

MAJOR MEDICAL CENTER¹

For the Major Medical Center financial statements on the following pages, complete the following:

- a. Read the auditor's opinion letter. Are any flags raised?
- b. Review the financial statements. Search for unusual items. What things catch your eye on the balance sheet, operating statement, and cash flow statement?
- c. Review the notes. Do any of them raise cause for concern?
- d. Calculate the following ratios: common size, current, quick, days of cash on hand, receivables turnover, average collection period, fixed asset turnover, total asset turnover, debt, debt to equity, times-interest-earned, operating margin, total margin, ROA, and RONA.
- e. What do you think of Major Medical Center's financial status?

¹Major Medical Center is a fictional organization. Any similarity to real organizations is purely coincidental.

I.N. SINCER AND OLD, CPAs
2650 East 38th Street
New York, New York 10089

Report of Independent Auditors

Board of Trustees
Major Medical Center

We have audited the accompanying statements of financial position of Major Medical Center (the "Medical Center") as of December 31, 2018 and 2017, and the related statements of operations, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Medical Center's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Major Medical Center at December 31, 2018 and 2017, and the results of its operations, changes in net assets, and cash flows for the years then ended, in conformity with generally accepted accounting principles.

April 30, 2018

I.N. SINCER AND OLD, CPAS

Major Medical Center
Statements of Financial Position

	December 31	
	2018	2017
	(In Thousands)	
Assets		
Current Assets		
Cash and cash equivalents	\$ 8,065	\$9,005
Assets limited as to use—compensating balance for letters of credit	1,000	—
Short-term investments	1,387	1,283
Receivables for patient care, net of allowance for doubtful accounts (2018—\$27,232; 2017—\$31,934)	49,719	47,614
Pledges receivable	1,814	2,205
Inventories, at average cost	1,690	2,326
Due from third-party reimbursement programs	6,539	—
Receivables for government grants	—	467
Other	<u>2,234</u>	<u>3,415</u>
Total Current Assets	\$ 72,448	\$66,315
Assets Limited as to Use		
Sinking fund	14,487	13,410
Compensating balance for standby letters of credit	923	—
Long-term investments	1,132	618
Due from affiliates, net	3,417	3,543
Pledges receivable, net of allowance for uncollectible pledges (2018—\$2,218; 2017—\$4,453)	1,889	1,468
Property, plant, and equipment net	98,555	89,777
Deferred financing costs	1,323	—
Other	<u>2,065</u>	<u>1,043</u>
	<u>\$196,239</u>	<u>\$176,174</u>
Liabilities and Net Assets		
Current Liabilities		
Current portion of long-term debt	\$ 11,608	\$11,488
Accounts payable and accrued expenses	29,489	25,311
Accrued salaries and related liabilities	25,572	20,096
Due to third-party reimbursement programs, net	—	1,874
Advances on government grants	<u>1,587</u>	<u>—</u>
Total Current Liabilities	\$ 68,256	\$58,769
Long-term debt, less current portion	55,539	47,709
Accrued post-retirement benefits	6,023	6,017
Other noncurrent liabilities	<u>16,445</u>	<u>17,014</u>
Total Liabilities	<u>\$146,263</u>	<u>\$129,509</u>

Net Assets		
Unrestricted	\$ 40,582	\$ 38,014
Temporarily restricted	8,262	7,519
Permanently restricted	<u>1,132</u>	<u>1,132</u>
Total Net Assets	<u>\$ 49,976</u>	<u>\$ 46,665</u>
<i>Total Liabilities and Net Assets</i>	<u>\$196,239</u>	<u>\$ 176,174</u>

See accompanying notes.

**Major Medical Center
Statements of Operations**

	Year ended December 31	
	2018	2017
	(In Thousands)	
<i>Operating Revenue</i>		
Net patient service revenue	\$402,921	\$369,512
Other revenue	13,356	13,850
Net assets released from restrictions	<u>4,708</u>	<u>2,863</u>
Total Operating Revenue	<u>\$420,985</u>	<u>\$386,225</u>
<i>Operating Expenses</i>		
Salaries and wages	\$207,141	\$196,453
Employee benefits	44,456	44,860
Supplies and expenses	137,505	117,838
Depreciation and amortization	22,541	18,856
Research	2,457	2,214
Interest	<u>4,456</u>	<u>5,253</u>
Total Operating Expenses	<u>\$418,556</u>	<u>\$385,474</u>
<i>Operating Income</i>	\$ 2,429	\$ 751
Net assets released from restrictions used for capital acquisitions	<u>139</u>	<u>146</u>
Increase in unrestricted net assets	<u>\$ 2,568</u>	<u>\$ 897</u>

See accompanying notes.

**Major Medical Center
Statements of Changes in Net Assets**

	Net Assets		
	Unrestricted	Temporarily Restricted	Permanently Restricted
	(In Thousands)		
<i>Net Assets at December 31, 2016</i>	<u>\$37,117</u>	<u>\$3,023</u>	<u>\$1,132</u>
Increase in unrestricted net assets	\$ 897	\$ —	\$ —
Restricted contributions, grants, and other receipts	—	7,253	—
Investment income restricted for specific purposes	—	252	—
Net assets released from restrictions for:			
Operating expenses	—	(2,863)	—
Capital asset acquisitions	—	(146)	—
Change in net assets	<u>\$ 897</u>	<u>\$4,496</u>	<u>\$ —</u>
<i>Net Assets at December 31, 2017</i>	<u>\$38,014</u>	<u>\$7,519</u>	<u>\$1,132</u>
Increase in unrestricted net assets	\$ 2,568	\$ —	\$ —

Restricted contributions, grants, and other	—	5,421	—
Investment income restricted for specific purposes	—	169	—
Net assets released from restrictions for:			
Operating expenses	—	(4,708)	—
Capital asset acquisitions	—	(139)	—
Change in net assets	<u>\$ 2,568</u>	<u>\$ 743</u>	<u>\$ —</u>
<i>Net Assets on December 31, 2018</i>	<u><u>\$40,582</u></u>	<u><u>\$8,262</u></u>	<u><u>\$1,132</u></u>

See accompanying notes.

**Major Medical Center
Statements of Cash Flows**

	Year Ended December	
	2018	2017
	(In Thousands)	
<i>Operating Activities</i>		
Operating income	\$ 2,429	\$ 751
Change in temporarily restricted net assets	<u>743</u>	<u>4,496</u>
	\$ 3,172	\$ 5,247
Adjustments to reconcile change in net assets to cash provided by operations:		
Depreciation and amortization	22,541	18,856
Investment income earned on assets limited as to use	(774)	(698)
Changes in operating assets and liabilities:		
(Increase) decrease in receivables for patient care	(2,105)	7,589
(Increase) decrease in due from third-party reimbursement	(8,413)	4,500
Increase in accounts payable and accrued expenses and accrued salaries and related liabilities	9,654	1,412
Net effect of increases and decreases in other assets and liabilities	<u>2,286</u>	<u>(8,707)</u>
Cash provided by operations	<u>\$ 26,361</u>	<u>\$ 28,199</u>
<i>Investing Activities</i>		
Acquisitions of property, plant, and equipment, net	\$(10,043)	\$(12,998)
Less amounts provided by restricted funds	139	146
Increase in investments	<u>(618)</u>	<u>(70)</u>
Cash used in investing activities	<u>\$(10,522)</u>	<u>\$(12,922)</u>
<i>Financing Activities</i>		
Net payment from (to) affiliates	\$ 126	\$ (1,773)
Increase in deferred financing costs	(1,323)	
Repayments of long-term debt	(13,326)	(9,510)
Deposits into sinking fund, as required by mortgage loan	(303)	
Increase in compensating balances for standby letters of credit	(1,923)	
(Increase) decrease in pledges receivable	<u>(30)</u>	<u>(3,190)</u>
Cash used in financing activities	<u>\$(16,779)</u>	<u>\$(14,473)</u>

Net (decrease) increase in cash and cash equivalents	\$ (940)	\$ 804
Cash and cash equivalents at beginning of year	<u>9,005</u>	<u>8,201</u>
Cash and cash equivalents at end of year	<u>\$ 8,065</u>	<u>\$ 9,005</u>

See accompanying notes.

Notes to Financial Statements

1. Organization and Summary of Significant Accounting Policies

Organization

Major Medical Center (the “Medical Center”) is a not-for-profit corporation. The Medical Center provides health care and related services. The accompanying financial statements do not include the accounts of the Research Foundation, a not-for-profit corporation that solicits funds and awards grants to the Medical Center for research purposes, nor for Hospital Support, Inc., which provides certain support services.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Medical Center has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Medical Center in perpetuity. When a donor restriction expires (i.e., when a stipulated time restriction ends or purpose restriction is accomplished), temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as temporarily restricted contributions and net assets released from restrictions in the accompanying financial statements.

Receivables for Patient Care

Patient accounts receivable from third-party programs for which the Medical Center receives payment under reimbursement formulas or negotiated rates are stated at the estimated net amounts receivable from such payors, which are generally less than the established charges of the Medical Center.

Investments

Investments consist of U.S. Treasury bonds and notes, certificates of deposit, and money market funds. Investments are carried at fair value. Amounts classified as long-term investments, consisting primarily of money market funds, represent permanently restricted net assets.

Investment Gains, Losses, and Income

Investment income, which includes real gains and losses, earned on permanently restricted and temporarily restricted funds upon which restrictions have been placed by donors, is added to temporarily restricted funds. All other investment income is reflected in the accompanying statements of operations.

Property, Plant, and Equipment

Property, plant, and equipment purchased are carried at cost, and those acquired by gifts and bequests are carried at appraised or fair market value established at the date of acquisition. Capitalized leases are recorded at the fair market value at the inception of the leases. The carrying amounts of assets and the related accumulated depreciation are removed from the accounts when such assets are disposed of, and any resulting gain or loss is included in operations. Depreciation of assets used in operations is recorded on the straight-line method over the estimated useful lives of the assets. Capitalized leases are amortized over the lease term.

Pledges

Unconditional promises to give cash and other assets are reported at their net present value at the date the promise is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. Pledges receivable, discounted at 10 percent, are expected to be paid as follows (in thousands):

Less than one year	\$ 1,814
One year to five years	3,145
In excess of five years	962
	\$ 5,921
Less allowance for uncollectible pledges receivable	(2,218)
	\$ 3,703

Assets Limited as to Use

Assets classified as limited as to use represent assets whose use is restricted for specific purposes under terms of agreements.

Accrued Post-Retirement Benefits

The Medical Center accounts for post-retirement health care and life insurance benefits on the accrual basis of accounting.

Uncompensated Care

As a matter of policy, the Medical Center provides significant amounts of partially or totally uncompensated patient care. For accounting purposes, such uncompensated care is treated either as charity care or bad debt expense. The Medical Center has defined charity care for accounting and disclosure purposes as the difference between its customary charges and the sliding scale rates given to patients in need of financial assistance. Since payment of this difference is not sought, charity care allowances are not reported as revenue. Patients who do not qualify for sliding scale fees and all uninsured inpatients who do not qualify for Medicaid assistance are billed at the Medical Center's full rates. Uncollected balances for these patients are categorized as bad debts. Total uncompensated care for all patient services approximated \$22 million and \$20 million in 2018 and 2017, respectively.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates. Management believes that the amounts recorded based on estimates and assumptions are reasonable, and any differences between estimates and actual should not have a material impact on the Medical Center's financial position.

Operating Income

Transactions deemed by management to be ongoing, major, or central to the provision of health care services are reported as operating revenue and expenses, and are included in operating income. Operating income also includes investment income and realized gains and losses from the sale of investments.

Tax Status

The Medical Center is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The Medical Center has been classified as an organization that is not a private foundation under Section 509(a)(1). Contributions received by the Medical Center qualify as tax-deductible charitable contributions.

2. Third-Party Reimbursement Programs

The Medical Center has agreements with third-party payers that provide for payments to the Medical Center at amounts different from its established charges. Payment arrangements include prospectively determined rates per discharge, reimbursement of costs, discounted charges, and per diem payments. Patient service revenue is recorded at the Medical Center's established charges when patient services are performed. Adjustments for differences between established charges and payment amounts are deducted directly from receivables for patient care and patient service revenue in the year incurred.

Federal and state regulations provide for certain retrospective adjustments to current and prior years' payment rates based on industrywide and hospital-specific data. The Medical Center has estimated the potential impact of such retrospective adjustments based on information presently available, and adjustments are accrued on an estimated basis in the period the services are rendered and are adjusted in future periods as final settlements are determined.

Management believes that amounts recorded in the accompanying financial statements will not be materially affected upon the final settlement of such retrospective adjustments.

Hospitals are reimbursed for Medicare inpatient services under the national prospective payment system ("PPS") and other methodologies of the Medicare program for patient services. Such Medicare payments are based on a blend of national industry and hospital-specific data. The Medicaid program pays rates determined by the state, primarily on a basis of prospectively determined rates per discharge. The Medical Center is paid by non-Medicare/Medicaid payers based on negotiated contract amounts or, if such contracts do not exist, at the Medical Center's established charges. In addition, the state has requested a waiver from the federal government that will allow it to enroll substantially all of its Medicaid participants into Medicaid managed

care programs. The ultimate outcome and effect of these changes and proposals on the Medical Center's future operations cannot presently be determined. In 2018, net revenue from the Medicare and Medicaid programs accounted for 44 percent and 23 percent, respectively, of total net patient service revenue.

3. Assets Limited as to Use

<i>A summary of assets limited as to use is as follows at December 31:</i>		
	2018	2017
	<i>(In Thousands)</i>	
Sinking Funds:		
Cash and cash equivalents	\$ 276	\$ 249
U.S. government and agency obligations	14,211	13,161
Total Sinking Funds	\$14,487	\$13,410
Collateral for Standby Letters of Credit:		
Cash and cash equivalents	\$ 582	\$ -
Corporate bonds	1,341	—
Total Collateral for Standby Letters of Credit	\$ 1,923	\$ —
Total Assets Limited as to Use	\$16,410	\$13,410

4. Property, Plant, and Equipment

A summary of property, plant, and equipment is as follows at December 31:

	2018	2017
	<i>(In Thousands)</i>	
Land	\$ 4,980	\$ 4,980
Buildings	58,827	58,827
Equipment	164,592 \$228,399	140,707 \$204,514
Less accumulated depreciation	141,502 \$ 86,897	125,148 \$ 79,366
Projects in progress	11,658 \$ 98,555	10,411 \$ 89,777

Approximately \$45,673,000 and \$45,706,000 of fully depreciated assets are included in buildings and equipment at December 31, 2018 and 2017, respectively. Substantially all property, plant, and equipment is pledged as collateral under various loan agreements. Capitalized equipment leases, included in property, plant, and equipment, are as follows at December 31:

	2018	2017
	<i>(In Thousands)</i>	
Assets recorded under capital leases	\$67,434	\$51,695
Less accumulated amortization	35,911	27,108
	\$31,523	\$24,587

5. Long-Term Debt

A summary of long-term debt is as follows at December 31:

	2018	2017
	<i>(In Thousands)</i>	
FHA Section 242 insured mortgage loan (a)	\$20,865	\$ —
FHA Section 241 mortgage loan (a)	10,941	12,125
2005 mortgage loan (b)	2,216	2,758
1998 insured mortgage loan (a)	—	15,492
Various mortgages, having interest rates ranging from 3.5% to 10.0%, maturing at various dates through 2021	2,020	2,892
Capitalized leases (c)	31,105	25,930
	\$67,147	\$59,197
Less current portion	11,608	11,488
	\$55,539	\$47,709

- a. As a condition of these borrowings, the Medical Center is required to establish and maintain a sinking fund. Amounts deposited into the sinking fund, together with investment earnings therein, are available for principal payments and purchases of specified levels of capital assets. Assets on deposit in the sinking fund at December 31, 2018 and 2017 are in compliance with the required amounts.
- b. Annual principal payments for all long-term debt, excluding capital leases and required sinking fund balances for the next five years, are as follows:

	<i>Principal Payments</i>	<i>Required Sinking Fund Balance</i>
	<i>(In Thousands)</i>	
2018	\$2,789	\$15,461
2019	4,688	14,937
2020	4,157	14,162
2021	4,089	13,129
2022	3,746	11,831

- c. Future minimum payments, by year and in the aggregate, under capitalized leases consisted of the following at December 31, 2018 (in thousands):

2018	\$11,102
2019	9,852
2020	8,204
2021	4,744
2022	1,518
Thereafter	850
Total minimum lease payments	\$36,270
Less amounts representing interest	(5,165)
Present value of lease payments	\$31,105

6. Retirement and Similar Benefits

The Medical Center provides retirement and similar benefits to its union employees through several defined benefit multi-employer pension plans and to its nonunion employees through a noncontributory defined benefit pension plan and tax-deferred annuity plans. Payments to the defined benefit multi-employer union plans are made in accordance with contractual arrangements under which contributions are generally based on gross salaries and are funded on a current basis. The Medical Center contributes amounts to the nonunion plan sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974. The Medical Center's pension expense under all existing plans aggregated approximately \$10,202,000 and \$10,683,000 for the years ended December 31, 2018 and 2017, respectively.

7. Other Post-Retirement Benefits

In addition to the pension plans and the tax-sheltered annuity plans described in Note 6, the Medical Center sponsors a defined benefit health care plan that provides post-retirement medical, dental, and life insurance benefits to certain full-time employees hired prior to July 1, 2004, and who have worked 10 years and attained age 65 while in service with the Medical Center. The plan contains cost-sharing features such as deductibles and coinsurance.

Effective in May 2018, the Medical Center changed the type of the plan from basic hospital plus major medical to a point-of-service plan for nonunion employees. The effects of this change have been reflected in the actuary's calculation for the plan year ended December 31, 2018. At the end of 2018 and 2017, the accrued post-retirement benefit cost was \$6,023,000 and \$6,017,000, respectively. As of December 31, 2018 and 2017, the plan was unfunded.

8. Government Grants

The Medical Center receives grants from various government agencies. For the contract years ending June 30, 2018, 2019, and 2020, these grant awards are as follows:

Contract Year	Amount
Ending June 30:	(In Thousands)
2018	\$3,791
2019	3,513
2020	3,765

Advances on government grants of \$1,587,000 at December 31, 2018, as reflected in the accompanying statement of financial position, represent amounts received from the granting agencies in excess of claims made at that date. The receivable amount of \$467,000 at December 31, 2017, represents claims made in excess of advances received from the granting agencies at that date.

9. Professional Liability Insurance

The Medical Center participates in a pooled program with certain other health care facilities (principally medical centers) for professional liability insurance. This participation is with captive insurance companies and, with the other health care facilities, in a pooled layer for additional insurance with commercial insurance companies.

During 2017, the Medical Center had an aggregate deposit of \$2,000,000 with two of the captive insurance companies. During 2018, these deposits were replaced with two letters of credit of \$1,000,000 each. The deposits were included in other current assets in the accompanying 2017 statement of financial position.

Malpractice claims in excess of insurance coverage have been asserted against the Medical Center by various claimants. The claims are in various stages of processing, and some may ultimately be brought to trial. Medical Center management and counsel are unable to conclude

about the ultimate outcome of the actions. There are known incidents occurring through December 31, 2018, that may result in the assertion of additional claims, and other claims may be asserted arising from services provided to patients in the past. It is the opinion of Medical Center management, based on prior experience, that adequate insurance is maintained to cover all significant professional liability losses.

10. Transactions with Affiliates

The amounts due from affiliates in the accompanying statements of financial position at December 31, 2018 and 2017, include a \$1,900,000 loan receivable and accrued interest thereon from Hospital Support, Inc. The loan, which does not have specified repayment terms, bears interest at the prime rate, which approximated 7.75 percent at December 31, 2018 and 2017.

11. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	2018	2017
	(In Thousands)	
Research and education	\$ 817	\$2,502
Plant replacement and expansion	7,445	5,017
	\$8,262	\$7,519

Permanently restricted net assets at both December 31, 2018 and 2017 consist of investments to be held in perpetuity and whose income is restricted as to use.

12. Other Operating Revenue

Other operating revenue consisted of the following for the year ended December 31:

	2018	2017
	(In Thousands)	
Government grant income	\$ 1,668	\$ 5,053
Real estate rentals	2,838	2,651
Investment income and gains on sale of investments	1,077	1,044
Faculty practice and research overhead	5,703	2,079
Dining room and parking lot income	996	958
Grants and contributions	343	499
Other	731	1,566
	\$13,356	\$13,850

13. Concentration of Credit Risk

Significant concentrations of patients accounts receivable include 30 percent and 37 percent from government-related programs, 6 percent and 8 percent from Empire Blue Cross and Blue Shield, and 27 percent and 23 percent from Cambridge Health Plans at December 31, 2018 and 2017, respectively.

At December 31, 2018, 95 percent of the Medical Center's cash and cash equivalents balance was held at one financial institution.

14. Fair Value of Financial Instruments

The following methods and assumptions were used by the Medical Center in estimating its fair value disclosures for financial instruments: The carrying amount reported in the statements of financial position for cash and cash equivalents approximates its fair value. Short-term investments consist primarily of government and other debt securities. Fair values are based on quoted market prices. Long-term investments consist primarily of money market funds. Fair values are based on quoted market prices. Assets limited as to use consist primarily of government securities. Fair values are based on quoted market prices. Most of the long-term debt of the Medical Center was refinanced during 2006. The carrying value of the Medical Center's long-term debt at December 31, 2018, approximates its fair value.

15. Contingencies

The Medical Center is a defendant in various legal actions arising out of the normal course of its operations, the final outcome of which cannot presently be determined. The amounts claimed would be material to the financial position of the Medical Center. Medical Center management is of the opinion that ultimate liability, if any, with respect to all of these matters will not have a material adverse effect on the Medical Center's financial position.

Approximately 67 percent of the Medical Center's employees are members of various unions. Of these employees, approximately 70 percent are covered by contracts expiring during 2018.