HOUSTON HEALTHCARE SYSTEM, INC.

COMBINED FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

DECEMBER 31, 2019 AND 2018

Warren Averett
CPAs AND ADVISORS

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Warren Averett
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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees
Houston Healthcare System, Inc.

We have audited the accompanying combined financial statements of Houston Healthcare System, Inc. (a Georgia corporation), which comprise the combined balance sheets as of December 31, 2019 and 2018 and the related combined statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the combined financial statements.

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

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the combined 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 combined 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 combined financial statements referred to above present fairly, in all material respects, the financial position of Houston Healthcare System, Inc. as of December 31, 2019 and 2018, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the combined financial statements as a whole. The supplementary combining information referred to in the table of contents is presented for purposes of additional analysis and is not a required part of the combined financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the combined financial statements. The information has been subjected to the auditing procedures applied in the audit of the combined financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the combined financial statements or to the combined financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the combining information is fairly stated, in all material respects, in relation to the combined financial statements as a whole.

Warren Averett, LLC

Atlanta, Georgia
March 24, 2020

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINED BALANCE SHEETS
DECEMBER 31, 2019 AND 2018

ASSETS

	2019	2018
CURRENT ASSETS		
Cash and cash equivalents	$ 7,069,000	$ 10,725,000
Assets limited as to use – current portion	791,000	610,000
Patient accounts receivable, net	22,949,000	26,616,000
Estimated third-party payor receivable	444,000	82,000
Insurance recoveries – current portion	1,216,000	1,651,000
Supplies, at lower of cost (first-in, first-out) or market and other assets	6,647,000	6,545,000
Total current assets	39,116,000	46,229,000
ASSETS LIMITED AS TO USE		
Internally designated for capital acquisition and other	224,923,000	207,634,000
Held by trustee under indenture agreement	2,352,000	2,295,000
	227,275,000	209,929,000
Less amounts required to meet current obligations	791,000	610,000
Total assets limited as to use	226,484,000	209,319,000
PROPERTY AND EQUIPMENT, NET	136,076,000	143,035,000
OTHER ASSETS		
Long-term investments and other	3,670,000	3,374,000
Insurance recoveries	3,972,000	5,411,000
Total other assets	7,642,000	8,785,000
TOTAL ASSETS	$ 409,318,000	$ 407,368,000

See notes to the combined financial statements.

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINED BALANCE SHEETS
DECEMBER 31, 2019 AND 2018

LIABILITIES AND NET ASSETS

	2019	2018
CURRENT LIABILITIES		
Current maturities of long-term debt	$ 4,025,000	$ 3,835,000
Accounts payable and accrued expenses	8,049,000	6,652,000
Accrued compensation and benefits	17,896,000	16,849,000
Estimated third-party payor settlements	2,539,000	3,833,000
Other current liabilities	3,754,000	6,412,000
Total current liabilities	36,263,000	37,581,000
LONG-TERM DEBT, NET OF CURRENT INSTALLMENTS	64,781,000	69,547,000
SELF-INSURANCE RESERVES	10,721,000	13,385,000
ACCRUED PENSION LIABILITY	9,408,000	9,893,000
TOTAL LIABILITIES	121,173,000	130,406,000
NET ASSETS		
Without donor imposed restrictions	288,145,000	276,962,000
Total net assets	288,145,000	276,962,000
TOTAL LIABILITIES AND NET ASSETS	$ 409,318,000	$ 407,368,000

See notes to the combined financial statements.

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED DECEMBER 31, 2019 AND 2018

	2019	2018
OPERATING REVENUES		
Net patient service revenue	$ 250,661,000	$ 237,385,000
Other revenue	2,697,000	2,174,000
Total operating revenues	253,358,000	239,559,000
OPERATING EXPENSES		
Salaries and benefits	146,192,000	141,397,000
Supplies and drugs	42,009,000	42,605,000
Other expenses	63,859,000	56,293,000
Depreciation and amortization	17,061,000	18,583,000
Interest expense	2,596,000	2,753,000
Total operating expenses	271,717,000	261,631,000
OPERATING LOSS	(18,359,000)	(22,072,000)
NONOPERATING REVENUES (EXPENSES)		
Investment income	5,179,000	4,682,000
Other components of net periodic pension costs	(163,000)	1,039,000
Net realized gains on sales of securities	14,973,000	12,740,000
Net unrealized gains (losses) on securities	11,865,000	(26,968,000)
Noncapital grants, contributions, and other	(11,000)	(124,000)
Total nonoperating revenues (expenses)	31,843,000	(8,631,000)
EXCESS OF REVENUES OVER (UNDER) EXPENSES	13,484,000	(30,703,000)
Changes in pension assets and benefit obligations not included in net periodic pension costs	(2,301,000)	(4,348,000)
INCREASE (DECREASE) IN NET ASSETS WITHOUT DONOR IMPOSED RESTRICTIONS	11,183,000	(35,051,000)
NET ASSETS AT BEGINNING OF YEAR	276,962,000	312,013,000
NET ASSETS AT END OF YEAR	$ 288,145,000	$ 276,962,000

See notes to the combined financial statements.

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2019 AND 2018

	2019	2018
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets	$ 11,183,000	$ (35,051,000)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	17,061,000	18,678,000
Bond premium / discount amortization	(740,000)	(900,000)
(Gain) loss on sale of assets	(38,000)	164,000
Net unrealized (gains) losses on securities	(11,865,000)	26,968,000
Net realized (gains) on securities	(14,973,000)	(12,740,000)
Changes in:		
Patient accounts receivable, net	3,667,000	3,123,000
Supplies and other assets	(102,000)	1,664,000
Self-insurance reserves and insurance recoveries	(790,000)	602,000
Long-term investments and other	(353,000)	157,000
Accounts payable and accrued expenses	2,444,000	2,558,000
Estimated third-party payor settlements	(1,656,000)	(168,000)
Other current liabilities	(2,658,000)	326,000
Accrued pension obligations	(485,000)	(1,327,000)
Net cash provided by operating activities	695,000	4,054,000
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of assets limited as to use	(182,217,000)	(137,053,000)
Proceeds from sale of assets limited as to use	176,766,000	133,548,000
Withdrawals from assets limited as to use	15,000,000	17,000,000
Capital expenditures	(10,335,000)	(8,261,000)
Proceeds from sale of property and equipment	271,000	-
Net cash (used in) provided by investing activities	(515,000)	5,234,000

See notes to the combined financial statements.

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINED STATEMENTS OF CASH FLOWS – CONTINUED
FOR THE YEARS ENDED DECEMBER 31, 2019 AND 2018

	2019	2018
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on long-term debt	$ (3,836,000)	$ (3,654,000)
Net cash used in financing activities	(3,836,000)	(3,654,000)
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(3,656,000)	5,634,000
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	10,725,000	5,091,000
AT END OF YEAR	$ 7,069,000	$ 10,725,000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	$ 3,396,000	$ 3,579,000

See notes to the combined financial statements.

1. DESCRIPTION OF ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Houston Healthcare System, Inc. (the System), located in Warner Robins, Georgia, is a not-for-profit corporation that operates acute care hospitals and freestanding outpatient treatment facilities. The System provides a full range of inpatient, outpatient, and emergency services to the residents of Houston County and surrounding areas. The following entities comprise the System: Houston Hospitals, Inc. operates two acute care hospitals, Houston Medical Center and Perry Hospital, which provide inpatient, outpatient, and urgent care services; Houston Healthcare EMS, Inc. provides ambulance services to the residents of Houston County; Houston Healthcare Properties, Inc. owns and manages the non-hospital property of the System; Houston Health Ventures, Inc. is a for-profit corporation engaged in joint ventures that assist and promote the tax exempt purposes of the System; Houston Primary Care Physicians, LLC and Houston Physician Specialties, LLC operate free-standing primary care and specialty physician practices. All intercompany transactions have been eliminated.

Effective January 1, 2009, the Hospital Authority of Houston County, Georgia (the Authority) implemented a reorganization plan for Houston Hospitals, Inc. and related facilities whereby all the assets, liabilities, management and governance of the facilities were transferred to Houston Hospitals, Inc., pursuant to a lease and transfer agreement which provides for a nominal rate to the Authority by the System. The lease term expires December 31, 2048.

Adoption of New Accounting Standards

In February 2016, the FASB issued ASU 2016-02, *Leases (Subtopic 842).* The purpose of this ASU is to increase transparency and comparability among organizations by recognizing leased assets and leased liabilities on the balance sheets and disclosing key information about leasing arrangements. The amendments in this ASU require that lessees recognize the rights and obligations resulting from leases as assets and liabilities on their balance sheets, initially measured at the present value of the lease payments over the term of the lease, including payments to be made in optional periods to extend the lease and payments to purchase the underlying assets if the lessee is reasonably certain of exercising those options. The main difference between previous accounting principles generally accepted in the United States of America (GAAP) and Topic 842 is the recognition of leased assets and leased liabilities by lessees for those leases classified as operating leases under previous GAAP.

At transition, entities are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, among other matters. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-to-use asset and a leased liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP. The System adopted this ASU on January 1, 2019, and the adoption of this ASU did not have a material impact on its financial position or changes in net assets.

1. DESCRIPTION OF ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Use of Estimates

The preparation of combined financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the combined financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less, excluding cash and cash equivalents included in assets limited as to use.

Investments and Investment Income

Investments in equity and debt securities are measured at fair value in the combined balance sheets. Investment income or loss (including realized and unrealized gains and losses on investments, interest and dividends) is included in excess of revenues over (under) expenses unless the income or loss is restricted by donor or law.

Assets Limited as to Use

Assets limited as to use primarily include assets held by trustee under indenture agreements and designated assets set aside by the Board of Trustees (the Board) for future capital improvements and other, over which the Board retains control and may at its discretion subsequently use for other purposes. Amounts required to meet current liabilities of the System have been reclassified in the combined balance sheets at December 31, 2019 and 2018.

Property and Equipment

Property and equipment acquisitions are recorded at cost and generally defined as items with an acquisition cost of $2,500 per unit or greater, a useful life of three years or more, and qualify as tangible personal property. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life Subsequent of the equipment. Such amortization is included in depreciation and amortization in the combined financial statements.

The System retired fully depreciated assets during the year 2019 of approximately $62,000,000. Subsequent to year end, the System evaluated estimated useful lives for all depreciable assets and, as a result, made changes to asset lives which will be treated as a change in estimate during the year ending 2020. The estimated impact of the change in estimate is a reduction in depreciation expense of approximately $5,400,000.

1. DESCRIPTION OF ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Gifts of long-lived assets, such as land, buildings, or equipment, are reported as unrestricted support, and are excluded from excess of revenues over (under) expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations addressing how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Impairment of Long-Lived Assets

The System evaluates on an ongoing basis the recoverability of its assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is required to be recognized if the carrying value of the asset exceeds the undiscounted future net cash flows associated with that asset. The impairment loss to be recognized is the amount by which the carrying value of the long-lived asset exceeds the asset's fair value. In most instances, the fair value is determined by discounted estimated future cash flows using an appropriate interest rate. The System has not recorded any impairment charges in the accompanying combined statements of operations and changes in net assets for the years ended December 31, 2019 and 2018.

Cost of Borrowing

Interest cost on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. There was no capitalized interest cost for the years ended December 31, 2019 and 2018.

Long-Term Investments and Other

Long-term investments and other consist of notes receivable and investments in unconsolidated companies. Notes receivable are from loans secured by promissory contracts. Investments in unconsolidated companies represent the System's participation in joint ventures and partnerships, which are accounted for on the cost and equity methods and are not material to the System's combined financial statements.

Deferred Financing Costs

Deferred financing costs related to the issuance of long-term debt were deferred and are being amortized using the straight-line method, which approximates the effective interest method. Unamortized deferred financing costs are presented in the accompanying combined balance sheets as an adjustment to the carrying value of the related debt.

Excess of Revenues Over (Under) Expenses

The combined statements of operations and changes in net assets include excess of revenues over (under) expenses. Changes in unrestricted net assets which are excluded from excess of revenues over (under) expenses, consistent with industry practice, include permanent transfers of assets to and from affiliates for other than goods and services, changes in pension assets and benefit obligations not included in net periodic pension costs, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

1. DESCRIPTION OF ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Net Patient Service Revenue

Net patient service revenues are recorded at the transaction price estimated by the System to reflect the total consideration due from patients and third-party payors in exchange for providing goods and services for patient care. These services are considered to be a single performance obligation and have a duration of less than one year. Revenues are recorded as these goods and services are provided.

The transaction price, which involves significant estimates, is determined based on the System's standard charges for the goods and services provided, with a reduction recorded for price concessions related to third-party contractual arrangements as well as patient discounts and other patient price concessions. During the years ended December 31, 2019 and 2018, the impact of changes to the inputs used to determine the transaction price was considered immaterial to the current periods.

Charity Care

The System provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the System does not pursue collection of amounts determined to qualify as charity care, they are not reported in net patient service revenue.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as support without donor restrictions if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, net assets with donor restrictions are reclassified as unrestricted net assets and reported in the combined statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as contributions without donor restrictions in the accompanying combined financial statements.

Risk Management

The System is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; medical malpractice; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The System is partially self-insured for employee health and professional liability as disclosed in Notes 12 and 13. The System is also partially self-insured for workers' compensation.

Estimated Malpractice Costs and Other Self-Insurance Costs

The provision for estimated medical malpractice claims and other self-insurance plans includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

1. DESCRIPTION OF ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Income Taxes

The System is a not-for-profit corporation that has been recognized as tax-exempt pursuant to Section 501(c)3 of the Internal Revenue Code.

The System applies accounting policies that prescribe when to recognize and how to measure the combined financial statement effects of income tax positions taken or expected to be taken on its income tax returns. These rules require management to evaluate the likelihood that, upon examination by the relevant taxing jurisdictions, those income tax positions would be sustained.

Based on that evaluation, the System only recognizes the maximum benefit of each income tax position that is more than 50% likely of being sustained. To the extent that all or a portion of the benefits of an income tax position are not recognized, a liability would be recognized for the unrecognized benefits, along with any interest and penalties that would result from disallowance of the position. Should any such penalties and interest be incurred, they would be recognized as operating expenses.

Based on the results of management's evaluation, no liability is recognized in the accompanying combined balance sheets for unrecognized income tax positions. Further, no interest or penalties have been accrued or charged to expense as of December 31, 2019 and 2018 or for the years then ended. The System's tax returns are subject to possible examination by taxing authorities. For federal income tax purposes, the tax returns essentially remain open for possible examination for a period of three years after the respective filing deadlines of those returns.

Houston Health Ventures, Inc. is a for-profit corporation and wholly owned subsidiary of the System. The System has not recorded a current or deferred tax provision, as this would not have a material effect on the combined financial statements.

Fair Value Measurements

The standards for fair value measurement of financial assets and liabilities define fair value, establish a framework for measuring fair value, and expand disclosures about fair value measurement. The guidance also emphasizes that fair value is based on a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Fair value measurements are disclosed by level within the hierarchy.

Under the guidance for fair value measurement of nonfinancial assets and liabilities, measurements occur on a nonrecurring basis, and recognition at fair value occurs when nonfinancial assets and liabilities are deemed to be other-than-temporarily impaired. The System does not have any nonfinancial assets or nonfinancial liabilities at December 31, 2019 and 2018 that require disclosure by levels within the hierarchy.

1. DESCRIPTION OF ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Subsequent Events
The System has evaluated the impact of subsequent events through March 24, 2020, representing the date on which the combined financial statements were issued.

The outbreak of the novel coronavirus has adversely impacted global commercial activity and contributed to significant declines and volatility in financial markets. The coronavirus pandemic and government responses are creating disruption in global supply chains and adversely impacting many industries. The outbreak could have a continued material adverse impact on economic and market conditions and trigger a period of global economic slowdown. The rapid development and fluidity of this situation precludes any prediction as to the ultimate material adverse impact of the novel coronavirus. Nevertheless, the novel coronavirus presents material uncertainty and risk with respect to the System, its performance, and its financial results.

2. PATIENT SERVICE REVENUE

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. The System does not believe there are any significant credit risks associated with receivables due from third-party payors.

A summary of the payment arrangements with major third-party payors follows:

Medicare
Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors.

The System is reimbursed for certain reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare Administrative Contractor (MAC). The System's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization under contract with the System. The System's Medicare cost reports have been audited by the MAC through 2014 for Houston Medical Center and through 2016 for Perry Hospital.

Revenue from the Medicare program accounted for approximately 38% and 42% of the System's net patient service revenue for 2019 and 2018, respectively. Laws and regulations governing the Medicare program are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Estimated reimbursement amounts are adjusted in subsequent periods as cost reports are prepared and filed and as final settlements are determined. The 2019 net patient service revenue increased approximately $332,000 (decreased $181,000 for 2018) primarily due to changes in previously estimated settlements.

2. PATIENT SERVICE REVENUE – CONTINUED

The System believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. However, there has been an increase in regulatory initiatives at the federal level including the initiation of the Recovery Audit Contractor (RAC) program. The RAC program was created to review Medicare claims for medical necessity and coding appropriateness. The RACs have the authority to pursue improper payments with a three year look back from the date the claim was paid. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action including fines, penalties, and exclusion from the Medicare program.

Medicaid
Inpatient acute care services rendered to Medicaid program beneficiaries are paid at a prospectively determined rate per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Outpatient services rendered to the Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology.

The System is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicaid fiscal intermediary. The System's Medicaid cost reports have been audited by the Medicaid fiscal intermediary through 2016 for Houston Medical Center and 2015 for Perry Hospital.

Revenue from the Medicaid program accounted for approximately 9% and 10% of the System's net patient service revenue for 2019 and 2018, respectively. Laws and regulations governing the Medicaid program are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Estimated reimbursement amounts are adjusted in subsequent periods as cost reports are prepared and filed and as final settlements are determined.

Payment arrangements with these managed care organizations consist primarily of prospectively determined rates per discharge, discounts from established charges, or prospectively determined per diems.

The System believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. However, there has been an increase in regulatory initiatives at the state level including the initiation of the Medicaid Integrity Contractor (MIC) program. This program was created to review Medicaid claims for medical necessity and coding appropriateness. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action including fines, penalties, and exclusion from the Medicaid program.

2. PATIENT SERVICE REVENUE – CONTINUED

During 2010, the State of Georgia (the State) enacted legislation known as the Provider Payment Agreement Act (the Act) whereby hospitals in the State are assessed a “provider payment” in the amount of 1.45% of their net patient service revenue. The Act became effective July 1, 2010, the beginning of state fiscal year 2011. The provider payments are due on a quarterly basis to the State’s Department of Community Health. The payments are to be used for the sole purpose of obtaining federal financial participation for medical assistance payments to providers on behalf of Medicaid recipients. The provider payment results in an increase in payments for Medicaid services to hospitals of approximately 11.88%. Approximately $3,158,000 and $3,149,000 of provider payments relating to the Act are included in other expense in the accompanying combined statements of operations and changes in net assets for years 2019 and 2018, respectively.

Other Agreements

The System has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the System under these agreements include prospectively determined rates per discharge, prospectively determined daily rates, fixed rate fee schedules, and discounts from established charges.

The System recognizes patient service revenue associated with services provided to patients who have third-party coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the System recognizes revenue on the basis of its standard rates for services provided (or on the basis of discounted rates, if negotiated or provided by policy). On the basis of historical experience, a significant portion of the System’s uninsured patients will be unable or unwilling to pay for the services provided. Therefore, the System records an implicit price concession equal to the estimated uncollectible portion of the charges related to uninsured patients in the period the services are provided.

The System’s net patient revenues during the years ended December 31, 2019 and 2018 have been presented in the following table based on an allocation of the estimated transaction price with the patient between the primary patient classification and insurance coverage:

	2019	2018
Medicare	$ 101,032,000	$ 100,544,000
Medicaid	24,936,000	23,979,000
Other third-party payors	115,955,000	109,507,000
Self-pay	8,738,000	3,355,000
Total	$ 250,661,000	$ 237,385,000

2. PATIENT SERVICE REVENUE – CONTINUED

Patient Accounts Receivable

Patient accounts receivable are recorded at net realizable value based on certain assumptions determined by each payor. For third-party payors including Medicare, Medicaid, and other third-party payors, the net realizable value is based on the estimated contractual reimbursement percentage, which is based on current contract prices or historical paid claims data by payor. For self-pay accounts receivable, which includes patients who are uninsured and the patient responsibility portion for patients with insurance, the net realizable value is determined using estimates of historical collection experience. These estimates are adjusted for estimated conversions of patient responsibility portions, expected recoveries and any anticipated changes in trends. Patient accounts receivable can be impacted by the effectiveness of the System's collection efforts. Additionally, significant changes in payor mix, business office operations, economic conditions or trends in federal and state governmental healthcare coverage could affect the net realizable value of accounts receivable. The System also continually reviews the net realizable value of accounts receivable by monitoring historical cash collections as a percentage of trailing net patient revenues, as well as by analyzing current period net revenue and admissions by payor classification, aged accounts receivable by payor, days revenue outstanding, and the composition of self-pay receivables between pure self-pay patients and the patient responsibility portion of third-party insured receivables.

Charity Care

In the ordinary course of business, the System renders services to patients who are financially unable to pay for hospital care. The System's policy is to not pursue collections for such amounts; therefore, the related charges for those patients who are financially unable to pay and that otherwise do not qualify for reimbursement from a governmental program are not reported in net operating revenues, and are; therefore, classified as charity care. The System determines amounts that qualify for charity care primarily based on the patient's household income relative to the federal poverty level guidelines, as established by the federal government. These charity care services are estimated to be $47,541,000 and $47,375,000 for the years ended December 31, 2019 and 2018, respectively, representing the value (at the System's standard charges) of these charity care services that are excluded from net operating revenues. The estimated cost incurred by the System to provide these charity care services to patients who are unable to pay was approximately $14,301,000 and $14,690,000 for the years ended December 31, 2019 and 2018, respectively. The estimated cost of these charity care services was determined using a ratio of cost to gross charges and applying that ratio to the gross charges associated with providing care to charity patients for the period.

3. UNCOMPENSATED SERVICES

The System was compensated for services at amounts less than its established rates. The following is a summary of uncompensated services and a reconciliation of gross patient charges to net patient service revenue for 2019 and 2018:

	2019	2018
Gross patient charges	$ 883,407,000	$ 792,474,000
Uncompensated services:		
Charity and indigent care	47,541,000	47,375,000
Medicare	288,715,000	255,594,000
Medicaid	88,838,000	82,503,000
Other allowances	207,652,000	169,617,000
Total uncompensated care	632,746,000	555,089,000
	$ 250,661,000	$ 237,385,000

4. INVESTMENTS

Assets Limited as to Use

The composition of assets limited as to use at December 31, 2019 and 2018 is set forth in the following table. Investments are stated at fair value.

	2019	2018
Internally designated for capital acquisition and other:		
Cash and cash equivalents	$ 3,290,000	$ 2,613,000
Mutual funds – fixed income	41,165,000	35,587,000
Mutual funds – equities	24,973,000	28,744,000
Mutual funds – real estate	7,018,000	-
Government agency obligations	46,129,000	37,399,000
U.S. corporate bonds	31,801,000	26,192,000
U.S. equities	43,126,000	48,771,000
International assets – corporate obligations	4,026,000	4,306,000
International assets – equities	23,395,000	24,022,000
	224,923,000	207,634,000
Held by trustee under indenture agreement:		
Cash and cash equivalents	2,352,000	2,295,000
	2,352,000	2,295,000
	$ 227,275,000	$ 209,929,000

4. INVESTMENTS – CONTINUED

The System's investments are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such change could affect the amounts reported in the accompanying combined financial statements.

Subsequent to yearend and as of March 24, 2020, the fair market value of the Hospital's investments declined by approximately $35,706,000.

5. CONCENTRATIONS OF CREDIT RISK

The System grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31, 2019 and 2018 is as follows:

	2019	2018
Medicare	29%	29%
Medicaid	8%	8%
Blue Cross	13%	14%
Other third-party payors	24%	19%
Patients	26%	30%
	100%	100%

At December 31, 2019, the System had deposits at major financial institutions which exceeded the Federal Deposit Insurance Corporation limits. Management believes the credit risks related to these deposits are minimal.

6. PROPERTY AND EQUIPMENT

A summary of property and equipment at December 31, 2019 and 2018 is as follows:

	2019	2018
Land	$ 14,910,000	$ 14,910,000
Land improvements	3,776,000	3,841,000
Buildings and improvements	205,100,000	218,844,000
Equipment	105,803,000	144,441,000
	329,589,000	382,036,000
Less accumulated depreciation	197,583,000	242,433,000
	132,006,000	139,603,000
Construction in progress	4,070,000	3,432,000
Property and equipment, net	$ 136,076,000	$ 143,035,000

Depreciation expense for the years ended December 31, 2019 and 2018 amounted to approximately $17,038,000 and $18,600,000, respectively.

Contracts of approximately $5,680,000 exist for the purchase of various equipment and renovations to facilities. At December 31, 2019, the remaining commitment on these contracts approximated $1,836,000.

7. LONG-TERM DEBT

A summary of long-term debt at December 31, 2019 and 2018 is as follows:

	2019	2018
Revenue certificates – Series 2016A, payable in annual installments ranging from $1,360,000 on October 1, 2017 to $1,420,000 on October 1, 2031, with an interest rate of 5% paid semi-annually secured by gross revenues	$ 13,210,000	$ 14,000,000
Revenue certificates – Series 2016B, payable in annual installments ranging from $2,900,000 on October 1, 2018 to $5,465,000 on October 1, 2031, with an interest rate of 5% paid semi-annually secured by gross revenues	50,875,000	53,920,000
Total revenue certificates	64,085,000	67,920,000
Less current maturities	4,025,000	3,835,000
Plus net premiums, discounts, and deferred issue costs	4,721,000	5,462,000
Total long-term debt	$ 64,781,000	$ 69,547,000

7. LONG-TERM DEBT – CONTINUED

Discounts and premiums on long-term debt are amortized using the straight-line method over the life of the related bonds, which approximates the effective interest method.

With the reorganization plan implemented by the Authority on January 1, 2009, Houston Hospitals, Inc. (Hospitals), along with the Authority, entered into a master trust indenture (MTI) with a commercial bank as the trustee in which Hospitals pledged its gross revenues to the payment of all obligations issued from time-to-time under the terms of the MTI. Such obligations take the form of tax-exempt issuances of the Authority, the proceeds of which are loaned to Hospitals as conduit obligations under related loan agreements. Such conduit obligations issued under the MTI are secured by a lien on the gross revenues of the members of the Obligated Group, which have joint and severable liability for such obligations. The Obligated Group is currently composed of the Authority, Houston Healthcare System, Inc., Houston Hospitals, Inc., Houston Healthcare Properties, Inc., Houston Healthcare EMS, Inc., Houston Primary Care Physicians, LLC, and Houston Physician Specialists, LLC. The MTI provides the terms for the addition and removal of members of the Obligated Group.

On November 1, 2016, the Authority issued $16,115,000 of Series 2016A Revenue Anticipation Certificates (the Series 2016A Certificates). In connection with the issuance of the Series 2016A Certificates, the Authority loaned the proceeds of the Series 2016A Certificates to the System to refund the previously issued Series 2013 Revenue Anticipation Certificates and to pay costs of issuance of the Series 2016A Certificates. The Series 2016A Certificates have outstanding sinking fund redemptions and maturities ranging from $1,360,000 to $1,420,000 through fiscal year 2031.

On November 1, 2016, the Authority issued $56,820,000 of Series 2016B Revenue Anticipation Certificates (the “Series 2016B Certificates”). In connection with the issuance of the Series 2016B Certificates, the Authority loaned the proceeds of the Series 2016B Certificates to the System for the purpose of (1) redeeming the Authority’s Revenue Anticipation Certificates Series 2007 maturing in years 2018 through and including 2042 on October 1, 2017, (2) paying interest on the Series 2016B Certificates up to October 1, 2017, and (3) paying the costs of issuance of the Series 2016B Certificates. The Series 2016B Certificates have outstanding sinking fund redemptions and maturities ranging from $2,900,000 to $5,465,000 through fiscal year 2031.

Under the terms of the MTI and related loan agreements, the System is required (1) to maintain certain deposits with a trustee and (2) meet certain financial and nonfinancial covenants as long as the certificates are outstanding. The System is in compliance with these requirements for 2019 and 2018.

7. LONG-TERM DEBT – CONTINUED

Scheduled principal repayments on long-term debt are as follows:

For the Years Ending December 31,	Amount
2020	$ 4,025,000
2021	4,225,000
2022	4,440,000
2023	4,660,000
2024	4,895,000
Thereafter	41,840,000
	$ 64,085,000

8. NET ASSETS

At December 31, 2019 and 2018, net assets without donor imposed restrictions were as follows:

	2019	2018
Without donor imposed restrictions:		
Internally designated for capital acquisition and other	$ 224,923,000	$ 207,634,000
Held by trustee under indenture agreement	2,352,000	2,295,000
Undesignated	60,870,000	67,033,000
Total net assets without donor imposed restrictions	$ 288,145,000	$ 276,962,000

9. LIQUIDITY

The following reflects the System's financial assets at December 31, 2019 and 2018, reduced by amounts not available for general use within one year of the combined balance sheet dates because of contractual or internal designations. Amounts not available include amounts set aside by the Board of Trustees for future capital acquisition and other reserves that could be drawn upon if the Board approves the action.

	2019	2018
Cash and cash equivalents	$ 7,069,000	$ 10,725,000
Patients accounts receivable, net	22,949,000	26,616,000
Estimated third-party payor receivable	444,000	82,000
Insurance recoveries – current portion	1,216,000	1,651,000
	$ 31,678,000	$ 39,074,000

As part of the System's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due.
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10. PENSION PLAN

Plan Description

The System contributes to a defined benefit pension plan (the Plan) managed by a trustee. All full-time and part-time employees who regularly worked 32 or more hours per week that were hired prior to May 1, 2009, age 21 or older and with at least one year of service, are eligible to participate in the Plan. Plan participants under the age of 45 as of January 1, 2011 no longer accumulate benefits. System employees who are vested are entitled to an annual benefit payable monthly for life, in an amount equal to 1% of final average earnings up to covered compensation, plus 1.55% of final average earnings in excess of covered compensation, times credited service up to 30 years. Participants are 100% vested after five years of employment. Participants are fully vested at age 65. The System's funding policy is to make the minimum annual contribution required by applicable regulations. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The measurement date was December 31, 2019 and 2018.

The following table sets forth the Plan's funded status and amounts recognized in the combined financial statements at December 31, 2019 and 2018:

	2019	2018
Plan assets at fair value at December 31	$ 126,055,000	$ 105,620,000
Projected benefit obligation at December 31	135,463,000	115,513,000
Funded status	$ (9,408,000)	$ (9,893,000)
Amounts recognized in the combined balance sheets consist of:		
Noncurrent liabilities	$ (9,408,000)	$ (9,893,000)
Amounts recognized in net assets without donor imposed restrictions:		
Net actuarial loss	$ 26,208,000	$ 23,907,000

10. PENSION PLAN – CONTINUED

The following table sets forth the components of net periodic pension cost and other amounts recognized in net assets without donor imposed restrictions for the years ended December 31, 2019 and 2018:

	2019	2018
Service cost	$ 1,051,000	$ 1,364,000
Interest cost	4,703,000	4,256,000
Expected return on Plan assets	(6,690,000)	(7,016,000)
Amortization of net actuarial loss	2,150,000	1,721,000
Net periodic cost	1,214,000	325,000
Other changes in Plan assets and benefit obligations recognized in net assets without donor imposed restrictions:		
Net actuarial loss	4,451,000	6,069,000
Amortization of net actuarial loss	(2,150,000)	(1,721,000)
Total recognized in net assets without donor imposed restrictions	2,301,000	4,348,000
Total recognized in net periodic benefit cost and net assets without donor imposed restrictions	$ 3,515,000	$ 4,673,000

The components of net periodic cost above other than service cost are included in nonoperating revenues (expenses) in the combined statements of operations and changes in net assets.

The System's expected rate of return on Plan assets is determined by the Plan assets' historical long-term investment performance, current asset allocation, and estimates of future long-term returns by asset class.

	2019	2018
Weighted-average assumptions used to determine pension benefit obligations:		
Discount rate	3.33%	4.45%
Rate of increase in future compensation levels	2.00%	2.00%
Weighted-average assumptions used to determine net period benefit cost:		
Discount rate	4.45%	3.77%
Expected long-term return on Plan assets	6.50%	6.50%
Rate of increase in future compensation levels	2.00%	2.00%

10. PENSION PLAN – CONTINUED

The change in projected benefit obligation for the Plan for the years ended December 31, 2019 and 2018 included the following components:

	2019	2018
Projected benefit obligation, end of year	$ 115,513,000	$ 121,084,000
Service cost	1,051,000	1,364,000
Interest cost	4,703,000	4,256,000
Actuarial loss (gain)	18,295,000	(7,728,000)
Benefits paid	(4,099,000)	(3,463,000)
Projected benefit obligation, end of year	$ 135,463,000	$ 115,513,000
Accumulated benefit obligation	$ 133,061,000	$ 113,248,000

The change in fair value of Plan assets for the years ended December 31, 2019 and 2018 is included the following components:

	2019	2018
Plan assets at fair value, beginning of year	$ 105,620,000	$ 109,864,000
Actual return on assets	20,534,000	(6,781,000)
Employer contributions	4,000,000	6,000,000
Benefits paid	(4,099,000)	(3,463,000)
Plan assets at fair value, end of year	$ 126,055,000	$ 105,620,000

10. PENSION PLAN – CONTINUED

Plan Assets

The composition of Plan assets at December 31, 2019 and 2018 is as follows:

	2019	%	2018	%
Cash and cash equivalents	$ 3,705,000	3%	$ 3,314,000	3%
Mutual funds – fixed income	14,950,000	12%	13,915,000	13%
Mutual funds – equities	29,939,000	24%	31,259,000	30%
Mutual funds – real estate	10,669,000	8%	-	0%
Government agency obligations	12,233,000	10%	10,744,000	10%
U.S. Corporate bonds	11,951,000	9%	11,194,000	11%
U.S. Equities	30,833,000	24%	24,148,000	23%
International assets – government agency obligations	-	0%	162,000	0%
International assets – corporate obligations	1,158,000	1%	1,783,000	2%
International assets – equities	10,617,000	8%	9,101,000	9%
	$ 126,055,000	100%	$ 105,620,000	100%

The System's investment strategy is to manage the portfolio to preserve principal and liquidity while maximizing the return on the investment portfolio through the full investment of available funds. The portfolio is diversified by investing in multiple types of investment-grade securities. The investment policy requires assets of the Plan to be primarily invested in securities with at least an investment grade rating to minimize interest rate and credit risk. The Plan assets are long-term in nature and are intended to generate returns while preserving capital. The target allocation for the Plan's investments is 45% U.S. equity, 10% international equity, 35% fixed income, and 10% other securities.

Pension assets are invested in equities, fixed income securities, and cash and cash equivalents. The allocation between different investment vehicles is determined by the System's investment committee, based on current market conditions, short-term and long-term market outlooks, and cash needs for distributions and Plan expenses. Assumptions for expected returns on Plan assets are based on historical performance, long-term market outlook, and a diversified investment approach designed to provide steady, consistent returns that minimize market fluctuations. The System utilizes the services of a professional investment advisor in the selection of individual fund managers. The investment advisor tracks the performance of each fund manager and makes recommendations for redistributions, as needed, to comply with targeted allocations or to replace underperforming funds.

The System attempts to mitigate investment risk by rebalancing between investment classes as the System's contributions and monthly benefit payments are made. Although changes in interest rates may affect the fair value of a portion of the investment portfolio and cause unrealized gains and losses, such gains or losses would not be realized unless the investments are sold.

Subsequent to yearend and as of March 24, 2020, the fair market value of the plan's investments declined by approximately $24,020,000.

10. PENSION PLAN – CONTINUED

The fair values of the System's Plan assets at December 31, 2019 and 2018, by asset category (see Note 15) are as follows:

		Fair Value Measurements		
December 31, 2019	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets Level 1**	**Significant Other Observable Inputs Level 2**	**Significant Unobservable Inputs Level 3**
Cash and cash equivalents	$ 3,705,000	$ 3,705,000	$ -	$ -
Mutual funds – fixed income	14,950,000	14,950,000	-	-
Mutual funds – equities	29,939,000	29,939,000	-	-
Mutual funds – real estate	10,669,000	10,669,000	-	-
Government agency obligations	12,233,000	-	12,233,000	-
U.S. corporate bonds	11,951,000	-	11,951,000	-
U.S. equities	30,833,000	30,833,000	-	-
International assets – corporate obligations	1,158,000	-	1,158,000	-
International assets – equities	10,617,000	10,617,000	-	-
Total	$ 126,055,000	$ 100,713,000	$ 25,342,000	$ -

		Fair Value Measurements		
December 31, 2018	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets Level 1**	**Significant Other Observable Inputs Level 2**	**Significant Unobservable Inputs Level 3**
Cash and cash equivalents	$ 3,314,000	$ 3,314,000	$ -	$ -
Mutual funds – fixed income	13,915,000	13,915,000	-	-
Mutual funds – equities	31,259,000	31,259,000	-	-
Government agency obligations	10,744,000	-	10,744,000	-
U.S. corporate bonds	11,194,000	-	11,194,000	-
U.S. equities	24,148,000	24,148,000	-	-
International assets – Government agency obligations	162,000	-	162,000	-
International assets – corporate obligations	1,783,000	-	1,783,000	-
International assets – equities	9,101,000	9,101,000	-	-
Total	$ 105,620,000	$ 81,737,000	$ 23,883,000	$ -

See Note 15 for the methods and assumptions used by the System in estimating the fair value of the above Plan assets.

10. PENSION PLAN – CONTINUED

Estimated Contributions

The System plans to contribute approximately $3,000,000 to the Plan in 2020. No Plan assets are expected to be returned to the System during 2020.

Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service and decrements as appropriate, are expected to be paid as follows:

For the Years Ending December 31,	Pension Benefits
2020	$ 5,054,000
2021	5,572,000
2022	5,990,000
2023	6,371,000
2024	6,756,000
2025 - 2029	37,667,000

The expected benefits to be paid are based on the same assumptions used to measure the System's benefit obligation at December 31, 2019.

The System will recognize approximately $2,150,000 of actuarial loss during the next 12 months beginning January 1, 2020.

11. DEFINED CONTRIBUTION PLAN

The System has a defined contribution retirement plan (the Retirement Plan) covering substantially all employees. The Retirement Plan is a tax-deferred annuity plan under Section 403(b) of the Internal Revenue Code which allows employee contributions upon employment and at least 1,000 hours of work and allows employer contributions upon attainment of the age of 21 and at least one year of service. Participants may contribute up to 20% of their annual compensation up to a maximum dollar limitation. Employer contributions are made at a matching level of 50% of the participants' annual contribution to the Retirement Plan, up to a maximum of 4% of the employee's annual compensation. The System made contributions to the Retirement Plan of approximately $2,302,000 and $2,400,000 for the years ended December 31, 2019 and 2018, respectively.

12. EMPLOYEE HEALTH PLAN

The System has a self-insurance program under which a third-party administrator processes and pays claims. The System reimburses the third-party administrator for claims incurred and paid and has purchased stop-loss insurance coverage for claims in excess of $650,000 for each individual employee. Under this self-insurance program, approximately $17,298,000 and $17,371,000 were paid or accrued during the years ended December 31, 2019 and 2018, respectively.

13. PROFESSIONAL LIABILITY CLAIMS

The System is covered by a claims-made general and professional liability insurance policy with excess coverage not to exceed $35 million. Self-insured retention related to this policy in 2019 and 2018 was $1 million per occurrence and $5 million in aggregate. The System uses a third-party administrator to review and analyze incidents that may result in a claim against the System. In conjunction with the third-party administrator, incidents are assigned reserve amounts for the ultimate liability that may result from an asserted claim. The System also uses independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. Long-term accrued professional claims are included in self-insurance reserves and the current portion is included in other current liabilities in the combined balance sheets, and in management's opinion, provide an adequate reserve for loss contingencies.

Various claims and assertions have been made against the System in its normal course of providing services. In addition, other claims may be asserted arising from services provided to patients in the past. In the opinion of management, adequate provision has been made for losses which may occur from such asserted and unasserted claims that are not covered by liability insurance.

Obligations covered by reinsurance contracts are included in the reserves for professional liability risks, as the System remains liable to the extent the reinsurers do not meet their obligations under the reinsurance contracts. The current amount receivable under the reinsurance contracts include $1,061,000 and $1,644,000 at December 31, 2019 and 2018, respectively, recorded in insurance recoveries – current portion and the long-term portion of $3,703,000 and $5,056,000, respectively, is recorded in insurance recoveries.

14. FUNCTIONAL EXPENSES

The System provides general health care services to residents within its geographic location. The following tables present expenses by both their nature and function for the years ended December 31:703

	2019			2018		
	Health Care Services	General and Administrative	Total	Health Care Services	General and Administrative	Total
Salaries and benefits	$ 132,503,000	$ 13,689,000	$ 146,192,000	$ 126,150,000	$ 15,247,000	$ 141,397,000
Supplies and drugs	41,787,000	222,000	42,009,000	42,229,000	376,000	42,605,000
Other expenses	48,997,000	14,862,000	63,859,000	39,068,000	17,225,000	56,293,000
Depreciation and amortization	14,180,000	2,881,000	17,061,000	13,394,000	5,189,000	18,583,000
Interest expense	1,869,000	727,000	2,596,000	1,984,000	769,000	2,753,000
Total operating expenses	$ 239,336,000	$ 32,381,000	$ 271,717,000	$ 222,825,000	$ 38,806,000	$ 261,631,000

The financial statements report certain categories of expenses that are attributable to health care services as well as general and administrative functions. Therefore, these expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include utilities, depreciation and amortization, and interest, all of which are allocated based on a square footage basis, as well as certain employee benefits, which are allocated based on salaries.

15. FAIR VALUE OF FINANCIAL INSTRUMENTS

The System's assets and liabilities recorded at fair value or for which fair value is required to be disclosed have been categorized based upon a fair value hierarchy in accordance with accounting standards which require that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

- Level 1 – Observable quoted market prices in active markets for identical assets or liabilities.
- Level 2 –- Observable inputs other than Level 1, such as quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.
- Level 3 – Unobservable inputs for the asset or liability that are significant to the fair value of the assets or liabilities.

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

- *Cash and cash equivalents*, *accounts payable, accrued expenses, and estimated third-party payor settlements*: The carrying amount reported in the combined balance sheets approximates its fair value, due to the short-term nature of these instruments.
- *Assets limited as to use*: Fair values, which are the amounts reported in the combined balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.
- *Long-term debt*: The fair value of the System's fixed rate long-term debt is estimated based on quoted market value, and would be classified as Level 1 in the fair value hierarchy.

Financial assets valued using Level 1 inputs are based on unadjusted quoted market prices within active markets. Financial assets valued using Level 2 inputs are based primarily on quoted prices for similar investments in active or inactive markets. Valuation techniques utilized to determine fair value are consistently applied. All assets have been valued using a market approach.

- *Government agency obligations:* Level 2 assets are valued using pricing models maximizing the use of observable inputs for similar securities.
- *U.S. Corporate bonds:* Level 2 assets are valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing values on yields currently available on comparable securities of issuers with similar credit ratings. The corporate bonds contain credit ratings of A3 to AAA.

15. FAIR VALUE OF FINANCIAL INSTRUMENTS-CONTINUED

The carrying amount and estimated fair values of the System's long-term debt at December 31, 2019 and 2018 are as follows:

	December 31, 2019		December 31, 2018	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-term debt	$ 68,806,000	$ 70,427,000	$ 73,382,000	$ 74,222,000

The estimated fair values of the System's investments at December 31, 2019 and 2018 and the level within the fair value hierarchy are as follows:

		Fair Value Measurements		
December 31, 2019	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets Level 1**	**Significant Other Observable Inputs Level 2**	**Significant Unobservable Inputs Level 3**
Cash and cash equivalents	$ 5,642,000	$ 5,642,000	$ -	$ -
Mutual funds – fixed income	41,165,000	41,165,000	-	-
Mutual funds – equities	24,973,000	24,973,000	-	-
Mutual funds – real estate	7,018,000	7,018,000	-	-
Government agency obligations	46,129,000	-	46,129,000	-
U.S. corporate bonds	31,801,000	-	31,801,000	-
U.S. equities	43,126,000	43,126,000	-	-
International assets – corporate obligations	4,026,000	-	4,026,000	-
International assets – equities	23,395,000	23,395,000	-	-
Total	$ 227,275,000	$ 145,319,000	$ 81,956,000	$ -

		Fair Value Measurements		
December 31, 2018	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets Level 1**	**Significant Other Observable Inputs Level 2**	**Significant Unobservable Inputs Level 3**
Cash and cash equivalents	$ 4,908,000	$ 4,908,000	$ -	$ -
Mutual funds – fixed income	35,587,000	35,587,000	-	-
Mutual funds – equities	28,744,000	28,744,000	-	-
Government agency obligations	37,399,000	-	37,399,000	-
U.S. corporate bonds	26,192,000	-	26,192,000	-
U.S. equities	48,771,000	48,771,000	-	-
International assets – corporate obligations	4,306,000	-	4,306,000	-
International assets – equities	24,022,000	24,022,000	-	-
Total	$ 209,929,000	$ 142,032,000	$ 67,897,000	$ -

16. MEDICAID UPPER PAYMENT LIMIT

The Medicare, Medicaid, and State Children's Health Insurance Program (SCHIP) Benefits Improvement and Protection Act of 2000 (BIPA) provides for enhanced payments to Medicaid providers under the Upper Payment Limit (UPL) methodology. Subsequent to the implementation of the UPL methodology, federal budget concerns have led to reconsideration of the BIPA legislation with possible elimination or reduction of enhanced Medicaid payments. Legislation has been enacted to reduce the level of UPL payments. These reductions are anticipated to remain in effect in future periods. Net patient service revenue includes enhanced payments for December 31, 2019 and 2018 of approximately $1,133,000 and $2,011,000, respectively.

17. INDIGENT CARE TRUST FUND

The System participates in the Georgia Indigent Care Trust Fund (ICTF) Program. The System receives ICTF payments for treating a disproportionate number of Medicaid and other indigent patients. ICTF payments are based on the System's estimated uncompensated cost of services to Medicaid and uninsured patients. The amount of ICTF payments recognized in net patient revenue was approximately $4,511,000 and $3,222,000 for the years ended December 31, 2019 and 2018, respectively.

18. COMMITMENTS AND CONTINGENCIES

Compliance Plan

The healthcare industry has recently been subjected to increased scrutiny from governmental agencies at both the national and state level with respect to compliance with regulations. Areas of noncompliance identified at the national level include Medicare and Medicaid, Internal Revenue Service (IRS), and other regulations governing the healthcare industry. The System has implemented a compliance plan focusing on such issues. There can be no assurance that the System will not be subjected to future investigations with accompanying monetary damages.

Health Care Reform

In recent years, there has been increasing pressure on Congress and some state legislatures to control and reduce the cost of healthcare on the national or at the state level. In 2010, legislation was enacted which included cost controls on hospitals, insurance market reforms, delivery system reforms and various individual and business mandates among other provisions. The costs of certain provisions will be funded in part by reductions in payments by government programs, including Medicare and Medicaid. There can be no assurance that these changes will not adversely affect the System.

Litigation

The System is involved in litigation and regulatory investigations arising in the normal course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the System's future financial position or results from operations.

SUPPLEMENTARY INFORMATION

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINING BALANCE SHEET
DECEMBER 31, 2019

ASSETS	Houston Medical Center	Perry Hospital	Houston Healthcare EMS, Inc.	Houston Healthcare System, Inc.	Houston Healthcare Ventures, Inc.	Houston Healthcare Properties, Inc.	Houston Primary Care Physicians, LLC	Houston Physcian Specialities, LLC	Eliminations	Total
CURRENT ASSETS										
Cash and cash equivalents	$ 5,431,000	$ 1,000	$ 23,000	$ 12,000	$ 1,361,000	$ 49,000	$ 7,000	$ 185,000	$ -	7,069,000
Assets limited as to use – current portion	791,000	-	-	-	-	-	-	-	-	791,000
Patient accounts receivable, net	20,352,000	2,274,000	323,000	-	-	-	-	-	-	22,949,000
Intercompany receivables	10,263,000	-	-	-	-	47,000	-	-	(10,310,000)	-
Estimated third-party payor receivable	371,000	73,000	-	-	-	-	-	-	-	444,000
Insurance recoveries – current portion	1,216,000	-	-	-	-	-	-	-	-	1,216,000
Supplies, at lower of cost (first-in, first-out)										-
or market and other assets	6,134,000	513,000	-	-	-	-	-	-	-	6,647,000
Total current assets	44,558,000	2,861,000	346,000	12,000	1,361,000	96,000	7,000	185,000	(10,310,000)	39,116,000
ASSETS LIMITED AS TO USE										
Internally designated for capital acquisition and other	224,923,000	-	-	-	-	-	-	-	-	224,923,000
Held by trustee under indenture agreement	2,352,000	-	-	-	-	-	-	-	-	2,352,000
	227,275,000	-	-	-	-	-	-	-	-	227,275,000
Less amounts required to meet current obligations	791,000	-	-	-	-	-	-	-	-	791,000
Total assets limited as to use	226,484,000	-	-	-	-	-	-	-	-	226,484,000
PROPERTY AND EQUIPMENT, NET	99,235,000	7,091,000	652,000	-	-	28,330,000	63,000	705,000	-	136,076,000
OTHER ASSETS										
Long-term investments and other	1,142,000	-	-	1,876,000	652,000	-	-	-	-	3,670,000
Insurance recoveries	3,972,000	-	-	-	-	-	-	-	-	3,972,000
Total other assets	5,114,000	-	-	1,876,000	652,000	-	-	-	-	7,642,000
TOTAL ASSETS	$ 375,391,000	$ 9,952,000	$ 998,000	$ 1,888,000	$ 2,013,000	$ 28,426,000	$ 70,000	$ 890,000	$ (10,310,000)	$ 409,318,000

See independent auditors' report.

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINING BALANCE SHEET
DECEMBER 31, 2019

LIABILITIES AND NET ASSETS	Houston Medical Center	Perry Hospital	Houston Healthcare EMS, Inc.	Houston Healthcare System, Inc.	Houston Healthcare Ventures, Inc.	Houston Healthcare Properties, Inc.	Houston Primary Care Physicians, LLC	Houston Physcian Specialities, LLC	Eliminations	Total
CURRENT LIABILITIES										
Current maturities of long-term debt	$ 4,025,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 4,025,000
Accounts payable and accrued expenses	8,019,000	3,000	-	-	-	25,000	15,000	(13,000)	-	8,049,000
Intercompany payables	-	2,052,000	846,000	-	2,000	-	3,311,000	4,099,000	(10,310,000)	-
Accrued compensation and benefits	15,889,000	971,000	237,000	-	-	-	388,000	411,000	-	17,896,000
Estimated third-party payor settlements	2,436,000	103,000	-	-	-	-	-	-	-	2,539,000
Other current liabilities	3,754,000	-	-	-	-	-	-	-	-	3,754,000
Total current liabilities	34,123,000	3,129,000	1,083,000	-	2,000	25,000	3,714,000	4,497,000	(10,310,000)	36,263,000
LONG-TERM DEBT, NET OF CURRENT INSTALLMENTS	64,781,000	-	-	-	-	-	-	-	-	64,781,000
SELF-INSURANCE RESERVES	10,721,000	-	-	-	-	-	-	-	-	10,721,000
ACCRUED PENSION LIABILITY	9,408,000	-	-	-	-	-	-	-	-	9,408,000
TOTAL LIABILITIES	119,033,000	3,129,000	1,083,000	-	2,000	25,000	3,714,000	4,497,000	(10,310,000)	121,173,000
NET ASSETS										
Without donor imposed restrictions	256,358,000	6,823,000	(85,000)	1,888,000	2,011,000	28,401,000	(3,644,000)	(3,607,000)	-	288,145,000
Total net assets	256,358,000	6,823,000	(85,000)	1,888,000	2,011,000	28,401,000	(3,644,000)	(3,607,000)	-	288,145,000
TOTAL LIABILITIES AND NET ASSETS	$ 375,391,000	$ 9,952,000	$ 998,000	$ 1,888,000	$ 2,013,000	$ 28,426,000	$ 70,000	$ 890,000	$ (10,310,000)	$ 409,318,000

See independent auditors' report.

HOUSTON HEALTHCARE SYSTEM, INC.
COMBINING STATEMENT OF OPERATIONS AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED DECEMBER 31, 2019

	Houston Medical Center	Perry Hospital	Houston Healthcare EMS, Inc.	Houston Healthcare System, Inc.	Houston Healthcare Ventures, Inc.	Houston Healthcare Properties, Inc.	Houston Primary Care Physicians, LLC	Houston Physcian Specialities, LLC	Eliminations	Total
OPERATING REVENUES										
Net patient service revenue	$ 215,645,000	$ 25,168,000	$ 5,165,000	$ -	$ -	$ -	$ 959,000	$ 3,724,000	$ -	$ 250,661,000
Other revenue	2,245,000	210,000	83,000	-	-	921,000	1,899,000	-	(2,661,000)	2,697,000
Total operating revenues	217,890,000	25,378,000	5,248,000	-	-	921,000	2,858,000	3,724,000	(2,661,000)	253,358,000
OPERATING EXPENSES										
Salaries and benefits	118,869,000	12,469,000	4,272,000	-	-	2,000	4,640,000	5,940,000	-	146,192,000
Supplies and drugs	37,917,000	3,661,000	166,000	-	-	-	69,000	196,000	-	42,009,000
Other expenses	57,445,000	5,695,000	1,184,000	-	2,000	204,000	1,012,000	978,000	(2,661,000)	63,859,000
Depreciation and amortization	13,999,000	1,043,000	321,000	-	-	1,647,000	3,000	48,000	-	17,061,000
Interest expense	2,596,000	-	-	-	-	-	-	-	-	2,596,000
Overhead allocation	(4,853,000)	3,496,000	468,000	-	-	41,000	606,000	242,000	-	-
Total operating expenses	225,973,000	26,364,000	6,411,000	-	2,000	1,894,000	6,330,000	7,404,000	(2,661,000)	271,717,000
OPERATING LOSS	(8,083,000)	(986,000)	(1,163,000)	-	(2,000)	(973,000)	(3,472,000)	(3,680,000)	-	(18,359,000)
NONOPERATING REVENUES (EXPENSES)										
Investment income	5,179,000	-	-	-	-	-	-	-	-	5,179,000
Other components of net periodic pension costs	(163,000)	-	-	-	-	-	-	-	-	(163,000)
Net realized gains on sales of securities	14,185,000	-	-	134,000	654,000	-	-	-	-	14,973,000
Net unrealized gains on securities	11,865,000	-	-	-	-	-	-	-	-	11,865,000
Noncapital grants, contributions, and other	(119,000)	108,000	-	-	-	-	-	-	-	(11,000)
Total nonoperating revenues (expenses)	30,947,000	108,000	-	134,000	654,000	-	-	-	-	31,843,000
EXCESS OF REVENUES OVER (UNDER) EXPENSES	22,864,000	(878,000)	(1,163,000)	134,000	652,000	(973,000)	(3,472,000)	(3,680,000)	-	13,484,000
Changes in pension assets and benefit obligations not included in net periodic pension costs	(2,301,000)	-	-	-	-	-	-	-	-	(2,301,000)
INCREASE (DECREASE) IN NET ASSETS WITHOUT DONOR IMPOSED RESTRICTIONS	20,563,000	(878,000)	(1,163,000)	134,000	652,000	(973,000)	(3,472,000)	(3,680,000)	-	11,183,000
NET ASSETS AT BEGINNING OF YEAR	235,795,000	7,701,000	1,078,000	1,754,000	1,359,000	29,374,000	(172,000)	73,000	-	276,962,000
NET ASSETS AT END OF YEAR	$ 256,358,000	$ 6,823,000	$ (85,000)	$ 1,888,000	$ 2,011,000	$ 28,401,000	$ (3,644,000)	$ (3,607,000)	$ -	$ 288,145,000

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