,847)	\$ (28,586)	\$ (2,261)	\$ 1,885
LIBOR-based to fixed (3.629%)	2029	3	131,700	(18,481)	(17,271)	(1,210)	2,053
LIBOR-based to fixed (3.635%)	2024	1	27,100	(1,436)	(1,516)	80	564
LIBOR-based to fixed (3.630%)	2024	1	39,100	(2,173)	(2,283)	110	806
LIBOR-based to fixed (3.690%)	2027	1	39,400	(3,366)	(3,314)	(52)	766
LIBOR-based to fixed (3.685%)	2027	2	106,900	(9,146)	(9,336)	190	2,068
LIBOR-based constant maturity swap	2034	1	500,000	(10,662)	-	(10,662)	-
		10	\$ 957,320	\$ (76,111)	\$ (62,306)	\$ (13,805)	\$ 8,142

The notional amounts under each of the interest rate swap agreements are reduced in conjunction with the Health System's principal payments on the associated bonds. At December 31, 2018 and June 30, 2018, the fair value of swap agreements was a liability of \$76,111,000 and \$62,306,000, respectively, and has been included in other long-term liabilities in the accompanying

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

7. Interest Rate Swap Agreements (continued)

consolidated balance sheets. As of December 31, 2018, none of the Health System's swap agreements include provisions that would require posting of collateral.

The Health System classified the net interest cost on its interest rate swaps for the six-month periods ended December 31, 2018 and 2017 of \$5,507,000 and \$7,643,000 respectively, in nonoperating expenses (interest rate swap agreements) in the consolidated statements of operations and changes in net assets.

8. Fair Value Measurement

The Health System categorizes, for disclosure purposes, assets and liabilities measured at fair value in the consolidated financial statements based upon whether the inputs used to determine their fair values are observable or unobservable. Observable inputs are inputs that are based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about pricing the asset or liability, based on the best information available in the circumstances.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement of the asset or liability. The Health System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The Health System follows the three-level fair value hierarchy to categorize these assets and liabilities recognized at fair value at each reporting period, which prioritizes the inputs used to measure such fair values. Level inputs are defined as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities on the reporting date.

Level 2 – Inputs to the valuation methodology other than quoted market prices included in Level 1 that are observable for the asset or liability. Level 2 pricing inputs include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

8. Fair Value Measurement (continued)

Level 3 – Inputs that are unobservable for the asset or liability.

The following tables present financial instruments carried at fair value as of December 31, 2018 and June 30, 2018, on a recurring basis. The tables do not include contributions receivable of \$30,213,000 and \$30,245,000 at December 31, 2018 and June 30, 2018, respectively, and real estate of \$187,000 that are not carried at fair value, and are included in assets limited as to use in the consolidated balance sheets. The tables also do not include Level 3 investments of \$1,142,979,000 and \$1,049,014,000 at December 31, 2018 and June 30, 2018, respectively, which are measured at fair value using net asset value as a practical expedient, as allowed under ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. Valuations provided by the respective investment's management consider variables, such as the financial performance of underlying investments, recent sales prices of underlying investments, and other pertinent information. In addition, actual market exchanges at year-end provide additional observable market inputs of the exit price. The majority of these funds have restrictions on the timing of withdrawals, which may reduce liquidity, in some cases for up to 12 months.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

8. Fair Value Measurement (continued)

	December 31, 2018			
	Level 1	Level 2	Level 3	Total
	<i>(In Thousands)</i>			
Assets				
Investments:				
Cash and equivalents	\$ 8,757	\$ –	\$ –	\$ 8,757
U.S. government securities	–	38,934	–	38,934
Pooled funds:				
Domestic equities	1,945	56,199	–	58,144
Global equities	121,084	208,389	–	329,473
Risk parity	8,930	25,359	–	34,289
Fixed income	179,751	–	–	179,751
Hedge fund	–	79,393	–	79,393
Corporate obligations	–	28,358	–	28,358
Corporate equities	192,297	–	–	192,297
Global equities	89,722	–	–	89,722
MLPs	118,644	–	–	118,644
Public REITs	57,710	–	–	57,710
Assets limited as to use:				
Cash and equivalents	56,260	–	–	56,260
Pooled funds:				
Domestic equities	9,672	–	–	9,672
Global equities	50,466	8,167	–	58,633
Fixed income	45,684	–	–	45,684
MLPs	4,409	–	–	4,409
Corporate equities	8,048	–	–	8,048
Public REITs	4,899	–	–	4,899
Total assets	\$ 958,278	\$ 444,799	\$ –	\$ 1,403,077
Liabilities				
Interest rate swap agreements	\$ –	\$ 76,111	\$ –	\$ 76,111
Total liabilities	\$ –	\$ 76,111	\$ –	\$ 76,111

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

8. Fair Value Measurement (continued)

June 30, 2018				
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets				
Investments:				
Cash and equivalents	\$ 12,896	\$ –	\$ –	\$ 12,896
U.S. government securities	34,882	7,454	–	42,336
Pooled funds:				
Domestic equities	2,119	60,813	–	62,932
Global equities	128,380	223,758	–	352,138
Risk parity	26,419	34,012	–	60,431
Fixed income	176,398	–	–	176,398
Hedge fund	–	82,417	–	82,417
Corporate obligations	–	22,374	–	22,374
Corporate equities	222,518	–	–	222,518
Global equities	97,557	–	–	97,557
MLPs	137,136	–	–	137,136
Public REITs	60,902	–	–	60,902
Assets limited as to use:				
Cash and equivalents	57,791	–	–	57,791
Pooled funds:				
Domestic equities	9,698	–	–	9,698
Global equities	54,714	8,504	–	63,218
Fixed income	44,372	–	–	44,372
MLPs	5,725	–	–	5,725
Corporate equities	9,109	–	–	9,109
Public REITs	5,407	–	–	5,407
Total assets	\$ 1,086,023	\$ 439,332	\$ –	\$ 1,525,355
Liabilities				
Interest rate swap agreements	\$ –	\$ 62,306	\$ –	\$ 62,306
Total liabilities	\$ –	\$ 62,306	\$ –	\$ 62,306

The fair values of the securities included in Level 1 were determined through quoted market prices, and include money market funds, mutual funds, and marketable debt and equity securities. The fair values of Level 2 securities were determined through evaluated bid prices based on recent trading activity, and other relevant information, including market interest rate curves and referenced credit spreads, and estimated prepayment rates, where applicable, are used for valuation purposes and are provided by third-party services where quoted market values are not available. The fair values of the interest rate swap agreements included in Level 2 were determined using third-party models that use as their inputs observable market conditions.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

9. Self-Funded Liabilities

The Health System is self-insured for general and professional liability, errors and omissions, and workers' compensation claims, and maintains excess insurance coverage at varying levels. A provision is made for estimated losses and related expenses on risks not covered by insurance. The provision includes estimated amounts for asserted claims, reported incidents for which a claim has not been asserted, and claims incurred but not reported. The provision is based on specific claim loss estimates by the Health System's management and on estimates of total annual losses by an independent consulting actuary using the Health System and similar facility experience.

The Health Professionals Insurance Company, Ltd. (HePIC), a wholly owned subsidiary, is a captive insurance company that provides professional liability, general liability, and other insurance coverage for the Health System and its affiliates. The Health System funds HePIC's required insurance reserves. Funding amounts are based on actuarial recommendations. The assets of HePIC and the established liability for self-funded losses are reported in the consolidated balance sheets. Investment income from the assets and the provision for estimated self-funded losses and administrative costs are reported in the consolidated statements of operations and changes in net assets. The Health System's established liability for self-funded losses was \$75,408,000 and \$63,533,000 as of December 31 and June 30, 2018, respectively, and is recorded in other long-term obligations in the accompanying consolidated balance sheets.

10. Commitments and Contingencies

Litigation

From time to time, the Health System is subject to litigation in the ordinary course of its operations. In management's opinion, any future settlements or judgments on asserted or unasserted claims will not have a material effect on the Health System's consolidated financial position.

Various federal and state agencies have initiated investigations regarding reimbursement claimed by the Health System and other matters. The investigations are in various stages of discovery, and the ultimate resolution of these matters, including the liabilities, if any, cannot be readily determined; however, in the opinion of management, the results of these investigations will not have a material adverse impact on the consolidated financial statements of the Health System.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (Unaudited) (continued)

10. Commitments and Contingencies (continued)

Other

Under terms of an agreement, as amended, originally dated January 1, 1968 and superseded with a new agreement dated August 16, 2004, the Health System and the University of Texas Health Science Center at Houston (the University) affiliated to operate and maintain a patient care, medical teaching, research, and community service facility. The agreement specifies that Memorial Hermann Hospital will serve as the primary private hospital teaching site for the University, and operate and maintain a fully accredited hospital, while maintaining final authority over operational policy. The University agrees to offer the hospital the opportunity to accommodate all teaching programs and clinical programs, maintain fully accredited educational programs, and conduct research activities while utilizing Memorial Hermann Hospital. Mutual commitments include administrative appointments and sharing of certain operational and research costs. Expenses for obligations to the University for the six-month periods ended December 31, 2018 and 2017 totaled \$158,103,000 and \$154,014,000, respectively. Following the initial term, this agreement will automatically renew on October 15, 2019 for an additional 10 years. The parties are in active discussions to establish a long-term extension to this academic and clinical affiliation agreement.

11. Impact of Hurricane Harvey

On August 24, 2017, Hurricane Harvey made landfall on the Southeast coast of Texas, which included many of the service areas where the Health System owns and operates its facilities. Widespread flooding occurred over several days in Houston and the surrounding area. The Health System temporarily evacuated one of its acute care facilities for several days and closed some of its smaller physician and ambulatory locations. All other Health System hospitals remained open throughout the period; however, certain services at all Health System hospitals were disrupted or cancelled, including elective admissions and surgeries. The hospitals subsequently returned to normal operations.

The Health System maintains insurance policies covering property damage, business interruption, and related costs, subject to applicable deductibles. Further, recovery of certain losses and costs may be provided by the Federal Emergency Management Agency (FEMA). Management is continuing to evaluate potential recoveries and file claims under existing insurance policies and FEMA. For the six months ended December 31, 2017, the Health System incurred expenses net of recoveries of approximately \$28,000,000 related to Hurricane Harvey.

Key Statistical Indicators



Memorial Hermann Health System
Key Statistical Indicators
For Period Ending December 31, 2018

Current	Current Period		O/(U)		Current	Year To Date		O/(U)
	Prior	Budget				Prior	Budget	
Inpatient								
15,090	15,525	15,299	(209)	Admissions	86,931	86,439	86,465	466
77,595	80,173	77,759	(164)	Patient Days	446,315	454,952	447,322	(1,007)
31,785	31,971	31,986	(0.6%)	Adjusted Admissions	184,930	177,681	181,081	2.1%
163,441	165,103	162,570	0.5%	Adjusted Patient Days	949,455	935,186	936,808	1.4%
2,097	2,025	2,293	(196)	Deliveries	13,040	12,949	13,653	(613)
4,040	4,314	4,299	(259)	Inpatient Surgeries	24,141	24,377	24,086	55
5.14	5.16	5.08	1.2%	Average Length of Stay	5.13	5.26	5.17	(0.8%)
1.7828	1.7725	1.7318	2.9%	Case Mix Index - Total	1.7871	1.7400	1.7454	2.4%
1.9864	1.9907	1.9662	1.0%	Case Mix Index - Medicare Acute	2.0295	1.9909	1.9818	2.4%
2.88	2.91	2.93	(1.7%)	CMI Adj Avg Length of Stay	2.87	3.02	2.96	(3.1%)
Outpatient								
6,840	6,505	6,474	366	Observation Days	39,527	39,248	39,022	505
5,808	5,280	5,508	300	Observation Patient Count	34,993	32,982	33,413	1,580
59,003	62,851	62,813	(3,810)	Emergency Visits	341,607	342,828	358,346	(16,739)
12,135	12,135	12,740	(605)	Outpatient Surgeries	68,126	63,887	68,170	(44)
119,562	123,941	120,711	(1,149)	Diag/Ther Registrations	771,542	742,120	745,913	25,629
Productivity/Cost Efficiency								
24,513	23,718	25,550	(1,037)	Paid Full Time Equivalents	24,879	24,315	24,978	(99)
4.6	4.5	4.9	(6.1%)	FTE per Adj Occ Beds	4.8	4.8	4.9	(2.0%)
43.2	38.8	44.3		Labor Cost as a % of NOR	43.8	44.0	44.5	
18.8	17.1	17.9		Supply Cost as a % of NOR	18.3	17.4	17.8	

Disclaimer

This Quarterly Report on Financial Information and Operating Data is provided solely to comply with contractual disclosure commitments, made in connection with outstanding bond issues, to provide specified information. Descriptions of the bonds, the source of payment and security for the bonds, and risks associated with an investment in the bonds are described in the Official Statements related to the bonds, as supplemented, copies of which are on file with the Municipal Securities Rulemaking Board. This Quarterly Report is not made in connection with a purchase or sale of bonds by MHHS and accordingly is not intended to contain all information material to a decision to purchase or sell bonds.

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