

CONSOLIDATED FINANCIAL STATEMENTS

Memorial Hermann Health System
Years Ended June 30, 2020 and 2019
With Report of Independent Auditors

Ernst & Young LLP



Memorial Hermann Health System

Consolidated Financial Statements

Years Ended June 30, 2020 and 2019

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Report of Independent Auditors

The Board of Directors
Memorial Hermann Health System

We have audited the accompanying consolidated financial statements of Memorial Hermann Health System (the Health System), which comprise the consolidated balance sheets as of June 30, 2020 and 2019, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Health System at June 30, 2020 and 2019, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Adoption of ASU No. 2016-02, *Leases (Topic 842)*

As discussed in Note 2 to the consolidated financial statements, the Health System changed its financial statement presentation as a result of the adoption of the amendments to the FASB Accounting Standards Codification resulting from Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*, effective July 1, 2019. Our opinion is not modified with respect to this matter.

Ernst & Young LLP

September 25, 2020

Memorial Hermann Health System

Consolidated Balance Sheets (In Thousands)

	June 30	
	2020	2019
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,138,471	\$ 279,220
Patient accounts receivable	555,900	604,765
Other current assets	343,342	269,925
Total current assets	2,037,713	1,153,910
Investments	2,904,424	2,666,516
Assets limited as to use, less current portion	436,234	239,936
Property, plant, and equipment, net	3,098,158	3,203,485
Operating lease right of use assets	719,735	—
Other assets	201,725	213,076
Total assets	<u>\$ 9,397,989</u>	<u>\$ 7,476,923</u>
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 248,082	\$ 243,612
Accrued payroll and related expenses	290,354	246,648
Medicare advance payment	393,524	—
Other accrued expenses	297,008	241,500
Current portion of long-term debt, including finance lease obligations	220,795	57,433
Long-term debt subject to liquidity agreements	455,111	440,775
Current portion of operating lease right of use obligation	82,569	—
Total current liabilities	1,987,443	1,229,968
Long-term debt, including finance lease obligations	2,133,361	1,807,282
Operating lease right of use obligation	651,861	—
Other long-term obligations	527,669	590,698
Total liabilities	5,300,334	3,627,948
Net assets without donor restrictions, including non-controlling interest of \$147,131 and \$131,563 in 2020 and 2019, respectively	3,969,905	3,722,735
Net assets with donor restrictions	127,750	126,240
Total liabilities and net assets	<u>\$ 9,397,989</u>	<u>\$ 7,476,923</u>

See accompanying notes.

Memorial Hermann Health System

Consolidated Statements of Operations and Changes in Net Assets (In Thousands)

	Year Ended June 30	
	2020	2019
Without donor restrictions		
Revenues, gains, and other support:		
Net patient service revenue	\$ 5,322,486	\$ 5,183,017
Other revenue	469,986	345,568
Total revenues, gains, and other support	5,792,472	5,528,585
Expenses:		
Salaries, benefits, and related personnel costs	2,583,650	2,416,282
Services and other	1,547,387	1,512,731
Supplies and medicines	1,061,247	1,015,886
Depreciation and amortization	318,380	300,221
Interest	92,058	92,945
Total expenses	5,602,722	5,338,065
Operating income	189,750	190,520
Nonoperating activities:		
Investment gains and other, net	24,989	146,270
Interest rate swap agreements	(34,196)	(30,498)
Loss on extinguishment of debt	(16,037)	—
Gain on sale of diagnostic laboratory	117,969	—
Revenues in excess of expenses	282,475	306,292
Revenues in excess of expenses attributable to non-controlling interests	(67,879)	(70,189)
Revenues in excess of expenses attributable to the Health System	214,596	236,103
Other changes in net assets:		
Change in pension obligation	(89,365)	(3,949)
Contributions and grants received and other changes in net assets, net	13,032	36,441
Cumulative effect of change in accounting principle	93,339	—
Change in non-controlling interests	15,568	635
Change in net assets without donor restrictions	247,170	269,230
With donor restrictions		
Contributions	29,108	25,767
Investment income, net	1,663	2,009
Net assets released from restrictions for operations and capital purchases	(29,261)	(26,431)
Change in net assets with donor restrictions	1,510	1,345
Change in net assets	248,680	270,575
Net assets at beginning of year	3,848,975	3,578,400
Net assets at end of year	\$ 4,097,655	\$ 3,848,975

See accompanying notes.

Memorial Hermann Health System

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended June 30	
	2020	2019
Operating activities		
Cash received for patient services	\$ 6,001,755	\$ 5,201,170
Cash paid to or on behalf of employees	(2,589,784)	(2,367,396)
Cash paid for supplies and services	(2,616,280)	(2,558,824)
Other receipts from operations	279,726	345,746
Investment gains realized	47,113	92,433
Interest paid	(80,551)	(96,764)
Net cash provided by operating activities	<u>1,041,979</u>	<u>616,365</u>
Investing activities		
Capital expenditures, net	(382,133)	(455,653)
Proceed from sale of business segment	120,000	—
Change in assets limited as to use	(23,591)	(20,821)
Change in investments	(306,015)	(283,931)
Proceeds from sale of investment in medical office building	—	115,935
Net cash used in investing activities	<u>(591,739)</u>	<u>(644,470)</u>
Financing activities		
Proceeds of issuance of long-term debt and note payable	1,738,489	—
Payments and defeasances on long-term debt and note payable	(1,136,145)	(28,281)
Restricted contributions	26,072	24,396
Noncontrolling interest	(52,311)	(69,554)
Net cash provided by (used in) financing activities	<u>576,105</u>	<u>(73,439)</u>
Net increase (decrease) in cash, cash equivalents, and restricted cash	1,026,345	(101,544)
Cash, cash equivalents, and restricted cash at beginning of year	340,169	441,713
Cash, cash equivalents, and restricted cash at end of year	<u>\$ 1,366,514</u>	<u>\$ 340,169</u>
Non-cash investing and financing activities		
Recognition of lease liabilities arising from obtaining right of use assets under operating lease	<u>\$ 826,486</u>	<u>\$ —</u>

See accompanying notes.

Memorial Hermann Health System

Notes to Consolidated Financial Statements

June 30, 2020

1. Mission and Organization

Memorial Hermann Health System (the Health System), a Texas nonprofit corporation, operates, directly and through affiliates, a multi-hospital, comprehensive healthcare system that has the largest market share in the Houston, Texas, greater metropolitan area. 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 currently operates 17 hospitals (including 11 general acute care hospitals, one children's hospital, one orthopedic & spine hospital, two rehabilitation hospitals, and two surgical hospitals), one nursing home, a Medicare-certified home health agency, an inpatient prevention and recovery center, a comprehensive network of ambulatory care facilities, two employed physician groups and an independent practice association, a health plan that underwrites group health coverage, a captive casualty and liability insurance company, and an accountable care organization. Additionally, the Health System is supported by the Memorial Hermann Foundation. The accompanying consolidated financial statements include the accounts of the Health System and its controlled affiliates. All significant intercompany accounts and transactions have been eliminated.

2. Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (U.S. GAAP) 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 June 30, 2020 through September 25, 2020, the date on which the accompanying consolidated financial statements were issued.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

Net Assets

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 accompanying consolidated financial statements, funds that have similar characteristics have been consolidated into two net asset categories:

- Net assets with donor restrictions are those net assets whose use has been restricted for a specific purpose or time period or those 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.
- Net assets without donor restrictions are not restricted by donors or are those net assets whose donor-imposed restrictions have expired or been met. When a donor restriction expires, the net assets with donor restrictions are reclassified as net assets without donor restrictions and reported in the consolidated statements of operations and changes in net assets with donor restrictions as assets released from restrictions.

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.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

Net Patient Service Revenue and Patient Accounts Receivable

Net Patient Service Revenue

The Health System's net patient service revenue is reported at the amount that reflects the consideration to which the Health System expects to be entitled in exchange for providing patient care. 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.

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 determines the estimates of contractual adjustments and discounts based on contractual agreements, discount policies, and historical experience.

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 estimate of implicit price concessions is 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.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

Amounts related to services provided to patients who were still receiving inpatient care in the Health System facilities at the end of the reporting period do not meet the conditions of unconditional right to payment and therefore are classified as contract assets. As of June 30, 2020 and 2019, the contract assets balance was \$65,000,000 and \$62,000,000 and is included in other current assets in the accompanying consolidated balance sheets.

The Health System's net patient service revenue by payer for the years ended June 30, 2020 and 2019, and approximate percentages of total, were as follows (in thousands):

	2020		2019	
	Amount	Ratio	Amount	Ratio
Managed care	\$ 2,781,451	52.3%	\$ 2,709,219	52.3%
Medicare	1,612,343	30.3	1,576,764	30.4
Medicaid	676,617	12.7	686,062	13.2
Self-pay	21,322	0.4	51,610	1.0
Other	230,753	4.3	159,362	3.1
Total	5,322,486	100.0%	5,183,017	100.0%

The Health System's accounts receivable by payer as a percentage of net accounts receivable were as follows at June 30:

	2020	2019
Managed care	47%	48%
Medicare	24	25
Medicaid	9	10
Self-pay	5	6
Other	15	11
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.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

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 intermediaries through December 31, 2016, for all hospitals and up to 2017 for certain entities. However, certain prior cost reports have been reopened by the Health System or by the fiscal intermediary. The reopenings are to expedite and accelerate the recovery of funds due the Health System. Additionally, from time to time, the Health System appeals legal decisions in nature made by 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. The Health System's policy is to record any funds received from reopenings or appeals as income in the year in which the notice of cost report settlement is received.

At June 30, 2020 and 2019, aggregate accruals and allowances for possible settlements, and pending reviews, as discussed above, of \$31,665,000 and \$27,656,000, respectively, are included in the accompanying consolidated balance sheets in other accrued expenses (2020: \$0; 2019: \$3,805,000) and other long-term liabilities (2020: \$31,665,000; 2019: \$23,851,000). It is reasonably possible that these estimates could differ from actual settlements and, thus, change in the near term by material amounts.

During 2020 and 2019, the Health System recognized \$7,793,000 and \$20,989,000, respectively, in net patient service revenue from differences between estimated and actual cost report settlements and appeals.

Medicaid Supplemental Payments

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, which created additional federal matching funds to increase access to health care by Texas' indigent patients and defray the cost of treating indigent patients.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

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 funding 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 in 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. Medicaid supplemental funds, which include Medicaid Disproportionate Share, DSRIP, UHRIP, and UC payments, of approximately \$365,105,000 and \$310,468,000, were recorded in 2020 and 2019, respectively. Net patient service revenue includes UC, UHRIP, and Disproportionate Share supplemental funds as a reduction of contractual adjustment. DSRIP is recorded as other revenue. At June 30, 2020 and 2019, the Health System recorded \$51,149,000 and \$44,932,000 receivables, respectively, and \$84,002,000 and \$15,238,000 deferred revenues, respectively, for Medicaid supplement payments. These amounts are included in other current assets and other accrued expenses in the accompanying consolidated balance sheets. Medicaid supplemental payments have been recognized based on the most recent information available.

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. Premium revenue of \$91,363,000 and \$101,638,000 was included in other revenue for the years ended June 30, 2020 and 2019, respectively.

The estimated cost of all health services rendered to members through June 30 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

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

relation to the dates of service. Subsequent changes to prior period estimates are reflected in the current period. Losses on contracts are recognized in the period when health care costs are expected to exceed premium revenue.

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.

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the statement of financial position that sum to the total of the same such amounts shown in the statement of cash flows for the years ended June 30, 2020 and 2019:

	June 30	
	2020	2019
	<i>(In Thousands)</i>	
Cash and cash equivalents	\$ 1,138,471	\$ 279,220
Investments	8,027	23,962
Assets limited as to use	220,016	36,987
Cash, cash equivalents, and restricted cash	<u>\$ 1,366,514</u>	<u>\$ 340,169</u>

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 (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 June 30, 2020, the unfunded commitment related to alternative investments is approximately \$524,212,000.

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

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

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 finance 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 (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 June 30, 2020 and 2019, the Health System has recognized net assets attributable to non-controlling interest of \$147,131,000 and \$131,563,000, 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 June 30, 2020 and 2019, the Health System had goodwill of \$180,525,000 and \$196,526,000, respectively, which relates to the purchase of several entities from 2010 to 2019, including purchases made by consolidated joint ventures. Goodwill is reflected in other assets.

Goodwill is tested 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. There was no material impairment of goodwill in the year ended June 30, 2020 or 2019.

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 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 material impairment charges were recorded for fiscal year 2020 or 2019.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

Taxes

The Health System and certain subsidiaries are Texas nonprofit corporations exempt from federal taxation under IRC Section 501(a), but are required to pay income taxes for their unrelated business activities. Most of the income received by the Health System and its subsidiaries is exempt from taxation under IRC Section 501(a). The Health System also owns subsidiaries that are taxable. The overall impact of federal income taxes to the Health System's combined financial statements is not significant. The Health System additionally has certain subsidiaries that file partnership income tax returns for U.S. tax purposes, as well as filing franchise tax returns in the state of Texas. The statutes of limitations for tax years between 2017 and 2019 remain open in the major U.S. taxing jurisdictions in which the Health System and subsidiaries are subject to taxation.

The Health System follows the provisions of Accounting Standards Codifications (ASC) 740, *Income Taxes*. Management has determined that there are no material uncertain tax positions that require recognition in the accompanying consolidated balance sheets. The Health System has net operating losses (NOLs) tax carryforwards that will expire between 2020 and 2038. 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 (Tax Act) was enacted on December 22, 2017. The Tax Act reduces the U.S. federal corporate tax rate from 35 percent to 21 percent, required companies to pay a onetime transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, and creates new taxes on certain foreign sourced earnings. The Health System was not impacted by the transition tax as its foreign sourced earnings are in the form of dividends or royalties that are exempt from unrelated business income tax.

On March 27, 2020, the President of the United States signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) into law. The CARES Act, among other things, includes provisions relating to refundable payroll tax credits, deferment of employer social security payments, net operating loss carryback periods, alternative minimum tax credit refunds, modifications to the net interest deduction limitations, and technical corrections to tax depreciation methods for qualified improvement property. Management does not expect a material impact on the Health System's consolidated financial statements.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (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 non-controlling 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.

New Accounting Pronouncement

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Updates (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 also required additional disclosures about the amount, timing, and uncertainty of cash flows arising from leases. The Health System adopted the provisions of ASU 2016-02 effective July 1, 2019, applying the transitional package of practical expedients allowed by the standard relating to the identification, classification, and initial direct costs of leases commencing before the effective date. The Health System used the optional transition method that allows entities to initially apply the new lease standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Health System did not elect the hindsight transitional practical expedients. The adoption resulted in the Health System recognizing right-of-use assets of approximately \$817,000,000 and right-of-use liabilities of \$826,000,000 as of the transition date with a cumulative adjustment of \$93,339,000 to the opening balance of retained earnings. Refer to Note 6 for additional disclosures regarding adoption.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, to provide guidance on the presentation of restricted cash or restricted cash equivalents in the statement of cash flows. The amendments require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The provisions of ASU 2016-18 were

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

2. Significant Accounting Policies (continued)

effective for the Health System for the fiscal year starting July 1, 2019, and for interim periods starting July 1, 2020. The Health System adopted the provisions of ASU 2016-18 effective July 1, 2019 by applying a retrospective transition method, which required a restatement of its consolidated statement of cash flows for all periods presented. The effect of the new standard was to increase the amounts include in cash, cash equivalents, and restricted cash on the consolidated statements of cash flows by \$228,043,000, \$60,949,000, and \$70,687,000 at June 30, 2020, June 30, 2019, and July 1, 2019, respectively.

Pending Accounting Pronouncements

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The amendments in this update eliminate Step 2 from the goodwill impairment test to simplify the subsequent measurement of goodwill. Step 2 requires determining the fair value at the impairment testing date of assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. The provisions of ASU 2017-04 are effective for the Health System starting July 1, 2021, and early adoption is permitted. Management is currently evaluating the impact of this pronouncement on the Health System's consolidated financial statements.

In July 2016, the FASB issued ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which is intended to change how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. The standard will replace today's "incurred loss" approach with an "expected loss" model for instruments measured at amortized cost and require entities to record allowances for available-for-sale debt securities rather than reduce the carrying amount, as they do today under the other-than-temporary impairment model. It also simplifies the accounting model for purchased credit-impaired debt securities and loans. The provisions of ASU 2016-13 are effective for the Health System for the annual and interim periods starting July 1, 2023, and early adoption is permitted. Management 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 (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.

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. For the year ended June 30, 2020 and 2019, these costs are \$302,252,000 and \$265,542,000 respectively.

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 Memorial Hermann – Texas Medical Center (Level I trauma center); a burn unit; a transplant center; a Level I Pediatric Trauma facility, 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 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 82 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

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

3. Community Service (continued)

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; collaborative work in a handful of at-risk communities predominantly providing Exercise is Medicine and Food as Health programming, and providing financial support to primary care clinics and social service agencies that support Memorial Hermann.

Memorial Hermann Community Benefit Corporation's four driving pillars are: access to health care, emotional well-being, food as health and exercise is medicine. Additionally, the Health System collaborates with various community and city-wide task forces committed to building 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 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 2020 and 2019, 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.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

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:

	June 30	
	2020	2019
	<i>(In Thousands)</i>	
Cash and cash equivalents	\$ 8,027	\$ 23,962
Fixed income	272,566	309,838
Equity securities	1,091,107	1,049,917
Alternative investments:		
Hedge fund	829,072	729,846
Private equity	381,716	240,941
Real assets	321,936	312,012
Total investments	<u>\$ 2,904,424</u>	<u>\$ 2,666,516</u>

Assets Limited as to Use

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

	June 30	
	2020	2019
	<i>(In Thousands)</i>	
Bond indenture agreements	\$ 184,562	\$ —
Self-insurance programs	121,541	107,057
Donor restrictions	127,750	126,240
Charity care, depreciation, and other funds	10,081	10,639
	<u>443,934</u>	<u>243,936</u>
Less current portion required for current liabilities	<u>(7,700)</u>	<u>(4,000)</u>
	<u>\$ 436,234</u>	<u>\$ 239,936</u>

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

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

Investment Income

Investment income related to net assets without donor restrictions comprises the following:

	Year Ended June 30	
	2020	2019
	<i>(In Thousands)</i>	
Interest and dividend income	\$ 28,160	\$ 66,951
Realized gains, net	33,090	47,582
Unrealized (losses) gains, net	(50,393)	21,816
	<u>\$ 10,857</u>	<u>\$ 136,349</u>

5. Financial Assets and Liquidity Reserve

The Health System defines general expenditures as the expenditures related to operations of the Health System, excluding capital expenditures. The table below represents financial assets and liquidity resources available for general expenditures within one year as of June 30, 2020. As part of the Health System's liquidity management plan, cash in excess of daily requirements are invested in money market funds and other liquid investments that can be drawn upon, if necessary, to meet liquidity needs. The Health System has assets limited as to use under self-insurance programs and or restricted by donors. These assets limited as to use are not reflected in the table below.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

5. Financial Assets and Liquidity Reserve (continued)

	June 30	
	2020	2019
	<i>(In Thousands)</i>	
Financial assets:		
Cash and cash equivalents	\$ 1,138,471	\$ 279,220
Investments	2,904,424	2,666,516
Patient accounts receivable	555,900	604,765
Other current assets	166,768	138,885
Total financial assets	4,765,563	3,689,386
Liquidity resource:		
Unused bank lines of credit	462,500	253,500
Less amounts not available within one year or not designated for general expenditures:		
Capital expenditures	(74,139)	(222,409)
Alternative investments subject to redemption restrictions	(917,883)	(1,120,246)
Financial assets not available for use within one year	(992,022)	(1,342,655)
Financial assets and liquidity resources available for general expenditures within one year	<u>\$ 4,236,041</u>	<u>\$ 2,600,231</u>

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

6. Property, Plant, and Equipment

Property, plant, and equipment consist of the following:

	June 30	
	2020	2019
	<i>(In Thousands)</i>	
Buildings and improvements	\$ 3,896,789	\$ 3,299,840
Building and equipment under finance lease	677,849	819,080
Equipment	2,439,927	2,281,664
Less accumulated depreciation	(4,169,170)	(3,911,883)
	<u>2,845,395</u>	<u>2,488,701</u>
Land	144,829	144,829
Construction-in-progress	107,934	569,955
	<u><u>\$ 3,098,158</u></u>	<u><u>\$ 3,203,485</u></u>

At June 30, 2020 and 2019, the Health System had leasehold improvements net of accumulated depreciation totaling \$232,692,000 and \$254,748,000, respectively.

At June 30, 2020 and 2019, the Health System had building and equipment under finance lease net of accumulated depreciation totaling \$428,141,000 and \$568,516,000, respectively.

At June 30, 2020, the Health System had remaining commitments for planned construction of approximately \$74,139,000.

Under the provisions of ASC 840-40, *Leases – Sale-Leaseback Transactions* and transition provisions of ASC 842 *Leases*, 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 \$133,821,000 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 June 30, 2020, the following amounts are recorded in property, plant, and equipment, net and other long-term obligations:

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

6. Property, Plant, and Equipment (continued)

	Property, Plant, and Equipment		Other Accrued Expenses and Other Long-term Obligations	
	June 30		June 30	
	2020	2019	2020	2019
Medical office buildings and improvements	\$ 44,027,000	\$ 53,613,000	\$ 204,378,000	\$ 223,414,000

As of June 30, 2020, future minimum payments related to these medical office buildings sold and leased back are as follows: \$14,698,000 in 2021, \$14,992,000 in 2022, \$15,292,000 in 2023, \$15,598,000 in 2024, \$15,910,000 in 2025, and \$985,000 thereafter.

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 \$116,000,000. Under the provisions of ASC 840-40, *Leases – Sale-Leaseback Transactions* a gain on the sale \$96,055,000 was deferred in conjunction with the sale. Effective July 1, 2019, with the adoption of ASC 842, *Leases*, the balance of this gain of approximately \$87,000,000 was recognized as a cumulative effect adjustment upon adoption and is reflected as an increase in net assets.

Under the provisions of ASC 842 transition requirements, the Health System derecognized \$126,000,000 of property, plant, and equipment, net, \$125,000,000 of finance lease obligations, \$1,000,000 of other accrued expenses, and \$12,000,000 of other long-term obligations related to transactions previously accounted for under build-to-suit and sale-leaseback guidance for certain medical and professional office buildings that were sold and leased back or were capitalized by the Health System due to its involvement during the asset construction period and its continuing involvement after the construction period. Following the derecognition of the assets and liabilities, the Health System recognized approximately \$123,000,000 as operating lease right-of-use assets and lease liabilities for these buildings, and \$12,000,000 was recognized as a cumulative effect adjustment as an increase in net assets without donor restrictions.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

7. Indebtedness

Long-term debt at June 30 consisted of the following:

	2020	2019
	<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 0.15% to 0.51% at June 30, 2020, due in varying installments through June 1, 2046:		
Series 2014C and D	\$ 70,400	\$ 70,400
Series 2015A and B	162,400	239,700
Series 2016B, C, D, and E	253,975	309,475
Series 2019E and F	132,800	—
Revenue bonds, in variable rate mode, with interest rate ranging from 0.13% to 0.70% at June 30, 2020, due in annual installments through December 1, 2049:		
Series 2013B	45,080	56,145
Series 2014B	—	70,425
Series 2019C	103,145	—
Revenue bonds, in fixed-rate mode, bearing interest from 3.13% to 5%, due in annual installments through July 1, 2049:		
Series 2010A	—	30,805
Series 2013A	133,905	294,705
Series 2014A	104,325	135,185
Series 2016A	132,900	132,900
Series 2019A	180,430	—
Series 2019B	173,690	—
Series 2020	20,200	—
Other long-term debt obligations:		
Finance lease obligations	713,931	840,188
Line of credit and other notes	506,088	98,347
	2,733,269	2,278,275
Premiums on long-term debt, net	82,057	34,899
Less deferred financing fees	(6,059)	(7,684)
	2,809,267	2,305,490
Less current portion, including amounts subject to self-liquidity	(675,906)	(498,208)
	\$ 2,133,361	\$ 1,807,282

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

7. 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. In April 2020, the Health System entered into additional lines of credit agreements with maximum amount available of \$625,000,000 for terms ranging from 364 days to 24 months. As of June 30, 2020 and 2019, \$462,500,000 and \$46,500,000 were outstanding, respectively.

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.

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.

On November 21, 2019, the Health System issued the Series 2019A (\$180,430,000) fixed-rate bonds and the Series 2019B (\$173,690,000) fixed-rate put bonds and defeased \$153,225,000 of Series 2013A and \$28,270,000 of Series 2014A. The defeasance resulted in a loss of \$14,758,000.

On November 21, 2019, the Health System refinanced Series 2014B (\$70,425,000) by issuing the Series 2019C (\$103,145,000) floating rate bonds.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

7. Indebtedness (continued)

On November 21, 2019, the Health System refinanced Series 2015C (\$77,347,000) and Series 2016E (\$55,535,000) by issuing the Series 2019E (\$66,400,000) and 2019F (\$66,400,000) variable rate demand bonds. The Series 2019E and 2019F 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.

On March 3, 2020, the Health System refinanced Series 2010A (\$25,230,000) by issuing the Series 2020 (\$20,200,000) fixed-rate bond.

On August 5, 2020, the Health System issued, Series 2020A (\$30,110,000) fixed-rate bonds to exchange Series 2013A, 2014A, 2016A, Series 2020B (\$8,230,000) fixed-rate bonds to fund the tender of Series 2013A, 2014A, and 2016A, Series 2020C (\$136,625,000) fixed-rate put bonds, and Series 2020D (\$91,425,000) taxable fixed-rate bonds to refund Series 2015A, 2015B, and 2013A.

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

As of June 30, 2020, scheduled principal payments for outstanding debt (excluding finance leases and other notes) for the next five fiscal years are as follows: \$38,475,000 in 2021, \$40,365,000 in 2022, \$42,460,000 in 2023, \$44,470,000 in 2024, and \$45,320,000 in 2025.

The estimated fair value of the Health System's serial and term fixed-rate bonds at June 30, 2020 and 2019, was approximately \$844,000,000 and \$651,000,000, 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 June 30, 2020 and 2019, due to the variable nature of the interest rate.

Leases

The Health System leases certain buildings, medical offices, and various equipment types. The Health System determines if an arrangement is a lease at inception. Operating leases are included in operating lease right of use assets and current and long-term operating lease right-of-use

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

7. Indebtedness (continued)

obligations on the consolidated balance sheet, as of June 30, 2020. Finance leases are included in property and equipment, current portion of long-term debt, and long-term debt on the consolidated balance sheet. Right of use assets and lease liabilities are recognized based on the net present value of the future minimum lease payments over the lease term at commencement date. The Health System has agreements with lease and non-lease components. The non-lease components are excluded from the right of use assets and liabilities. The Health System uses a risk-free rate in measuring lease liabilities and lease terms range from 1 to 24 years.

As of June 30, 2020, minimum future rentals under noncancelable leases, for the next five fiscal years and in aggregate, are as follows:

	Finance Leases	Operating Leases
2021	\$ 54,137,000	\$ 82,945,000
2022	54,515,000	94,897,000
2023	54,357,000	87,922,000
2024	53,963,000	80,221,000
2025	56,121,000	79,303,000
Thereafter	1,224,371,000	399,255,000
Total minimum lease payments	1,497,464,000	824,543,000
Less portion representing interest	(783,533,000)	(90,113,000)
Total lease obligations	<u>\$ 713,931,000</u>	<u>\$ 734,430,000</u>

For the year ended June 30, 2020, lease cost and cash paid for operating leases were \$109,122,000 and \$101,127,000, respectively.

Weighted average remaining lease term (years):	
Operating leases	17.84
Finance leases	23.30
Weighted average discount rate:	
Operating leases	2.22%
Finance leases	6.76%

For the year ended June 30, 2020, new leases added were \$33,000,000, and variable lease expense was \$21,993,000.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

8. 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 June 30, 2020 and 2019, the change in value, and the net amounts paid and received for the years ended June 30, 2020 and 2019 (in thousands):

Swap Description	Term Date	Interest Rate Agreements	Aggregate Notional Amount	Fair Value Liability		Change in Fair Value		Settlement Activity Paid	
				June 30 2020	June 30 2019	June 30 2020	June 30 2019	June 30 2020	June 30 2019
LIBOR-based to fixed (5.343%)	2032	1	\$ 113,120	\$ (54,094)	\$ (39,753)	\$ (14,341)	\$ (11,167)	\$ 4,347	\$ 3,503
LIBOR-based to fixed (3.629%)	2029	3	131,700	(30,486)	(23,438)	(7,048)	(6,167)	832	753
LIBOR-based to fixed (3.635%)	2024	1	17,900	(1,496)	(1,580)	84	(64)	586	460
LIBOR-based to fixed (3.630%)	2024	1	26,500	(2,353)	(2,410)	57	(127)	3,390	2,794
LIBOR-based to fixed (3.690%)	2027	1	31,800	(4,536)	(3,993)	(543)	(679)	2,446	2,108
LIBOR-based to fixed (3.685%)	2027	2	86,400	(12,350)	(10,836)	(1,514)	(1,500)	955	782
LIBOR-based constant maturity swap	2034	1	500,000	2,318	(390)	2,708	(390)	1,045	4
		10	\$ 907,420	\$ (102,997)	\$ (82,400)	\$ (20,597)	\$ (20,094)	\$ 13,601	\$ 10,404

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, except for the constant maturity swap, the notional amount of which does not change. At June 30, 2020 and 2019, the fair value of swap agreements was a liability of \$102,997,000 and \$82,400,000, respectively, and has been included in other long-term liabilities in the accompanying consolidated balance sheets. As of June 30, 2020 and 2019, 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 years ended June 30, 2020 and 2019, of \$13,601,000 and \$10,404,000, respectively, in nonoperating expenses (interest rate swap agreements) in the consolidated statements of operations and changes in net assets.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

9. 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.

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

The following tables present financial instruments carried at fair value as of June 30, 2020 and 2019, on a recurring basis. The tables do not include contributions receivable of \$35,145,000 and \$31,545,000 at June 30, 2020 and 2019, 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 alternative investments of \$1,344,189,000 and \$1,279,782,000 at June 30, 2020 and 2019, respectively, which are measured at fair value using

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

9. Fair Value Measurement (continued)

net asset value as a practical expedient, as allowed under ASU 2009-12, *Fair Value Measurement 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 over 12 months.

June 30, 2020				
	Level 1	Level 2	Level 3	Total
<i>(In Thousands)</i>				
Assets				
Investments:				
Cash and equivalents	\$ 8,027	\$ —	\$ —	\$ 8,027
U.S. government securities	33,595	18,978	—	52,573
Pooled funds:				
Domestic equities	2,251	70,191	—	72,442
Global equities	143,184	320,830	—	464,014
Fixed income	81,569	—	—	81,569
Hedge fund	36,350	203,564	—	239,914
Corporate obligation	66,463	35,461	—	101,924
Corporate equities	316,285	9,728	—	326,013
Global equities	186,595	308	—	186,903
MLPs	41,735	—	—	41,735
Public REITs	—	—	—	—
Assets limited as to use:				
Cash and equivalents	220,016	—	—	220,016
Pooled funds:				
Domestic equities	1,117	—	—	1,117
Global equities	8,562	11,078	—	19,640
Fixed income	105,777	—	—	105,777
Hedge Funds	—	11,588	—	11,588
MLPs	2,981	—	—	2,981
Corporate equities	12,923	—	—	12,923
Global equities	11,957	24	—	11,981
Total assets	\$ 1,279,387	\$ 681,750	\$ —	\$ 1,961,137
Liabilities				
Interest rate swap agreements	\$ —	\$ 102,997	\$ —	\$ 102,997
Total liabilities	\$ —	\$ 102,997	\$ —	\$ 102,997

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

9. Fair Value Measurement (continued)

	June 30, 2019			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets				
Investments:				
Cash and equivalents	\$ 23,962	\$ —	\$ —	\$ 23,962
U.S. government securities	—	74,894	—	74,894
Pooled funds:				
Domestic equities	2,204	67,772	—	69,976
Global equities	102,603	305,951	—	408,554
Risk parity	—	43,305	—	43,305
Fixed income	125,185	—	—	125,185
Hedge fund	—	137,463	—	137,463
Corporate equities	290,117	—	—	290,117
Global equities	128,013	—	—	128,013
MLPs	56,087	—	—	56,087
Public REITs	53,865	—	—	53,865
Assets limited as to use:				
Cash and equivalents	36,987	—	—	36,987
Pooled funds:				
Domestic equities	5,410	—	—	5,410
Global equities	55,143	8,556	—	63,699
Fixed income	52,262	—	—	52,262
MLPs	5,481	—	—	5,481
Corporate equities	9,501	—	—	9,501
Global equities	4,999	—	—	4,999
Public REITs	5,178	—	—	5,178
Total assets	\$ 956,997	\$ 637,941	\$ —	\$ 1,594,938
Liabilities				
Interest rate swap agreements	\$ —	\$ 82,400	\$ —	\$ 82,400
Total liabilities	\$ —	\$ 82,400	\$ —	\$ 82,400

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 (continued)

10. Pension Plans

The Health System sponsors a cash balance defined benefit pension plan covering all eligible employees. The Health System's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974, plus such additional amounts as the Health System may determine to be appropriate from time to time. Funding requirements are determined through consultation with an independent actuary. Effective July 1, 2011, the Health System closed the plan to new participants. Participants as of June 30, 2011, continue to accrue benefits.

The Health System recognizes the funded status (that is, the difference between the fair value of plan assets and the projected benefit obligations) of its plan in the consolidated balance sheets, with a corresponding adjustment to net assets. Actuarial gains and losses that arise and are not recognized as net periodic pension cost in the same periods are recognized as a component of net assets.

The assumptions used in calculating the pension amounts recognized in the Health System's consolidated financial statements include discount rates, interest costs, expected return on plan assets, retirement and mortality rates, inflation rates, salary growth, and other factors. While the Health System believes the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect future pension obligations and expense.

The plan was amended effective March 31, 2019. For pay periods commencing after March 31, 2019, the employer contribution credits changed from tiered funding to 3% of the employee's compensation payable as of the end of such biweekly pay period.

The following tables set forth the plan's funding status as of the measurement dates, amounts recognized in the consolidated financial statements, and assumptions used. The plan's measurement dates were June 30, 2020 and 2019, with participant census dates of July 1, 2019 and 2018, respectively.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

10. Pension Plans (continued)

	Year Ended June 30	
	2020	2019
	<i>(In Thousands)</i>	
Change in projected benefit obligation:		
Benefit obligation, beginning of year	\$ 655,622	\$ 650,701
Service cost	22,217	27,696
Interest cost	22,287	26,128
Actuarial loss, net	59,345	40,744
Benefits paid	(36,465)	(35,335)
Administrative expenses paid	(2,257)	(2,420)
Effect of plan amendment	—	(51,892)
Projected benefit obligation (including \$716,692 and \$654,081 in 2020 and 2019, respectively, in accumulated benefit obligation), end of year	<u>\$ 720,749</u>	<u>\$ 655,622</u>
Change in plan assets:		
Fair value of assets, beginning of year	\$ 582,015	\$ 598,132
Employer contributions	72,000	1,200
Return on plan assets	6,636	20,438
Benefits paid	(36,465)	(35,335)
Administrative expenses paid	(2,257)	(2,420)
Fair value of assets, end of year	<u>\$ 621,929</u>	<u>\$ 582,015</u>
Funded status:		
Pension liability recorded in other long-term obligations in the consolidated balance sheets	<u>\$ (98,820)</u>	<u>\$ (73,607)</u>

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

10. Pension Plans (continued)

At June 30, 2020, net assets without donor restrictions include \$251,051,000 of primarily unrecognized actuarial losses of the Health System's defined benefit plan that have not yet been recognized in net periodic benefit cost, of which \$14,901,000 will be amortized in fiscal year 2020.

	Year Ended June 30	
	2020	2019
	<i>(In Thousands)</i>	
Components of net periodic cost:		
Service cost	\$ 22,217	\$ 27,696
Interest cost	22,287	26,128
Expected return on plan assets	(47,353)	(46,130)
Amortization of prior service cost	17,811	11,740
Amortization of losses and other, net	(7,140)	(2,380)
Net periodic cost	<u>\$ 7,822</u>	<u>\$ 17,054</u>

Service cost is included in salaries, benefits, and related personnel costs in the consolidated financial statements and other costs are included in net investment income.

Weighted average assumptions for determining benefit obligations at end of year and net periodic costs for the year:

Discount rates – benefit obligations	2.83%	3.60%
Discount rates – net periodic costs	3.60	4.34
Rates of increase in future compensation levels	3.12	3.50
Expected long-term rate of return on plan assets	8.10	8.10

The assumption for the expected return on assets is derived from a study conducted by the Health System's actuaries and financial management. The study includes a review of the plan's asset allocation strategy, anticipated long-term performance of individual asset classes, risks and correlations of asset classes, and general economic conditions of the investment marketplace. Because of revisions to the plan's investment policy, asset allocation strategy, and changes in professional managers utilized, historical returns performance of the plan was not a significant factor in the analysis.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

10. Pension Plans (continued)

The assets of the pension plan by weighted average asset allocation categories are set forth in the following table:

	2020	2019
Asset category:		
Short-term investments	2%	—%
Fixed income	13	24
Domestic equity	15	19
Global equity	14	8
International equity	14	14
Risk parity	1	—
Private equity and hedge funds	41	35
Total	100%	100%

The plan's general investment objective is to seek to achieve attractive long-term total return from income and growth of capital over a full market cycle with a low-to-moderate level of risk, emphasizing, primarily, the preservation of principal and, secondarily, the real purchasing power of assets over the long term while maintaining adequate liquidity to meet benefits and expense cash flow requirements when due through the utilization of investments in a balanced and diversified portfolio of equity, fixed income, short-term liquid securities, and alternative investments. Investments will be well-diversified across individual issuers, economic sectors, and asset classes to ensure a level of risk that is comparable to the general investment markets. At June 30, 2020, the unfunded commitment related to the plan's assets is \$91,436,000.

The plan's assets measured at fair value on a recurring basis were determined using the following inputs at June 30, 2020 and 2019. The tables do not include Level 3 alternative investments of \$204,611,000 and \$198,533,000, respectively, which are measured at fair value using net asset value as a practical expedient. The plan's investment in alternative investments includes hedge funds, private equity, and real assets.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

10. Pension Plans (continued)

June 30, 2020				
	Level 1	Level 2	Level 3	Total
<i>(In Thousands)</i>				
Cash and cash equivalents	\$ 11,801	\$ —	\$ —	\$ 11,801
U.S. government securities	—	9,269	—	9,269
Pooled funds:				
Domestic equities	—	14,399	—	14,399
Global equities	56,757	71,117	—	127,874
Fixed income	41,894	—	—	41,894
Hedge fund	9,997	58,280	—	68,277
Private equity	5,027	—	—	5,027
Corporate obligations	—	19,131	—	19,131
Corporate equities	65,461	—	—	65,461
Global equities	43,959	69	—	44,028
MLPs	10,157	—	—	10,157
Total	\$ 245,053	\$ 172,265	\$ —	\$ 417,318

June 30, 2019				
	Level 1	Level 2	Level 3	Total
<i>(In Thousands)</i>				
Cash and cash equivalents	\$ 9,566	\$ —	\$ —	\$ 9,566
U.S. government securities	—	12,206	—	12,206
Pooled funds:				
Domestic equities	—	13,869	—	13,869
Global equities	28,988	70,704	—	99,692
Fixed income	66,629	—	—	66,629
Hedge fund	—	44,573	—	44,573
Corporate obligations	—	17,647	—	17,647
Corporate equities	61,524	—	—	61,524
Global equities	27,486	—	—	27,486
MLPs	15,417	—	—	15,417
Public REITs	14,873	—	—	14,873
Total	\$ 224,483	\$ 158,999	\$ —	\$ 383,482

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

10. Pension Plans (continued)

As described in Note 9, management has elected to use the net asset value per share, or its equivalent, as a practical expedient for fair value of the plan's interest in alternative investments. The majority of these funds have restrictions on the timing of withdrawals, which may reduce liquidity, in some cases over 12 months.

All of the assets are managed by external investment managers and are maintained in actively managed security portfolios. Derivative investments are not allowed except by fund managers who employ such techniques to offset or reduce the risk associated with an existing group of investments. There are no required contributions for fiscal year 2020.

	Estimated <i>(In Thousands)</i>
Expected benefit payments estimated for fiscal years:	
2021	\$ 44,047
2022	43,717
2023	45,047
2024	44,335
2025	44,976
2026–2030	217,460

In addition to the defined benefit plan discussed above, eligible employees participate in certain other retirement plans, including defined contribution plans with employer matches of \$80,716,000 and \$71,241,000 for 2020 and 2019, respectively.

11. 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.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

11. Self-Funded Liabilities (continued)

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's 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 \$60,383,000 and \$59,100,000 as of June 30, 2020 and 2019, respectively, and is recorded in accrued payroll and related expenses, other accrued expenses, and other long-term obligations in the accompanying consolidated balance sheets.

12. Functional Expenses

The table below present expenses by both their nature and function for the years ending June 30, 2020 and 2019.

	Health Services	Insurance Services	General and Administrative	Total
Year ended June 30, 2020:				
Salaries, benefits, and related personnel costs	\$ 2,374,082	\$ 13,513	\$ 196,055	\$ 2,583,650
Services and other	1,378,068	73,619	95,700	1,547,387
Supplies and medicines	1,059,589	1,135	523	1,061,247
Depreciation and amortization	274,667	832	42,881	318,380
Interest	92,040	—	18	92,058
	<u>\$ 5,178,446</u>	<u>\$ 89,099</u>	<u>\$ 335,177</u>	<u>\$ 5,602,722</u>
Year ended June 30, 2019:				
Salaries, benefits, and related personnel costs	\$ 2,202,106	\$ 16,079	\$ 198,097	\$ 2,416,282
Services and other	1,332,000	83,991	96,740	1,512,731
Supplies and medicines	1,014,659	938	289	1,015,886
Depreciation and amortization	255,142	1,022	44,057	300,221
Interest	91,886	—	1,059	92,945
	<u>\$ 4,895,793</u>	<u>\$ 102,030</u>	<u>\$ 340,242</u>	<u>\$ 5,338,065</u>

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

13. 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.

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 Health System 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 Health System. Mutual commitments include administrative appointments and sharing of certain operational and research costs. Expenses for obligations to the University for the years ended June 30, 2020 and 2019, totaled \$355,000,000 and \$328,000,000, respectively. This agreement renewed 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.

14. Sale of Memorial Hermann Diagnostic Laboratory Services

In April 2020, the Health System sold the assets of the diagnostic laboratory services to Quest Diagnostics Clinical Laboratories, Inc. for \$120,000,000. The net gain from the sale of diagnostic laboratory assets of \$117,000,000 is recorded in gain on sale of diagnostic laboratory in the consolidated statement of operations and changes in net assets.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

15. COVID-19

On March 11, 2020, the World Health Organization designated COVID-19 as a global pandemic. Patient volumes and the related revenue for most services were significantly impacted beginning in mid-March 2020 as various policies were implemented by federal, state and local governments in response to the COVID-19 pandemic, including stay-at-home orders, business closures, social distancing and suspension of elective and nonemergent procedures. In early May, certain of these policies such as suspension of elective and nonemergent procedures were lifted and the Health System experienced gradual improvement in volumes and related revenue. During this time the Health System has also experienced supply chain disruptions, including significant price increases in medical supplies, particularly personal protective equipment. In addition, the pandemic has created significant volatility in the U.S. and global financial markets that has impacted the Health System's investment portfolio but has gradually improved in the second quarter of 2020.

Sources of pandemic relief include the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was enacted on March 27, 2020, and the Paycheck Protection Program and Health Care Enhancement Act (PPHCE Act), which was enacted on April 24, 2020. Together the CARES Act and the PPHCE Act include \$175,000,000,000 in funding to hospitals and other healthcare providers through the Public Health and Social Services Emergency Fund (PHSSEF). Grant payments from the PHSSEF are intended to reimburse healthcare providers for lost revenue and increased expenses due to the pandemic. Beginning in April and through June 2020, the Health System had received approximately \$97,000,000 through the PHSSEF, of which the System recognized approximately \$96,000,000 as other revenue in the accompanying consolidated statement of operations and changes in net assets for the year ended June 30, 2020. In July and August 2020, additional PHSSEF funds of approximately \$216,000,000 were received. The Health System recognizes grant payments as income when there is reasonable assurance that the grant conditions are met. These estimates could change materially based on lost revenue or expenses related to COVID-19 as well as the evolving grant compliance guidance provided by the government.

The CARES Act provides for an expansion of the Medicare Accelerated and Advance Payment Program (Accelerated Payment Program), which allows inpatient acute care hospitals to request accelerated payments of up to 100% of their Medicare payment amount for a six-month period. In April 2020, the System received approximately \$395,000,000 from the Accelerated Payment Program before the Centers for Medicare and Medicaid Services (CMS) paused to reevaluate pending and new applications in light of direct payments made available through the PHSSEF.

Memorial Hermann Health System

Notes to Consolidated Financial Statements (continued)

15. COVID-19 (continued)

Such accelerated payments are interest free for inpatient acute care hospitals for 12 months, and the Accelerated Payment Program requires CMS to recoup the payments by withholding future Medicare fee-for-service payments for claims until the full accelerated payment has been recouped. The Accelerated Payment Program currently requires that any outstanding balances remaining after 12 months must be repaid or be subjected to a 10.25% annual interest rate. The amount received is recorded as a contract liability in other current liabilities in the accompanying consolidated balance sheet as of June 30, 2020.

The CARES Act also allows for deferred payment of the employer portion of certain payroll taxes between March 27, 2020 and December 31, 2020, with 50% due December 31, 2021 and the remaining 50% due December 31, 2022. The Health System began deferring these payroll tax payments in April 2020. As of June 30, 2020, the System had deferred payroll tax payments of approximately \$27,000,000, which is included in accrued payroll and related expenses in the accompanying consolidated balance sheet. Due to the evolving nature of the COVID-19 pandemic, the ultimate impact to the System and its financial condition is presently unknown.

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