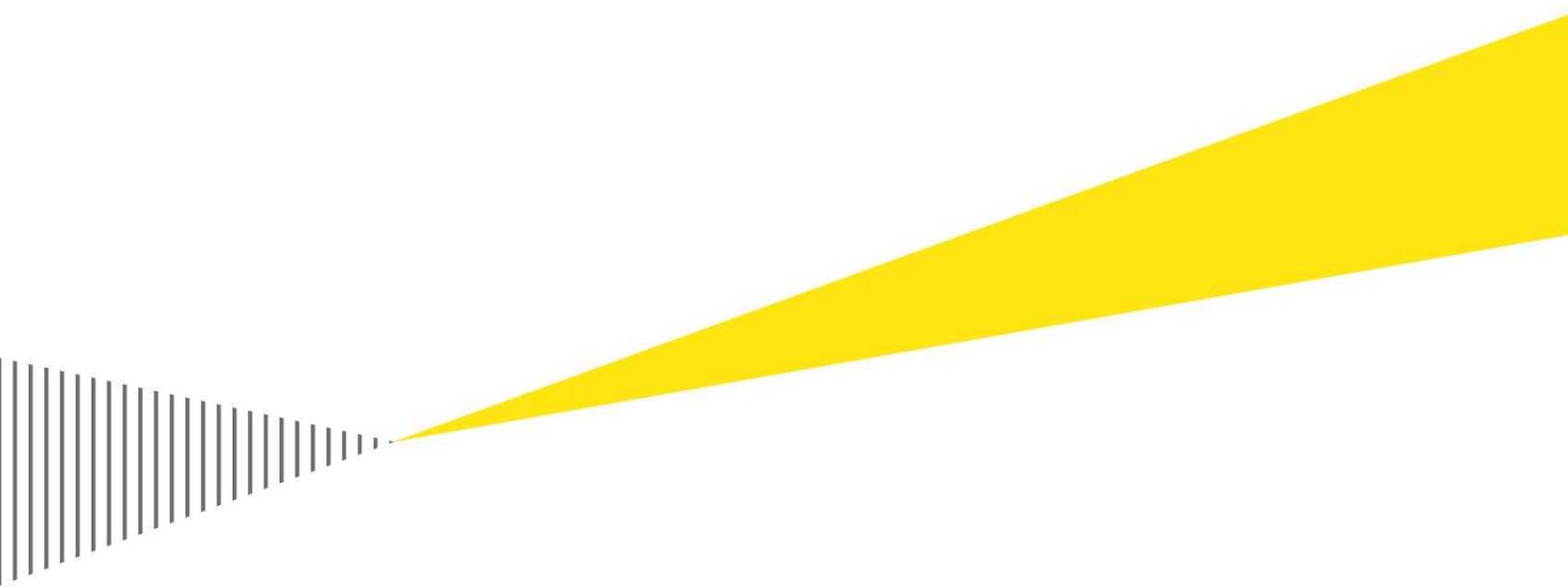


CONSOLIDATED FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION, INCLUDING
UNIFORM GUIDANCE REPORTS AND SCHEDULES

Mercy Health
Years Ended June 30, 2018 and 2017
With Reports of Independent Auditors

Ernst & Young LLP



Mercy Health

Consolidated Financial Statements and Supplementary Information, Including Uniform Guidance Reports and Schedules

Years Ended June 30, 2018 and 2017

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Report of Independent Auditors

The Board of Directors
Mercy Health

We have audited the accompanying consolidated financial statements of Mercy Health, which comprise the consolidated balance sheets as of June 30, 2018 and 2017, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management’s Responsibility for the Financial Statements

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

Auditor’s Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

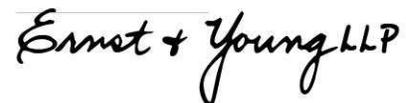
In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mercy Health at June 30, 2018 and 2017, and the consolidated results of its operations, changes in net assets, and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The schedule of expenditures of federal awards for the year ended June 30, 2018, as required by Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. The accompanying schedule of state assistance for the year ended June 30, 2018, as required by Section IX.C.1. of the *Guidelines for Financial and Compliance Audits of Programs Funded by the Arkansas Department of Human Services* (1998), is presented for purposes of additional analysis and is not a required part of the consolidated 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 consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we also have issued our report dated October 1, 2018, on our consideration of Mercy Health's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of Mercy Health's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Mercy Health's internal control over financial reporting and compliance.



October 1, 2018, except for the schedule of expenditures of federal awards and schedule of state assistance for which the date is December 19, 2018

Mercy Health

Consolidated Balance Sheets
(In Thousands)

	June 30	
	2018	2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 481,881	\$ 523,451
Accounts receivable, net of allowance for uncollectible receivables of \$290,814 and \$200,519 in 2018 and 2017, respectively	724,824	659,818
Inventories	115,945	104,510
Short-term investments	34,686	32,610
Other current assets	134,467	148,484
Total current assets	<u>1,491,803</u>	1,468,873
Investments	2,399,438	2,093,175
Property and equipment, net	3,005,229	2,941,387
Other assets	610,828	579,686
Total assets	<u>\$ 7,507,298</u>	<u>\$ 7,083,121</u>
Liabilities and net assets		
Current liabilities:		
Current maturities of long-term obligations	\$ 18,811	\$ 13,449
Accounts payable	279,512	228,872
Accrued payroll and related liabilities	442,828	428,141
Accrued liabilities and other	240,256	250,878
Total current liabilities	<u>981,407</u>	921,340
Insurance reserves and other liabilities	457,312	455,828
Pension liabilities	300,479	363,384
Long-term obligations, less current maturities	1,706,492	1,524,860
Total liabilities	<u>3,445,690</u>	3,265,412
Net assets:		
Unrestricted	3,956,780	3,713,187
Restricted	104,828	104,522
Total net assets	<u>4,061,608</u>	3,817,709
Total liabilities and net assets	<u>\$ 7,507,298</u>	<u>\$ 7,083,121</u>

See accompanying notes.

Mercy Health

Consolidated Statements of Operations

(In Thousands)

	Year Ended June 30	
	2018	2017
Operating revenues:		
Patient service revenues (net of contractually and discounts)	\$6,216,328	\$5,305,455
Provision for uncollectible receivables	(537,734)	(330,078)
Net patient service revenues	5,678,594	4,975,377
Capitation revenues	274,379	258,899
Other operating revenues	301,481	301,602
Total operating revenues	6,254,454	5,535,878
Operating expenses:		
Salaries and benefits	3,592,391	3,070,252
Supplies and other	2,115,815	1,863,582
Medical claims expense	84,800	84,169
Interest	44,692	33,432
Depreciation and amortization	312,079	295,763
Impairment, restructuring, and accelerated depreciation	36,372	-
Total operating expenses	6,186,149	5,347,198
Operating income	68,305	188,680
Nonoperating gains (losses):		
Investment returns, net	115,151	150,206
Realized and unrealized gains on interest rate swaps, net	13,315	20,797
Acquisition of St. Anthony's, see <i>Note 1</i>	(11,949)	120,206
Other, net	(16,475)	(15,004)
Total nonoperating gains, net	100,042	276,205
Excess of revenues over expenses	168,347	464,885
Other changes in unrestricted net assets:		
Pension liability adjustments	58,389	66,706
Net assets released from restrictions for property acquisitions	11,630	10,104
Other	5,227	2,495
Increase in unrestricted net assets	\$ 243,593	\$ 544,190

See accompanying notes.

Mercy Health

Consolidated Statements of Changes in Net Assets
(In Thousands)

	Year Ended June 30	
	2018	2017
Increase in unrestricted net assets	\$ 243,593	\$ 544,190
Restricted net assets:		
Pledges, bequests, and gifts for specific purposes	26,491	24,823
Investment returns, net	1,912	2,548
Net assets released from restrictions	(30,581)	(20,691)
Contribution of restricted net assets of acquired entities	–	6,725
Other	2,484	523
Increase in restricted net assets	<u>306</u>	<u>13,928</u>
Increase in net assets	243,899	558,118
Net assets at beginning of year	<u>3,817,709</u>	<u>3,259,591</u>
Net assets at end of year	<u>\$ 4,061,608</u>	<u>\$ 3,817,709</u>

See accompanying notes.

Mercy Health

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended June 30	
	2018	2017
Operating activities		
Change in net assets	\$ 243,899	\$ 558,118
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Pension liability adjustments	(58,389)	(66,706)
Pledges, bequests, and gifts for specific purposes	(26,491)	(24,823)
Inherent contribution of acquired entities	11,949	(126,931)
Unrealized gain on interest rate swap	(21,611)	(30,154)
Depreciation, amortization, and restructuring	348,451	295,763
Provision for uncollectible receivables	537,734	330,078
Net loss (gain) on disposal of property	1,677	(1,047)
Changes in assets and liabilities:		
Accounts receivable	(601,258)	(342,045)
Investments classified as trading	(241,931)	(154,961)
Inventories and other current assets	(10,852)	9,217
Accounts payable	49,949	36,056
Accrued liabilities and other	236	(68,526)
Insurance reserves and other liabilities	18,418	13,284
Net cash provided by operating activities	251,781	427,323
Investing activities		
Additions to property and equipment, net	(403,335)	(321,613)
Net change in notes receivable and other assets	3,042	(2,865)
Net change in alternative investments	(59,664)	(146,525)
Business acquisitions	(44,409)	-
Cash received from contribution of St. Anthony's Medical Center	-	10,132
Net cash used in investing activities	(504,366)	(460,871)

Mercy Health

Consolidated Statements of Cash Flows (continued)
(In Thousands)

	Year Ended June 30	
	2018	2017
Financing activities		
Proceeds from issuance of long-term debt, net of original issue discount and financing costs	\$ 298,652	\$ 81,790
Principal payments on long-term obligations	(114,128)	(93,576)
Pledges, bequests, and gifts for specific purposes	26,491	24,823
Net cash provided by financing activities	<u>211,015</u>	<u>13,037</u>
Net decrease in cash and cash equivalents	(41,570)	(20,511)
Cash and cash equivalents at beginning of year	523,451	543,962
Cash and cash equivalents at end of year	<u>\$ 481,881</u>	<u>\$ 523,451</u>
Supplemental disclosures		
Cash paid for interest	<u>\$ 51,294</u>	<u>\$ 36,182</u>

See accompanying notes.

Mercy Health

Notes to Consolidated Financial Statements *(Tables in Thousands)*

June 30, 2018

1. Organization

Mercy Health (Mercy) was incorporated in September 1986 and is the sole corporate member of various health care corporations. Mercy is sponsored by Mercy Health Ministry, a Public Juridic Person whose board members include Sisters of Mercy and lay leaders. Prior to sponsorship by Mercy Health Ministry, Mercy was sponsored by the Institute of the Sisters of Mercy of the Americas, Regional Community of St. Louis, a religious order of the Roman Catholic Church.

Mercy and each of its subsidiaries listed below are incorporated as not-for-profit corporations under the laws of the state of incorporation and are tax-exempt organizations as described in Section 501(c)(3) of the Internal Revenue Code (the Code).

Mercy's ministry office (headquarters) is located in St. Louis, Missouri. The Health System (Health System) comprises the following corporations and their subsidiaries:

- Mercy Health; St. Louis, Missouri
- Mercy Health Fort Smith Communities; Fort Smith, Arkansas
- Mercy Health Northwest Arkansas Communities; Rogers, Arkansas
- Mercy Health East Communities; St. Louis, Missouri
- Mercy Health Springfield Communities; Springfield, Missouri
- Mercy Health Oklahoma Communities, Inc.; Oklahoma City and Ardmore, Oklahoma
- Mercy Health Southwest Missouri/Kansas Communities; Joplin, Missouri, and Fort Scott, Kansas

All significant intercompany transactions and balances have been eliminated in consolidation.

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

1. Organization (continued)

Acquisitions

During fiscal 2018, various of the Health System's subsidiaries entered into asset purchase agreements to make certain acquisitions, including physician practices, for approximately \$44.7 million in cash (\$44.4 million net of cash acquired).

On June 1, 2017, the Health System entered into a change in sponsorship agreement with St. Anthony's Medical Center (St. Anthony's), a not-for-profit hospital located in Arnold, Missouri. The acquisitions provided the Health System's patients with access to a greater number of specialists and enhanced the coordination of health services. These transactions were accounted for as acquisitions in accordance with Accounting Standards Codification (ASC) Topic 958-805, *Business Combinations – Not-for-Profit Entities*, and acquired assets and liabilities were recorded at fair value, a Level 3 measurement.

The following table summarizes the acquisition date fair values of the assets acquired and liabilities assumed:

	Fiscal 2018 Acquisitions	Fiscal 2017 Acquisitions
Assets acquired:		
Cash and investments	\$ 303	\$ 59,247
Accounts receivable	1,482	52,978
Inventory, prepaid expenses, and other current assets	185	14,390
Property, plant, and equipment	12,063	282,683
Other long-term assets	34,400	13,658
Total assets acquired	48,433	422,956
Liabilities assumed:		
Accounts payable	691	22,329
Accrued and other liabilities	559	102,005
Long-term obligations	2,470	183,640
Total liabilities assumed	3,720	307,974
	\$ 44,713	\$ 114,982

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

1. Organization (continued)

The fair value of net assets of \$126.9 million was recognized in the consolidated statement of operations and changes in net assets for the year ended June 30, 2017, as a nonoperating inherent contribution of acquired entities of \$120.2 million and contribution of restricted net assets of acquired entities of \$6.7 million. For fiscal year 2018, subsequent purchase price adjustments of an \$11.9 million charge resulting in a final fair value of net assets of \$115.0 million.

The fair value of net assets of \$115.0 million in the preceding table was recognized in the consolidated statement of operations and changes in net assets for the year ended June 30, 2017, as a nonoperating inherent contribution of acquired entities of \$108.3 million and contribution of restricted net assets of acquired entities of \$6.7 million.

The operating results of entities acquired are included in the Health System's consolidated financial statements from the date of acquisition. Operating revenues of the entities acquired in fiscal 2018 included in the consolidated statement of operations were \$31.4 million for the year ended June 30, 2018. Operating revenues of St. Anthony's included in the consolidated statement of operations was \$38.6 million for the year ended June 30, 2017.

On an unaudited pro forma basis, had the Health System completed the fiscal 2018 acquisitions as of the beginning of each fiscal year presented, the acquisitions would have reported \$58.6 million and \$56.3 million in additional operating revenues in fiscal years 2018 and 2017, respectively, and \$7.4 and \$9.2 million in reduction of excess of revenues over expenses for the years ended June 30, 2018 and 2017, respectively. However, the unaudited pro forma information is not necessarily indicative of the historical results that would have been obtained had the transactions actually occurred on those dates, nor of future results.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents

Investments in highly liquid debt instruments with a maturity of three months or less when purchased, excluding amounts classified as investments, are considered cash equivalents. The Health System routinely invests in money market mutual funds. These funds generally invest in highly liquid U.S. government and agency obligations. Financial instruments that potentially subject the Health System to concentrations of credit risk include the Health System's cash and

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

cash equivalents. The Health System places its cash and cash equivalents with institutions with high credit quality. However, at certain times, such cash and cash equivalents are in excess of government-provided insurance limits.

Inventories

Inventories, which consist principally of medical supplies and pharmaceuticals, are stated at the lower of cost or market. Cost is determined principally using the average cost method.

Property and Equipment

Property and equipment are stated at cost or, if donated, at fair value at the date of receipt.

Depreciation is provided using the straight-line method over the estimated useful lives of land and leasehold improvements, buildings, and equipment. The estimated useful lives are as follows: land and leasehold improvements, 2 to 40 years; buildings, 3 to 80 years; and equipment, 2 to 20 years.

Property and equipment under capital lease obligations are amortized using the straight-line method over the lease term or the estimated useful life of the leased asset, whichever period is shorter. Such amortization is included with depreciation on the accompanying consolidated statements of operations.

Asset Impairment

The Health System periodically evaluates the carrying value of its long-lived assets for impairment when indicators of impairment are identified. These evaluations are primarily based on the estimated recoverability of the assets' carrying value based on undiscounted cash flows. Impairment write-downs are recognized in operating income at the time the impairment is identified.

Mercy Health

Notes to Consolidated Financial Statements (continued) *(Tables in Thousands)*

2. Summary of Significant Accounting Policies (continued)

Other Assets

Other assets consist primarily of investment securities held under deferred compensation arrangements, land held for future development, notes receivable, and investments in unconsolidated affiliates. The equity method of accounting is used for investments in unconsolidated affiliates where the Health System does not have significant control or where ownership is 50% or less. The equity income or loss on these investments is recorded in other operating revenues on the consolidated statements of operations.

Goodwill

The Health System records goodwill arising from a business combination as the excess of purchase price and related costs over the fair value of identifiable tangible and intangible assets acquired and liabilities assumed. The Health System has six reporting units. The Health System annually reviews the carrying value of goodwill for impairment. In addition, a goodwill impairment assessment is performed whenever circumstances indicate a potential impairment may exist. If such circumstances suggest that the recorded amounts of any of these assets cannot be recovered, the carrying values of such assets are reduced to fair value. If the carrying value of any of these assets is impaired, a material charge may be incurred to results of operations.

Net Assets

The Health System's net assets and activities are classified into two classes, restricted and unrestricted, based on the existence or absence of donor-imposed restrictions. Restricted net assets include temporarily restricted net assets (76% of restricted net assets at June 30, 2018 and 2017), whose use by the Health System has been limited by donors to a specific time period or for a particular purpose, and permanently restricted net assets (24% of restricted net assets at June 30, 2018 and 2017), which must be maintained by the Health System in perpetuity with the related investment income available to support the donor-designated purpose. The general nature of the donor restrictions is to support the Health System's indigent care mission and health education programs and to assist with capital projects.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

Net Patient Service Revenues and Patient Accounts Receivable

Patient service revenues (net of contractuels and discounts) are recorded during the period the health care services are provided and are reported at estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Estimates of contractual allowances under managed care health plans are based upon the services provided, historical payment rates, and the payment terms specified in the related contractual agreements. Revenues related to uninsured patients have discounts applied in accordance with the Health System's policy. Net patient service revenue is reported net of the provision for uncollectible receivables.

Patient accounts receivable that are deemed uncollectible, including those placed with collection agencies, are initially charged against the allowance for uncollectible accounts in accordance with collection policies of the Health System and, in certain cases, are reclassified to charity care if deemed to otherwise meet the Health System's charity care policy. The provision for uncollectible receivables is based upon management's assessment of historical and expected net collections considering business and economic conditions, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the allowance for uncollectible receivables based upon the payor composition and aging of receivables with consideration of the historical payment and write-off experience by payor category. The results of these reviews are then used to make any modifications to the provision for uncollectible receivables to establish an appropriate allowance for uncollectible receivables. After satisfaction of amounts due from insurance, the Health System follows established guidelines for placing past-due patient balances with collection agencies.

Retroactive third-party adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known. Adjustments to revenue based on prior periods increased net patient service revenues by approximately \$33.0 million and \$20.8 million in 2018 and 2017, respectively, due to revised estimates consisting primarily of retroactive third-party adjustments for years that are subject to audits, reviews, and investigations.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

Capitation Revenues and Medical Claims Expense

Mercy has entered into various risk-based contracts with certain health maintenance organizations (HMOs). Under these arrangements, Mercy receives capitated payments based on the demographic characteristics of covered members in exchange for agreeing to provide certain medical services to those members. These payments are reflected as capitation revenues on the consolidated statements of operations. Mercy recognizes medical claims expense for services provided to members from out-of-network providers. The medical claims expense represents claims paid, claims reported but not yet paid, and an estimate of claims incurred but not reported (IBNR). The claims IBNR amount is estimated based upon prior experience modified for current trends. The claims IBNR amount was \$7.0 million and \$9.6 million at June 30, 2018 and 2017, respectively, and was included in accrued liabilities and other on the consolidated balance sheets.

Services to the Community

In support of its mission, the Health System provides care to patients who personally bear a significant financial burden relative to their health care services and are deemed to be medically indigent. Traditional charity care includes the cost of services provided to persons who cannot afford health care because of the financial burden of the health care services and/or who are uninsured or underinsured. Traditional charity care also includes services for which the patient may not participate in the charity care process but is otherwise deemed to meet the Health System's charity care policy.

Because the Health System does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as net patient service revenue. The cost of traditional charity care was \$109.1 million and \$160.7 million in 2018 and 2017, respectively. The Health System estimates cost of charity care using a calculated ratio of costs to charges by hospital and clinic and applies that ratio to the relevant gross charges, less any payments received.

Health care services to patients under government programs, such as Medicare and Medicaid, are also considered part of the Health System's benefit provided to the community since a portion of such services are reimbursed at amounts less than cost. In addition, the Health System maintains community benefit programs designed to positively impact the health status of the communities served. These services include various clinics and outreach programs (designed to deliver health care services to underserved communities), medical education and research activities, and direct cash and in-kind charitable contributions.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

These community benefit programs also include the activities of Mercy Ministries of Laredo (MML), Mercy Caritas, Catherine's Fund, and Mercy Family Center which are administered by the Health System. These programs finance charitable activities to help meet the needs of the poor, sick, and uneducated.

Investments

Investments include assets set aside through resolution by the Board of Directors for future long-term purposes. In addition, investments include amounts contributed by donors with stipulated restrictions. Investments also include amounts held by trustees under bond indenture agreements, as well as amounts held under the terms of other trust agreements. These assets include investments in equity securities and debt securities, which are measured at fair value. The cost of securities sold is based on the specific-identification method. The Health System accounts for its ownership interest in alternative investments under the equity method. Management has utilized the best available information for reported alternative investment values, which in some instances are valuations as of an interim date.

For purposes of recognizing investment returns as a component of excess of revenues over expenses, substantially all investments, other than alternative investments, are considered to be trading securities. Investment returns arising from donor-restricted resources are reported as a direct increase or decrease in restricted net assets on the consolidated statements of changes in net assets, consistent with the donors' restrictions. In addition, a portion of investments are used to fund payments of professional liability claims; and as a result, the investment returns related to the amount of investments expected to settle the professional liability is included in other operating revenues within the consolidated statements of operations. All other investment returns, including alternative investments, are included in nonoperating gains and losses on the consolidated statements of operations. In addition, cash flows from the purchases and sales of marketable securities designated as trading are reported as a component of operating activities on the accompanying consolidated statements of cash flows.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

Derivative Financial Instruments

Derivative financial instruments are contracts between the Health System and a third party (counterparty) that provide for economic payments between the parties based on changes in a defined market security or index or combination thereof. The Health System's derivative financial instruments are primarily interest rate swap agreements utilized as part of its debt management process. The Health System recognizes all derivative financial instruments as either assets or liabilities on the consolidated balance sheets at fair value. The Health System does not offset fair value amounts recognized for derivative financial instruments and fair value amounts posted as cash collateral. The Health System does not account for any of its interest rate swap agreements as hedges, and accordingly, realized and unrealized gains (losses) and net settlement payments are reflected as a component of nonoperating gains and losses on the accompanying consolidated statements of operations.

Pledges, Bequests, and Gifts for Specific Purposes

Unconditional promises to give cash and other assets 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. Gifts are recorded as an increase in restricted net assets if they are received with donor stipulations that limit the use of the assets. Upon expenditure in accordance with a donor's restrictions and when the asset is placed in service, net assets restricted for capital acquisitions are reported as direct additions to unrestricted net assets, and assets restricted for operating purposes are reported as an increase in other operating revenues. Donor-restricted contributions for operating purposes whose restrictions are met within the same year as received, and contributions received by donors without restrictions, are reflected as other operating revenues on the accompanying consolidated statements of operations.

Functional Classification of Expenses

The Health System provides general health care services to residents within communities served, including acute inpatient, subacute inpatient, physician, outpatient, ambulatory, long-term, and home care, as well as related general and administrative services.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

The Health System does not present expense information by functional classification because its resources and activities are primarily related to providing health care services. Furthermore, since the Health System receives substantially all of its resources from providing health care services in a manner similar to a business enterprise, other indicators contained in these consolidated financial statements are considered important in evaluating how well management has discharged its stewardship responsibilities.

Operating Indicator

The Health System's operating indicator (operating income) includes all unrestricted revenue, gains and other support, and expenses directly related to the recurring and ongoing health care operations during the reporting period. The operating indicator excludes nonoperating gains and losses, pension liability adjustments, inherent contribution of acquired entities, and net assets released from restrictions for property acquisitions.

Performance Indicator

The Health System's performance indicator, excess of revenues over expenses, includes all changes in unrestricted net assets other than pension liability adjustments, and net assets released from restrictions for property acquisitions.

Operating and Nonoperating Gains (Losses)

The Health System's primary mission is to meet the health care needs in its market areas by providing general health care services to residents within communities served, including acute inpatient, subacute inpatient, physician, outpatient, ambulatory, and home care, as well as related general and administrative services. Activities directly associated with the furtherance of this purpose are considered to be operating activities. Other activities that result in gains or losses peripheral to the Health System's primary mission are considered to be nonoperating. Nonoperating activities include net investment returns, excluding the estimated earnings related to the investments attributed to professional liabilities, net realized and unrealized gains (losses) on interest rate swaps, and inherent contribution of acquired entities. A portion of investments are used to fund payments of professional liability claims, and as a result, the investment returns related to the amount of investments expected to settle the professional liability is included in other operating revenues on the consolidated statements of operations.

Mercy Health

Notes to Consolidated Financial Statements (continued) *(Tables in Thousands)*

2. Summary of Significant Accounting Policies (continued)

Impairment, Restructuring, and Accelerated Depreciation

The Health System periodically evaluates property, equipment, goodwill, and certain other intangible assets to determine whether assets may have been impaired. In fiscal 2018, the asset lives for software and hardware currently in use at St. Anthony's were shortened to correspond with the planned transition to the Health System's software. During the year ended June 30, 2018, the Health System recorded impairment, restructuring, and accelerated depreciation of \$36.4 million as a separate line item in the consolidated statement of operations. No restructuring, impairment, and accelerated depreciation was recorded in 2017.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain prior year amounts on the accompanying consolidated financial statements have been reclassified to conform to the 2018 presentation. These reclassifications had no effect on excess of revenues over expenses and losses or net assets previously reported.

Federal Income Tax

Primarily all of the Health System entities are recognized by the Internal Revenue Service (IRS) as exempt from federal income tax under Section 501(a) of the Internal Revenue Code as charitable organizations qualifying under Internal Revenue Code Section 501(c)(3), by virtue of IRS determination letters or inclusion in the Official Catholic Directory. The Health System completed an analysis of its tax positions in accordance with applicable accounting guidance and determined that no amounts were required to be recognized on the consolidated financial statements at June 30, 2018 or 2017.

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

Accounting Pronouncements Adopted

In March 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This guidance changes how employers that sponsor defined benefit pension plans present the cost of the benefits in the consolidated statement of operations and changes in net assets. The service cost component of net periodic benefit cost related to defined benefit pension plans will be reported in the same financial statement line as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented separately from service cost and outside of operating income. Only the service cost component of net periodic benefit cost will be eligible for capitalization in assets. The standard is not effective for the Health System until the fiscal year ending June 30, 2019; however, the Health System elected to early adopt the standard. The adoption of the guidance requires expanded disclosures and the reclassification of the other components of net benefit cost from salaries and benefits expense to other, net within nonoperating gains (losses) in the consolidated statements of operations but did not impact financial results.

Accounting Pronouncements Not Yet Adopted

In May 2014, the FASB and International Accounting Standards Board issued ASU 2014-09, *Revenue from Contracts with Customers*. The ASU outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 requires expanded disclosures regarding an entity's revenue recognition policies and significant judgements employed in the determination of revenue. The core principle of the revenue model is that an entity recognizes as revenue the amount that reflects the consideration to which the entity expects to be entitled in exchange for goods or services as it transfers control to its customers.

The requirements of ASU 2014-09 will result in changes to the presentation and disclosure of revenue from services to patients. Currently, a significant portion of the Health System's provision for uncollectible receivables relates to uninsured patients as well as deductibles and co-pays due from patients with insurance. Under ASU 2014-09, the estimated uncollectible amounts due from patients are generally considered implicit price concessions that are a direct reduction to net patient service revenue, with a corresponding significant reduction in the amounts presented separately as

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

provision for uncollectible receivables. Although the adoption of ASU 2014-09 will have a significant impact on the amounts presented in certain categories of the Health System's consolidated statements of operations, it will not materially impact the Health System's financial position, results of operations or cash flows. The standard is not effective for the Health System until the fiscal year ending June 30, 2019.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which replaces all existing U.S. GAAP lease requirements. The ASU will require lessees to put most leases on their balance sheets but recognize related expenses in their statements of operations in a manner similar to existing accounting standards. This guidance also eliminates the current real estate specific provisions for all entities. The Health System is currently evaluating the effects of the standard on its financial statements. The standard is not effective for the Health System until the fiscal year ending June 30, 2020.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. This ASU will change certain financial statement requirements for not-for-profit (NFP) entities in an effort to make the information more meaningful and make reporting less complex. NFP entities will no longer be required to distinguish between resources with temporary and permanent restrictions on the face of their financial statements, meaning they will present two classes of net assets instead of three. The guidance also changes how NFP entities report certain expenses and provide information about their available resources and liquidity. In addition, NFP entities will be required to present their expenses by their natural and functional classification and present investment returns net of external and direct investment expenses. The Health System is currently evaluating the effects of the standard on its financial statements. The standard is not effective for the Health System until the fiscal year ending June 30, 2019.

In January 2017, the FASB issued ASU 2017-04, *Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The Health System is currently evaluating the effects of the standard on its financial statements. The standard is not effective for the Health System until the fiscal year ending June 30, 2022.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

2. Summary of Significant Accounting Policies (continued)

In June 2018, the FASB issued ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. The Health System is currently evaluating the effects of the standard on its financial statements. The standard is not effective for the Health System until the fiscal year ending June 30, 2019.

3. Net Patient Service Revenue and Patient Receivables

The following is a summary of the Health System's patient service revenues, net of contractual allowances and discounts (before the provision for uncollectible receivables), by major payor. Medicare and Medicaid managed plans are grouped with Medicare and Medicaid, respectively.

	Year Ended June 30	
	2018	2017
Medicare	\$ 2,393,427	\$ 1,964,479
Medicaid	602,041	466,557
Managed care/other	2,900,997	2,640,932
Self-pay	319,863	233,487
	<u>\$ 6,216,328</u>	<u>\$ 5,305,455</u>

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Noncompliance with Medicare and Medicaid laws and regulations can make the Health System subject to significant regulatory action, including substantial fines and penalties, as well as exclusion from the Medicare and Medicaid programs.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

3. Net Patient Service Revenue and Patient Receivables (continued)

The Health System provides health care services through inpatient and outpatient care facilities located in several states. The Health System grants credit to patients in return for health care services rendered to said patients, substantially all of whom are residents of the communities served. The Health System does not require collateral or other security in extending credit to patients; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans, or policies (e.g., Medicare, Medicaid, HMOs, and commercial insurance policies). At June 30, 2018 and 2017 approximately 38% and 38%, respectively, of net accounts receivable were collectible from governmental payors (including Medicare and Medicaid), with approximately 52% and 48%, respectively, of net accounts receivable collectible from commercial insurance and managed care payors.

The allowance for uncollectible receivables was approximately \$290.8 million and \$200.5 million as of June 30, 2018 and 2017, respectively. These balances as a percentage of accounts receivable net of contractual allowances were approximately 29% and 23% as of June 30, 2018 and 2017, respectively. The Health System's allowance for uncollectible receivables covered approximately 72% and 66% of self-pay patient receivables, including patient responsibility, as of June 30, 2018 and 2017, respectively. The Health System has experienced an increase in write-off trends related to charity driven by loss of employer-sponsored insurance plans and rising patient responsibility balances. The Health System reviews and updates its uninsured discount rate on an annual basis. There have been no significant changes to the charity care policies for the years ended June 30, 2018 or 2017. The Health System does not maintain a material allowance for uncollectible receivables from third-party payors, nor did it have significant write-offs from third-party payors.

The following is a summary of the Health System's allowance for uncollectible receivables activity:

Balance at June 30, 2016	\$ 142,518
Provision for uncollectible receivables	330,078
Accounts written off, net of recoveries and other	(272,077)
Balance at June 30, 2017	200,519
Provision for uncollectible receivables	537,734
Accounts written off, net of recoveries and other	(447,439)
Balance at June 30, 2018	<u>\$ 290,814</u>

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

4. Investments

The following is a summary of investments:

	June 30	
	2018	2017
Board-designated	\$ 2,320,549	\$ 2,043,160
Bond proceeds held under indenture	27,497	–
Professional liability trust fund	16,681	15,802
Restricted by donor or grantor	69,397	66,823
Total investments	<u>2,434,124</u>	<u>2,125,785</u>
Less short-term investments	<u>(34,686)</u>	<u>(32,610)</u>
	<u>\$ 2,399,438</u>	<u>\$ 2,093,175</u>

The professional liability trust fund is related to the prior year acquisition of St. Anthony's; refer to Note 1.

Mercy Health

Notes to Consolidated Financial Statements (continued)
(Tables in Thousands)

4. Investments (continued)

The following is a summary of investments by classification:

	June 30	
	2018	2017
Cash and cash equivalents	\$ 149,634	\$ 136,653
Equities:		
Domestic equities	381,634	275,552
International equities – developed	259,254	246,014
International equities – emerging markets	83,458	78,091
Fixed income:		
Corporate bonds	398,201	371,400
Government and agencies	208,531	147,372
Real assets – commodities	142,456	108,677
Mutual funds – multi-asset class	57,865	56,998
Alternative investments:		
Hedge funds	481,980	464,497
Private equity investment funds	114,764	75,793
Private debt investment funds	75,107	106,583
Real assets – limited partnerships private energy	37,977	19,954
Real assets – limited partnerships real estate	25,953	17,865
Other	17,310	20,336
	2,434,124	2,125,785
Less short-term investments	(34,686)	(32,610)
Total investments	\$ 2,399,438	\$ 2,093,175

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

4. Investments (continued)

The following is a summary of investment returns:

	Year Ended June 30	
	2018	2017
Investments:		
Interest and dividends	\$ 28,601	\$ 23,844
Realized gains, net	101,623	31,043
Interest expense on Series 2001 bonds	(4,198)	(2,392)
Unrealized (losses) gains, net	(10,875)	97,711
Investment returns included in nonoperating gains (losses), net	115,151	150,206
Investment returns included in restricted net assets	1,912	2,548
Investment returns included in other operating revenues	4,992	8,048
Total investment returns	\$ 122,055	\$ 160,802

The Health System's investments are exposed to various kinds and levels of risk. Fixed income securities expose the Health System to interest rate risk, credit risk, and liquidity risk. As interest rates change, the value of many fixed income securities is affected, particularly those with fixed rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness of market participants to buy and sell given securities. Equity securities expose the Health System to market risk, performance risk, and liquidity risk. Market risk is the risk associated with major movements of the equity markets, both foreign and domestic. Performance risk is the risk associated with a company's operating performance. Liquidity risk as previously defined tends to be higher for foreign equities and equities related to small capitalization companies.

Certain of the Health System's investments are made through alternative investments, primarily private limited partnership investments (equity, debt, real asset) and absolute return (hedge) funds. These investments provide the Health System with a proportionate share of the investment gains and losses. The fund manager has full discretionary authority (within their given mandate) over the investment decisions and provides the net asset valuation, typically through third-party administrators. The hedge funds and private limited partnership funds present risks similar to those of traditional investments, as well as some additional risks. Due to the fact that these funds are invested through limited partnerships or other limited access-type vehicles, pricing is infrequent

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

4. Investments (continued)

and liquidity may also be limited, in some cases, up to 24 months for hedge funds. Due to infrequent pricing and illiquidity of underlying investments, it is common practice for private limited partnership funds to require investors to commit to a ten-year investment period, although the distribution of capital is likely to occur prior to the ten-year termination date. Certain hybrid limited partnership funds may invest in liquid securities; however, the investments would be inaccessible for the term of the structure. Terms for these hybrid vehicles could be shorter in duration, lasting up to five years for the full investment and distribution periods. These investments may also employ leverage, which may lead to additional risk of loss. These investments are subject to market risk, default risk, interest rate risk, credit risk, and liquidity risk, as well as various other types of risks. At June 30, 2018, the Health System has commitments to fund \$380.3 million in these investments.

At the balance sheet dates, receivables and payables for investment trades not settled are presented with other current assets and accrued liabilities and other. Unsettled sales resulted in receivables due from brokers of \$20.2 million and \$28.7 million at June 30, 2018 and 2017, respectively. Unsettled buys resulted in payables of \$13.8 million and \$15.8 million at June 30, 2018 and 2017, respectively.

5. Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurements and disclosures topic of the FASB ASC establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement).

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

5. Fair Value Measurements (continued)

The three levels of the fair value hierarchy and a description of the valuation methodologies used for instruments measured at fair value are as follows:

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

Level 2 – Pricing inputs other than quoted prices included in Level 1, which are either directly observable or can be derived or supported from observable data as of the reporting date.

Level 3 – Pricing inputs include those that are significant to the fair value of the financial asset or financial liability and are not observable from objective sources. In evaluating the significance of input, the Health System generally classifies assets or liabilities as Level 3 when their fair value is determined using unobservable inputs that individually, or when aggregated with other unobservable inputs, represent more than 10% of the fair value of the assets or liabilities. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

5. Fair Value Measurements (continued)

Financial assets and financial liabilities measured at fair value on a recurring basis were determined using the following inputs at June 30, 2018:

	Level 1	Level 2	Level 3	Total
Assets				
Investments:				
Cash and cash equivalents	\$ 149,634	\$ –	\$ –	\$ 149,634
Equities:				
Domestic equities	381,634	–	–	381,634
International equities – developed	117,856	–	–	117,856
International equities – emerging markets	47,333	–	–	47,333
Fixed income:				
Corporate bonds	17,036	225,296	–	242,332
Government and agencies	18,629	189,902	–	208,531
Real assets – commodities	81,081	–	–	81,081
Mutual funds – multi-asset class	57,865	–	–	57,865
Other	–	929	–	929
Assets not at fair value:				
Hedge funds				481,980
Private equities				189,871
Real assets				63,930
Commingled funds				394,767
Other				16,381
Total investments				<u>\$ 2,434,124</u>
Deferred compensation plan assets:				
Equities – mutual funds	\$ 248,230	\$ –	\$ –	\$ 248,230
Collateral posted on interest rate swap agreements				
	\$ 34,010	\$ –	\$ –	\$ 34,010
Liabilities				
Interest rate swap agreements	\$ –	\$ 41,456	\$ –	\$ 41,456

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

5. Fair Value Measurements (continued)

Financial assets and financial liabilities measured at fair value on a recurring basis were determined using the following inputs at June 30, 2017:

	Level 1	Level 2	Level 3	Total
Assets				
Investments:				
Cash and cash equivalents	\$ 136,653	\$ –	\$ –	\$ 136,653
Equities:				
Domestic equities	275,552	–	–	275,552
International equities – developed	87,220	–	–	87,220
International equities – emerging markets	37,562	–	–	37,562
Fixed income:				
Corporate bonds	9,267	224,584	–	233,851
Government and agencies	7,722	139,650	–	147,372
Real assets – commodities	83,584	–	–	83,584
Mutual funds – multi-asset class	56,998	–	–	56,998
Other	–	4,008	–	4,008
Assets not at fair value:				
Hedge funds				464,497
Private equities				182,376
Real assets				37,819
Commingled funds				361,965
Other				16,328
Total investments				<u>\$ 2,125,785</u>
Deferred compensation plan assets:				
Cash and cash equivalents	\$ 1,090	\$ –	\$ –	\$ 1,090
Equities – mutual funds	216,792	–	–	216,792
	<u>\$ 217,882</u>	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 217,882</u>
Collateral posted on interest rate swap agreements	\$ 52,110	\$ –	\$ –	\$ 52,110
Liabilities				
Interest rate swap agreements	\$ –	\$ 62,906	\$ –	\$ 62,906

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

5. Fair Value Measurements (continued)

Deferred compensation plan assets and interest rate swaps (assets) are reported in other assets, and interest rate swaps (liabilities) are reported in insurance reserves and other liabilities on the consolidated balance sheets.

The following is a description of the Health System's valuation methodologies for assets and liabilities measured at fair value. Fair value for Level 1 is based upon quoted market prices. The fair value of certain Level 2 securities was determined using multiple price types of bid/offer, last traded, settlement, evaluated, and the official primary exchange close-time pricing, provided by third-party pricing services if quoted market prices were not available. The quality of the prices received is evaluated through price comparisons and tolerance level checks. These Level 2 investments include corporate bonds, treasuries and agencies. The fair values of the interest rate swap contracts, also Level 2 measurements, are determined based on the present value of expected future cash flows using discount rates appropriate with the risks involved. The valuations reflect a credit spread adjustment to the London Interbank Offered Rate (LIBOR) discount curve in order to reflect non-performance risk.

The credit spread adjustment is derived from the Health System's and other comparable rated entities' bonds priced in the market and adjusted with a gross up of the tax-exempt spread to a taxable equivalent spread for the Health System and counterparty bond trading levels (or credit default swap spreads).

The carrying values of cash and cash equivalents, accounts receivable, pledges receivable, and current liabilities are reasonable estimates of their fair values due to the short-term nature of these financial instruments. The fair value of the Health System's fixed rate bonds is based on quoted market prices for the same or similar issues and approximates \$999.3 million and \$710.8 million as of June 30, 2018 and 2017, respectively, which is a Level 2 measurement. The carrying amount approximates fair value for all other long-term debt, which is variable rate, and excludes the impact of third-party credit enhancements; this is a Level 2 measurement.

Due to the volatility of the financial market, there is a reasonable possibility of changes in fair value and additional gains and losses in the near term subsequent to June 30, 2018.

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

6. Property and Equipment

The following is a summary of property and equipment:

	June 30	
	2018	2017
Land, land improvements, and leasehold improvements	\$ 339,024	\$ 319,008
Buildings	3,795,600	3,622,827
Equipment	2,493,434	2,416,515
Construction-in-progress	241,765	187,597
	6,869,823	6,545,947
Less accumulated depreciation	(3,864,594)	(3,604,560)
Property and equipment, net	\$ 3,005,229	\$ 2,941,387

At June 30, 2018, construction and software-related contracts and commitments exist for capital improvements at certain of the Health System's facilities. The remaining commitment on these contracts at June 30, 2018, was approximately \$152.1 million. During the years ended June 30, 2018 and 2017, interest of \$4.7 million and \$1.5 million, respectively, was capitalized.

7. Other Assets

The following is a summary of other assets:

	June 30	
	2018	2017
Deferred compensation plan assets	\$ 248,230	\$ 217,882
Goodwill	175,112	140,751
Investment in unconsolidated affiliates	68,680	63,622
Swap collateral	34,010	52,110
Land held for future development	43,655	43,814
Notes receivable	4,318	8,414
Other	36,823	53,093
	\$ 610,828	\$ 579,686

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

8. Goodwill

The following table presents the changes in the carrying amount of goodwill during the years ended June 30, 2018 and 2017:

Balance at June 30, 2016	\$ 140,751
Acquisitions	—
Balance at June 30, 2017	<u>140,751</u>
Acquisitions	34,361
Balance at June 30, 2018	<u>\$ 175,112</u>

9. Liability Programs

The Health System administers a liability program to provide for general and professional liability risks within certain limits. Health care professional liabilities in excess of self-insured limits are insured on a claims-made basis subject to an annual maximum of \$25.0 million over the self-insured retention of \$10.0 million, after which the Health System would again be responsible. The recorded liabilities are based upon actuarial estimates of reported claims and IBNR claims using historical claim experience and other relevant industry and hospital-specific factors and trends, discounted at an interest rate of 4.75% for 2018 and 2017. The discounted general and professional liability was \$124.9 million and \$125.0 million at June 30, 2018 and 2017, respectively, which is included in accrued liabilities and insurance reserves and other liabilities on the accompanying consolidated balance sheets. In addition, at June 30, 2018 and 2017, Mercy recorded net insurance receivables of \$2.9 million and \$2.3 million, respectively, which are included in other assets on the accompanying consolidated balance sheets.

St. Anthony's maintains a separate liability program for general and professional liability risks. St. Anthony's is self-insured for the first \$4.0 million per occurrence of professional liability claims and purchases insurance coverage above the self-insurance limits. Losses from asserted and unasserted claims are accrued based on estimates that incorporate past experience, the nature of each claim or incident and relevant trend factors, and are discounted at an interest rate of 4.75% and 4.50% for 2018 and 2017, respectively. The discounted general and professional liability was \$11.2 million and \$9.7 million at June 30, 2018 and 2017, respectively, which is included in accrued liabilities and insurance reserves and other liabilities.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

10. Employee Retirement Plans

Defined Contribution Plans

The Health System retirement benefits are provided through 401(k) and 403(b) plans covering all eligible employees. All contributions to the plan are subject to IRS limitations on contributions and includable compensation. There are three primary types of contributions to these plans: employee deferrals, employer service-based contributions, and employer matching contributions. Benefits for employer service-based contributions are determined as a percentage of a participant's salary and based on their years of service for certain entities. Benefits for employer matching contributions are determined as a percentage of an eligible participant's annual deferrals. These employer contributions are funded annually and become fully vested over three years of vesting service. For the years ended June 30, 2018 and 2017, the total expenses incurred related to these defined contribution plans were \$109.0 million and \$104.0 million, respectively.

Defined Benefit Plans

The Health System has frozen defined benefit retirement plans. The plans were designed to provide retirement benefits to substantially all co-workers. The plans were cash balance-type formula. The cash balance formula provided an annual pay credit, based on employee compensation and years of service, and an annual interest credit based on the U.S. Treasury bill rates. Co-workers with benefits earned under the cash balance formula continue to earn interest credits each year. The interest credit continues to be based on the U.S. Treasury bill rates. The Plans are funded consistent with actuarial funding recommendations and the funding policy.

The Health System has frozen non-qualified defined benefit retirement plans that provide retirement income in excess of the limitations on benefits imposed by IRS limitations to certain key executives.

Mercy Health

Notes to Consolidated Financial Statements (continued)
(Tables in Thousands)

10. Employee Retirement Plans (continued)

The following table sets forth the frozen defined benefit retirement plans' benefit obligations, fair value of plan assets, and funded status at the measurement date:

	June 30	
	2018	2017
Accumulated benefit obligation	\$ 890,782	\$ 962,331
Changes in projected benefit obligation:		
Projected benefit obligation at beginning of period	\$ 962,331	\$ 992,780
St. Anthony Plan beginning projected benefit obligation	—	41,614
Interest cost	27,835	26,318
Plan amendments	—	(14,106)
Actuarial gain	(38,538)	(19,522)
Benefits paid	(60,846)	(64,753)
Projected benefit obligation at end of period	890,782	962,331
Changes in plan assets:		
Fair value of plan assets at beginning of period	589,442	552,251
St. Anthony Plan beginning fair value of plan assets	—	38,886
Actual return on plan assets	34,946	46,638
Employer contributions	14,463	16,420
Benefits paid	(60,846)	(64,753)
Fair value of plan assets at end of period	578,005	589,442
Funded status	\$ (312,777)	\$ (372,889)

Mercy Health

Notes to Consolidated Financial Statements (continued)
(Tables in Thousands)

10. Employee Retirement Plans (continued)

Amounts recognized on the accompanying consolidated balance sheets at June 30 consist of:

	2018	2017
Noncurrent assets	\$ 423	\$ –
Accrued liabilities and other	(12,721)	(9,505)
Pension liabilities	(300,479)	(363,384)
	\$ (312,777)	\$ (372,889)

No plan assets are expected to be returned to the Health System during the fiscal year ended June 30, 2019.

Included in unrestricted net assets are the following amounts that have not yet been recognized in net periodic pension cost:

	Year Ended June 30	
	2018	2017
Unrecognized actuarial gain	\$ (376,048)	\$ (435,515)
Prior service cost (credit)	12,488	13,566
	\$ (363,560)	\$ (421,949)

Changes in plan assets and benefit obligations recognized in unrestricted net assets include:

	Year Ended June 30	
	2018	2017
Current year actuarial gain	\$ 31,558	\$ 21,397
Amortization of actuarial loss	9,720	9,078
Settlement reduction of net actuarial loss	18,189	22,665
Current year prior service cost	–	14,105
Amortization of prior service credit	(1,078)	(539)
	\$ 58,389	\$ 66,706

Mercy Health

Notes to Consolidated Financial Statements (continued)
(Tables in Thousands)

10. Employee Retirement Plans (continued)

The estimated net actuarial loss included in unrestricted net assets and expected to be recognized in net periodic benefit cost during the year ending June 30, 2019, is \$7.5 million. The impact of the change in discount rate on the projected benefit obligation of the plans' was a decrease of approximately \$38.3 million and \$22.3 million for the years ended June 30, 2018 and 2017, respectively.

The following is a summary of the components of net periodic pension cost:

	Year Ended June 30	
	2018	2017
Interest cost on projected benefit obligation	\$ 27,835	\$ 26,318
Expected return on plan assets	(41,927)	(44,762)
Amortization of prior service costs	(1,078)	(539)
Amortization of unrecognized actuarial loss	9,536	9,061
Settlement/curtailment	18,189	22,682
Net periodic pension cost	<u>\$ 12,555</u>	<u>\$ 12,760</u>

The components of net periodic pension cost are included in the line item "other, net" in the consolidated statement of operations.

Weighted average assumptions used to determine the plans' projected benefit obligation and net periodic benefit costs are as follows:

	Projected Benefit Obligation		Net Periodic Benefit Costs	
	2018	2017	2018	2017
Discount rates	4.04%–4.18%	3.42%–3.67%	2.81%–3.67%	2.50%–3.20%
Expected long-term return on plan assets	5.00%–7.30%	5.00%–7.50%	5.00%–7.50%	5.00%–7.70%

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

10. Employee Retirement Plans (continued)

The plans' weighted average asset allocations and policy allocation range by asset category are as follows:

<u>Asset Category</u>	<u>Policy Allocation Range</u>	<u>Plan Assets at June 30</u>	
		<u>2018</u>	<u>2017</u>
Equity securities	30%–50%	34%	33%
Debt securities	25–35	25	25
Alternative investments	17–56	34	34
Other	0–5	7	8
Total	100%	100%	100%

The plans' assets measured at fair value were determined using the following inputs at June 30, 2018:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets				
Cash and cash equivalents	\$ 35,168	\$ –	\$ –	\$ 35,168
Equity securities:				
Domestic equities	92,857	–	–	92,857
International equities – developed	28,870	–	–	28,870
International equities – emerging markets	11,841	–	–	11,841
Fixed income:				
Corporate bonds	3,138	50,771	–	53,909
Government and agencies	4,720	27,133	–	31,853
Real assets – commodities	20,406	–	–	20,406
Mutual funds – multi-asset class	12,678	–	–	12,678
Other	–	–	2,709	2,709
Assets (fair value determined using NAV practical expedient):				
Hedge funds				143,824
Private equities				48,004
Real assets				16,201
Commingled funds				79,685
				<u>\$ 578,005</u>

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

10. Employee Retirement Plans (continued)

The following table is a rollforward of the pension plan assets classified within Level 3 of the valuation hierarchy:

	<u>Other</u>
Fair value at July 1, 2017	\$ 2,721
Purchases, sales, and settlements, net	(106)
Actual return	94
Transfers in and/or out of Level 3	—
Fair value at June 30, 2018	<u>\$ 2,709</u>

The plans' assets measured at fair value were determined using the following inputs at June 30, 2017:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets				
Cash and cash equivalents	\$ 47,249	\$ —	\$ —	\$ 47,249
Equity securities:				
Domestic equities	76,944	—	—	76,944
International equities – developed	24,484	—	—	24,484
International equities – emerging markets	10,800	—	—	10,800
Fixed income:				
Corporate bonds	1,801	59,797	—	61,598
Government and agencies	2,243	21,652	—	23,895
Real assets – commodities	24,215	—	—	24,215
Mutual funds – multi-asset class	14,210	—	—	14,210
Other	—	—	2,721	2,721
Assets (fair value determined using NAV practical expedient):				
Hedge funds				157,130
Private equities				52,949
Real assets				10,979
Commingled funds				82,268
				<u>\$ 589,442</u>

Mercy Health

Notes to Consolidated Financial Statements (continued) *(Tables in Thousands)*

10. Employee Retirement Plans (continued)

The following table is a rollforward of the pension plan assets classified within Level 3 of the valuation hierarchy:

	Other
Fair value at July 1, 2016	\$ 2,738
Purchases, sales, and settlements, net	—
Actual return	(17)
Transfers in and/or out of Level 3	—
Fair value at June 30, 2017	\$ 2,721

Fair value methodologies for Level 1 and Level 2 assets are consistent with the inputs described in Note 5.

Management opted to use the net asset value (NAV) per share, or its equivalent, as a practical expedient for fair value of the plan's interest in hedge funds, private limited partnership funds, and commingled funds. Valuations provided by the respective fund's management include variables such as the financial performance of underlying investments, recent sales prices of underlying investments, and other pertinent information. In addition, actual market exchanges at period-end provide additional observable market inputs of the exit price. The majority of these funds have restrictions on the timing of withdrawals, which may reduce liquidity, in some cases for up to 24 months in the case of hedge funds and up to 10 years for private limited partnership funds. At June 30, 2018, the Plan has commitments to fund \$96.1 million in these investments.

The plans employ investment managers to invest fund balances in a structured portfolio of equity, fixed income, and alternative investments (which includes hedge funds, private equity, private debt, and real assets). The plans retain outside consultants to support the overall asset allocation and manager selection process. The performance of all managers is reviewed to test that market performance has been calculated accurately, to monitor performance versus peers and benchmarks, and to evaluate portfolio structure considering current and future needs based on economic forecasts and actuarial projections. Mercy believes that a diversified portfolio will limit the degree of risk to the plans and stabilize the long-term results. The plans' diversified blend of marketable securities also takes into consideration the cash flow requirements of the plans to help ensure the ability to meet the monthly payout of benefits required. Projected rates of return for each asset category were selected after analyzing historical experience and future expectations of the returns and volatility for assets of that category.

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

10. Employee Retirement Plans (continued)

The Health System expects to contribute at least \$14.0 million to the plans during fiscal 2019.

The following benefit payments, which reflect expected future service, are expected to be paid by the plans:

	Amount
Year ending June 30:	
2019	\$ 85,600
2020	86,500
2021	81,500
2022	74,300
2023	72,900
2024 through 2028	311,800
	\$ 712,600

11. Long-Term Obligations

The following is a summary of long-term obligations:

	June 30	
	2018	2017
Revenue bonds, fixed interest rates of 2.20%–5.00% due 2019 through 2049	\$ 1,020,318	\$ 725,006
Revenue bonds, variable interest rates with weighted average interest rates of 2.44% and 1.51% in fiscal 2018 and 2017, respectively, due through June 2053	644,225	760,265
Capital lease obligations	53,338	43,153
Other mortgage notes and notes	18,155	18,597
	1,736,036	1,547,021
Less current maturities of long-term obligations	(18,811)	(13,449)
Less unamortized debt issuance costs	(10,733)	(8,712)
Long-term obligations, less current maturities	\$ 1,706,492	\$ 1,524,860

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

11. Long-Term Obligations (continued)

Certain of Mercy's subsidiaries have executed a commitment agreement governing certain borrowing arrangements under the Mercy Master Trust Indenture and related agreements (Financing Agreements). While only the revenues of Mercy collateralize the outstanding borrowings of the Health System, each of these subsidiaries has committed to transfer such funds to Mercy to pay the amounts due on borrowings when they come due. The Financing Agreements contain certain restrictive covenants, including debt service coverage and liquidity ratios. At June 30, 2018, Mercy was in compliance with all covenants.

Tax-exempt revenue bonds have been issued by various issuing authorities, the proceeds of which were used by Mercy primarily to finance capital projects and to refinance existing indebtedness of certain subsidiaries.

In June 2017, \$81.8 million of variable rate, tax-exempt health facility revenue bonds were issued by the Health and Educational Facilities Authority of the State of Missouri on behalf of Mercy under the Master Trust Indenture. The proceeds of these bonds were used to redeem St. Anthony's Series 2013 bonds in conjunction with the affiliation of Mercy and St. Anthony's. The bonds were directly purchased by one bank and have a final maturity of 2053. Interest is paid monthly at a borrowing rate based on a percentage of one-month LIBOR plus an applicable spread. The bonds include mandatory puts by the purchasing bank in 2021 and 2022. Mercy may elect to renegotiate with the initial purchasers, remarket or redeem the bonds at any time.

In June 2017, Mercy issued replacement master notes under its Master Trust Indenture in replacement of and substitution for master notes previously issued by St. Anthony's (Series 2015 bonds). The Series 2015 bonds were originally issued by the Health and Educational Facilities Authority of the State of Missouri and consisted of \$101.0 million of fixed rate (ranging from 2.20% to 5.00%), tax-exempt health facility revenue bonds with a final maturity of 2045.

In November 2017, \$284.7 million of fixed rate, tax-exempt health facility revenue bonds were issued by the Health and Educational Facilities Authority of the State of Missouri on behalf of Mercy under the Master Trust Indenture. The proceeds of these bonds were used to finance all or a portion of several capital projects. The bonds have various maturities between November 15, 2033 and November 15, 2049. Coupon rates were set at 3.125%–5% with yields to maturity ranging from 3.63%–4.152%. The net premium paid to Mercy totaled \$15.3 million.

Other notes payable, mortgage notes payable, and capital lease obligations are secured by certain property and equipment of the specific borrowers.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

11. Long-Term Obligations (continued)

Aggregate maturities of long-term obligations as scheduled at June 30, 2018, are as follows:

	<u>Amount</u>
Year ending June 30:	
2019	\$ 18,811
2020	19,521
2021	20,295
2022	16,224
2023	16,735
Thereafter	1,644,450
	<u>\$ 1,736,036</u>

The Health System has \$120.0 million of unused 364-day lines of credit with four banks. The agreements terminate on December 7, 2018; however, the Health System anticipates renewal of the agreements. During 2018, the Health System had no borrowings against the lines of credit. There were no borrowings outstanding under these lines of credit as of June 30, 2018.

12. Derivatives

The Health System has interest rate-related derivative instruments to manage its interest rate exposure on its variable rate debt instruments and does not enter into derivative instruments for any purpose other than risk management. Interest rate swap contracts between the Health System and a third party (counterparty) provide for the periodic exchange of payments between the parties based on changes in a defined index and a fixed rate. These agreements expose the Health System to market risk and credit risk. Credit risk is the risk that contractual obligations of the counterparties will not be fulfilled. Concentrations of credit risk relate to groups of counterparties that have similar economic or industry characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. Counterparty credit risk is managed by requiring high credit standards for the Health System's counterparties. The Health System will enter into transactions where the counterparty rating is high enough to maintain the rating on Health System bonds. The interest rate swap contracts contain collateral provisions applicable to both parties to mitigate credit risk. As of June 30, 2018 and 2017, Mercy had collateral posted of \$34.0 million and \$52.1 million, respectively. The Health System does not anticipate nonperformance by its counterparties. Market risk is the adverse effect

Mercy Health

Notes to Consolidated Financial Statements (continued) (Tables in Thousands)

12. Derivatives (continued)

on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. Management also mitigates risk through periodic reviews of the Health System's derivative positions in the context of its blended cost of capital.

The following is a summary of the outstanding positions under these interest rate swap agreements:

Interest Rate Swap Type	Expiration Date	Health System Pays	Health System Receives	Notional Value June 30	
				2018	2017
Fixed payor	June 2, 2031	3.36%–3.75%	70% of one-month LIBOR	\$ 252,200	\$ 252,200
Fixed payor	June 2, 2031	3.85%	70% of one-month LIBOR	50,000	50,000
Fixed payor	February 1, 2043	1.847%	67% of one-month LIBOR	80,500	81,790

The fair value of derivative instruments is as follows:

Derivatives Not Designated as Hedging Instruments	Balance Sheet Location	June 30	
		2018	2017
Collateral posted on interest rate swap agreements	Other assets	\$ 34,010	\$ 52,110
Interest rate swap agreements	Other liabilities	41,456	62,906

The effects of derivative instruments on the consolidated statements of operations for the years ended June 30, 2018 and 2017, are reflected in realized and unrealized losses on interest rate swaps on the consolidated statements of operations.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

13. Operating Leases

Rent expense for the years ended June 30, 2018 and 2017, totaled \$127.3 million and \$105.7 million, respectively.

Future minimum rental payments under non-cancelable operating leases as of June 30, 2018, that have initial or remaining terms in excess of one year are as follows:

	<u>Amount</u>
Year ending June 30:	
2019	\$ 77,913
2020	75,930
2021	68,632
2022	61,224
2023	55,177
Thereafter	254,410
	<u>\$ 593,286</u>

14. Commitments and Contingencies

Regulatory Compliance

The U.S. Department of Justice and other federal agencies are increasing resources dedicated to regulatory investigations and compliance audits of health care providers. The Health System is not exempt from these regulatory efforts and has received correspondence from federal agencies with regard to such initiatives. In consultation with legal counsel, management estimates these matters will be resolved without a material adverse effect on the Health System's consolidated financial position or results of operations.

Litigation

The Health System is involved in litigation arising in the normal course of business. After consultation with legal counsel, it is management's opinion that these matters will be resolved without a material adverse effect on the Health System's consolidated financial position or results of operations.

Mercy Health

Notes to Consolidated Financial Statements (continued)

(Tables in Thousands)

15. Subsequent Events

The Health System evaluated events and transactions occurring subsequent to June 30, 2018 through October 1, 2018, the date the accompanying consolidated financial statements were issued. During this period, there were no subsequent events that required recognition in the consolidated financial statements.

Supplementary Information

Mercy Health

Schedule of Expenditures of Federal Awards

Year Ended June 30, 2018

Federal Grantor/Program or Cluster Title/Pass-Through Grantor	Location	Federal CFDA Number	Federal or Pass-Through Entity Identifying Number	Research and Development Cluster Expenditures	Other Federal Expenditures	Total Federal Expenditures	Subrecipient Expenditures
United States Department of Agriculture							
Child and Adult Care Food Program							
Pass-Through Grantor:							
Missouri Department of Health and Senior Services	Springfield	10.558	ERS46110115	\$ -	\$ 15,317	\$ 15,317	\$ -
Total United States Department of Agriculture				-	15,317	15,317	-
United States Department of Housing and Urban Development							
Emergency Solutions Grant Program							
Pass-Through Grantor:							
City of Laredo	Casa de Misericordia	14.231	S-16-MC-48-0505	-	39,202	39,202	-
Total United States Department of Housing and Urban Development				-	39,202	39,202	-
United States Department of Justice							
National Institute of Justice Research, Evaluation, and Development							
Project Grants							
Pass-Through Grantor:							
The Administrators of the Tulane Educational Fund d/b/a Tulane University	Mercy Family Center	16.560	2015-CK-BX-0020	168,961	-	168,961	-
Crime Victim Assistance							
Pass-Through Grantor:							
The State of Arkansas Office of Intergovernmental Services	Cooper-Anthony Mercy Child Advocacy Center	16.575	2016-VA-GX-0015	-	154,551	154,551	-
Violence Against Women Formula Grants							
Pass-Through Grantor:							
State of Texas Office of the Governor Criminal Justice Division	Casa de Misericordia	16.588	2015-WF-AX-xxxx	-	18,514	18,514	-
State of Texas Office of the Governor Criminal Justice Division	Casa de Misericordia	16.588	2016-WF-AX-0034	-	11,997	11,997	-
State of Texas Office of the Governor Criminal Justice Division	Casa de Misericordia	16.588	2017-WF-AX-0053	-	68,172	68,172	-
Total Violence Against Women Formula Grants				-	98,683	98,683	-
Grants to Encourage Arrest Policies and Enforcement of Protection Orders Program							
Pass-Through Grantor:							
Webb County Sheriff's Office	Casa de Misericordia	16.590	2017-WE-AX-0048	-	34,690	34,690	-
Total United States Department of Justice				168,961	287,924	456,885	-
United States Department of Transportation							
Highway Safety Cluster							
State and Community Highway Safety							
Pass-Through Grantor:							
Missouri Department of Transportation Traffic and Highway Safety Division	Springfield	20.600	17-CP-09-004	-	15,473	15,473	-
Missouri Department of Transportation Traffic and Highway Safety Division	Springfield	20.600	18-CP-09-002	-	36,705	36,705	-
Total Highway Safety Cluster				-	52,178	52,178	-
Total United States Department of Transportation				-	52,178	52,178	-

Mercy Health

Schedule of Expenditures of Federal Awards (continued)

Year Ended June 30, 2018

Federal Grantor/Program or Cluster Title/Pass-Through Grantor	Location	Federal CFDA Number	Federal or Pass-Through Entity Identifying Number	Research and Development Cluster Expenditures	Other Federal Expenditures	Total Federal Expenditures	Subrecipient Expenditures
United States Department of Education							
Rehabilitation Services Vocational Rehabilitation							
Grants to States							
Pass-Through Grantor:							
Arkansas Department of Human Services	Fort Smith	84.126	Not specified	\$ -	\$ 269	\$ 269	\$ -
Missouri Department of Elementary and Secondary Education	Springfield	84.126	Not specified	-	4,590	4,590	-
Total United States Department of Education				-	4,859	4,859	-
United States Department of Health and Human Services							
Hospital Preparedness Program (HPP) and Public Health							
Emergency Preparedness (PHEP) Aligned Cooperative Agreements							
Pass-Through Grantor:							
Arkansas Department of Health	Fort Smith	93.074	4600041422	-	98,774	98,774	-
Food and Drug Administration Research	MHM Support Services	93.103	5U01FD005476-02	38,527	-	38,527	12,159
Food and Drug Administration Research	MHM Support Services	93.103	5U01FD005476-03	53,486	-	53,486	37,705
Total Food and Drug Administration Research				92,013	-	92,013	49,864
Substance Abuse and Mental Health Services Projects of							
Regional and National Significance							
Substance Abuse and Mental Health Services Projects of	Mercy Family Center	93.243	1U79SM063100-01	-	155,869	155,869	-
Substance Abuse and Mental Health Services Projects of	Mercy Family Center	93.243	5U79SM063100-02	-	295,645	295,645	-
Total Substance Abuse and Mental Health Services Projects of Regional and National Significance				-	451,514	451,514	-
Assistance Program for Chronic Disease Prevention and Control							
Pass-Through Grantor:							
Missouri Department of Health and Senior Services/Missouri Arthritis Program	Springfield	93.945	DH1716A0004	-	37,600	37,600	-
Small Rural Hospital Improvement Grant Program							
Pass-Through Grantor:							
Kansas Hospital Education and Research Foundation	Kansas/Joplin	93.301	Not specified	-	8,032	8,032	-
Pass-Through Grantor:							
Missouri Department of Health and Senior Services	Kansas/Joplin	93.301	CS180238042	-	4,500	4,500	-

Mercy Health

Schedule of Expenditures of Federal Awards (continued)

Year Ended June 30, 2018

Federal Grantor/Program or Cluster Title/Pass-Through Grantor	Location	Federal CFDA Number	Federal or Pass-Through Entity Identifying Number	Research and Development Cluster Expenditures	Other Federal Expenditures	Total Federal Expenditures	Subrecipient Expenditures
Pass-Through Grantor:							
Missouri Department of Health and Senior Services Office of Primary and Rural Health	Springfield	93.301	CS180238033	\$ -	\$ 8,717	\$ 8,717	\$ -
			CS180238034	-	8,717	8,717	-
			CS180238035	-	8,717	8,717	-
			CS180238036	-	8,717	8,717	-
Missouri Department of Health and Senior Services Office of Primary and Rural Health	St. Louis	93.301	CS180238019	-	8,717	8,717	-
Pass-Through Grantor:							
Arkansas Department of Health	Springfield	93.301	4600041158	-	8,186	8,186	-
Pass-Through Grantor:							
Arkansas Department of Health	Fort Smith	93.301	4600041139	-	8,186	8,186	-
			4600041141	-	8,186	8,186	-
			4600041072	-	8,186	8,186	-
			4501743749	-	8,186	8,186	-
Pass-Through Grantor:							
OSU Center for Health Sciences, Center for Rural Health	Oklahoma	93.301	Not specified	-	45,900	45,900	-
Total Small Rural Hospital Improvement Grant Program				-	142,947	142,947	-
Cancer Detection and Diagnosis Research				-	-	-	-
Pass-Through Grantor:							
The Board of Regents of the University of Oklahoma	Oklahoma	93.394	2016-03	165,701	-	165,701	-
Community-Based Child Abuse Prevention Grants				-	-	-	-
Pass-Through Grantor:							
The State of Louisiana Department of Children and Family Services	Mercy Family Center	93.590	1000148336	-	15,336	15,336	-
Social Services Block Grant							
Pass-Through Grantor:							
Texas Health and Human Services Commission	Casa de Misericordia	93.667	529-15-0032-00060C	-	27,432	27,432	-
Texas Health and Human Services Commission	Casa de Misericordia	93.667	529-15-0032-00060D	-	122,288	122,288	-
Total Social Services Block Grant				-	149,720	149,720	-
Family Violence Prevention and Services/Domestic Violence							
Shelter and Supportive Services							
Pass-Through Grantor:							
Texas Health and Human Services Commission	Casa de Misericordia	93.671	529-15-0032-00060C	-	12,756	12,756	-
Texas Health and Human Services Commission	Casa de Misericordia	93.671	529-15-0032-00060D	-	57,349	57,349	-
Total Family Violence Prevention and Services/Domestic Violence Shelter and Supportive Services				-	70,105	70,105	-

Mercy Health

Schedule of Expenditures of Federal Awards (continued)

Year Ended June 30, 2018

Federal Grantor/Program or Cluster Title/Pass-Through Grantor	Location	Federal CFDA Number	Federal or Pass-Through Entity Identifying Number	Research and Development Cluster Expenditures	Other Federal Expenditures	Total Federal Expenditures	Subrecipient Expenditures
Cancer Prevention and Control Programs for State, Territorial and Tribal Organizations Financed in Part by Prevention and Public Health Funds							
Pass-Through Grantor:							
Missouri Department of Health and Senior Services	St. Louis	93.752	ERS1618064	\$ -	\$ 52,688	\$ 52,688	\$ -
Missouri Department of Health and Senior Services	St. Louis	93.752	ERS16118065	-	2,559	2,559	-
Total Cancer Prevention and Control Programs for State, Territorial and Tribal Organizations Financed in Part by Prevention and Public Health Funds				-	55,247	55,247	-
Cardiovascular Diseases Research							
Pass-Through Grantor:							
Brigham and Women's Hospital, Inc.	Springfield	93.837	5U01HL101422-03	19,350	-	19,350	-
Extramural Research Programs in the Neurosciences and Neurological Disorders							
Pass-Through Grantor:							
Mayo Clinic Jacksonville	Springfield	93.853	5U01NS080168-04	51,685	-	51,685	-
Pass-Through Grantor:							
Mayo Clinic Jacksonville	St. Louis	93.853	5U01NS080168-04	6,300	-	6,300	-
Total Extramural Research Programs in the Neurosciences and Neurological Disorders				57,985	-	57,985	-
Child Health and Human Development Extramural Research							
Pass-Through Grantor:							
Washington University	St. Louis	93.865	1R01HD086007-01 A1	9,402	-	9,402	-
Washington University	St. Louis	93.865	5R01HD086007-02	29,633	-	29,633	-
Total Child Health and Human Development Extramural Research				39,035	-	39,035	-
National Bioterrorism Hospital Preparedness Program							
Pass-Through Grantor:							
Missouri Hospital Association	Kansas/Joplin	93.889	Not specified	-	1,630	1,630	-
Maternal and Child Health Services Block Grant to the States							
Pass-Through Grantor:							
Missouri Department of Health and Senior Services	Springfield	93.994	1B04MC30623-01	-	9,637	9,637	-
Missouri Department of Health and Senior Services	Springfield	93.994	1B04MC31498-01	-	8,533	8,533	-
Total Maternal and Child Health Services Block Grants to the States				-	18,170	18,170	-
Total United States Department of Health and Human Services				374,084	1,041,043	1,415,127	49,864
Corporation for National and Community Service							
Social Innovation Fund							
Pass-Through Grantor:							
Methodist Healthcare Ministries of South Texas, Inc.	Mercy Ministries of Laredo	94.019	14SIHTX001	-	298,687	298,687	-
Total Corporation for National and Community Service				-	298,687	298,687	-

Mercy Health

Schedule of Expenditures of Federal Awards (continued)

Year Ended June 30, 2018

Federal Grantor/Program or Cluster Title/Pass-Through Grantor	Location	Federal CFDA Number	Federal or Pass-Through Entity Identifying Number	Research and Development Cluster Expenditures	Other Federal Expenditures	Total Federal Expenditures	Subrecipient Expenditures
United States Department of Homeland Security							
Disaster Grants – Public Assistance (Presidentially Declared Disasters)							
Pass-Through Grantor:							
State of Missouri Emergency Management Agency	St. Louis	97.036	PA-07-MO-4238	\$ –	\$ 429,418	\$ 429,418	\$ –
State of Missouri Emergency Management Agency	Joplin	97.036	FEMA-1980-DR-MO	–	588	588	–
Total Disaster Grants – Public Assistance (Presidentially Declared Disasters)				–	430,006	430,006	–
Total United States Department of Homeland Security				–	430,006	430,006	–
Total expenditures of federal awards				\$ 543,045	\$ 2,169,216	\$ 2,712,261	\$ 49,864

See accompanying notes to schedule of expenditures of federal awards.

Mercy Health

Notes to Schedule of Expenditures of Federal Awards

Year Ended June 30, 2018

1. Basis of Presentation

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Mercy Health and is presented on the accrual basis of accounting, except for expenditures for disaster grants from the U.S. Department of Homeland Security, which are recorded on the schedule of expenditures of federal awards when the funds are approved (i.e., federal amount obligated through the approval of the Project Worksheets) and eligible expenditures have been incurred, and are presented net of estimated insurance recoveries. Disaster grant expenditures included in the schedule of expenditures of federal awards for the year ended June 30, 2018 that related to prior fiscal years were \$87,400. The information in this schedule is presented in accordance with the requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (the Uniform Guidance). Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the consolidated financial statements.

Mercy Health's reporting entity is defined in Mercy Health's consolidated financial statements.

2. Indirect Costs

Indirect cost rates for certain Mercy Health entities are based on applicable U.S. Department of Health and Human Services (HHS) negotiated rates or sponsor-specified rates. For Mercy Health entities that do not have a negotiated indirect cost rate with HHS, the 10% de minimis indirect cost rate allowed by the Uniform Guidance is used, as applicable. Specifically, the 10% de minimis indirect cost rate was used by MHM Support Services for its Food and Drug Administration: Research awards under CFDA 93.103; by Mercy Research for its Cancer Detection and Diagnosis Research award under CFDA 93.394 and for its award under HHS' Child Health and Human Development Extramural Research CFDA 93.865; and by Mercy Family Center for its Substance Abuse and Mental Health Services: Projects of Regional and National Significance award under CFDA 93.243, its HHS Community-Based Child Abuse Prevention award under CFDA 93.590 and its National Institute of Justice Research, Evaluation, and Development Project Grants award under CFDA 16.560.

Mercy Health

Schedule of State Assistance

Year Ended June 30, 2018

Grantor/Program Name	Location	State Revenues	State Expenditures
Arkansas Department of Human Services			
Division of Services for the Blind (DSB) – Administration	Fort Smith	\$ 888	\$ 888
Developmental Disabilities Services (DDS) – Operations	Fort Smith	165	165
Total Arkansas Department of Human Services		1,053	1,053
Arkansas Department of Health			
EMS and Trauma	Rogers	135,000	135,000
EMS and Trauma	Fort Smith	295,000	295,000
EMS and Trauma	Springfield	237,701	237,701
Trauma Regional Advisory Council	Fort Smith	4,881	4,881
Advanced Stroke Life Support (ASLS)	Fort Smith	4,804	4,804
Advanced Stroke Life Support (ASLS)	Rogers	5,000	5,000
Lifeline	Springfield	8,220	8,220
Rural Health Services Revolving Grant	Fort Smith	14,758	14,758
Tobacco State Tax Revenue – Arkansas Stroke Registry	Rogers	2,750	2,750
Tobacco State Tax Revenue – Arkansas Stroke Registry	Fort Smith	9,286	9,286
Total Arkansas Department of Health		717,400	717,400
Arkansas Commission on Child Abuse, Rape, and Domestic Violence			
Passed through the University of Arkansas for Medical Sciences: Child Advocacy Support Garland County	Hot Springs	70,000	70,000
Passed through the University of Arkansas for Medical Sciences: Child Advocacy Support Polk County	Mena	40,000	40,000
Passed through the University of Arkansas for Medical Sciences: Child Advocacy Support Saline County	Hot Springs	36,107	36,107
Passed through the University of Arkansas for Medical Sciences: ARBest SHIPS	Hot Springs	2,086	2,086
Passed through the University of Arkansas for Medical Sciences: ARBest Mental Health Services	Hot Springs	68,400	68,400
Total Arkansas Commission on Child Abuse, Rape, and Domestic Violence		216,593	216,593
Grand total		\$ 935,046	\$ 935,046

See accompanying notes to schedule of state assistance.

Mercy Health

Notes to Schedule of State Assistance

Year Ended June 30, 2018

1. Arkansas State Assistance

The schedule of state assistance for the year ended June 30, 2018 for Mercy Health Fort Smith Communities, Fort Smith, Arkansas; Cooper-Anthony Mercy Child Advocacy Center, Hot Springs, Arkansas; Mercy Child Advocacy Center, Mena, Arkansas; Mercy Health Springfield Communities, Springfield, Missouri; and Mercy Health Northwest Arkansas Communities, Rogers, Arkansas, is presented pursuant to Section IX.C.1. of the *Guidelines for Financial and Compliance Audits of Programs Funded by the Arkansas Department of Human Services* (1998).

2. Medicaid Funding

Per the State of Arkansas Department of Human Services' Audit Guidelines, Mercy is providing the AR Medicaid funding received during the year ended June 30, 2018, as a footnote to the Schedule of State Assistance. The Medicaid funding received for the year ended June 30, 2018 amounted to \$2,532,157 for Mercy Hospital Berryville, Berryville, Arkansas; \$42,903,708 for Mercy Health Fort Smith Communities, Fort Smith, Arkansas; and \$26,722,630 for Mercy Health Northwest Arkansas Communities, Rogers, Arkansas.

Internal Control and Compliance Reports and Schedule

Report of Independent Auditors on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Board of Directors, Chief Executive Officer, and
Chief Financial Officer
Mercy Health

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of Mercy Health, which comprise the consolidated balance sheet as of June 30, 2018, and the related consolidated statements of operations, changes in net assets, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated October 1, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Mercy Health's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Mercy Health's internal control. Accordingly, we do not express an opinion on the effectiveness of Mercy Health's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Mercy Health’s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity’s internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity’s internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



October 1, 2018



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Report of Independent Auditors on Compliance for Each Major Federal Program and Report on Internal Control Over Compliance Required by the Uniform Guidance

The Board of Directors, Chief Executive Officer, and
Chief Financial Officer
Mercy Health

Report on Compliance for Each Major Federal Program

We have audited Mercy Health's compliance with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Compliance Supplement* that could have a direct and material effect on each of Mercy Health's major federal programs for the year ended June 30, 2018. Mercy Health's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of federal statutes, regulations and the terms and conditions of its federal awards applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Mercy Health's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States and the audit requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Those standards and the Uniform Guidance require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Mercy Health's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of Mercy Health's compliance.

Opinion on Each Major Federal Program

In our opinion, Mercy Health complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2018.

Other Matters

The results of our auditing procedures disclosed instances of noncompliance which are required to be reported in accordance with the Uniform Guidance, and which are described in the schedule of findings and questioned costs as follows:

Finding No.	CFDA No.	Program Name	Compliance Requirement
2018-001	97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)	Reporting
2018-002	97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)	Equipment and Real Property Management
2018-003	97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)	Reporting

Our opinion on each major federal program is not modified with respect to these matters.

Mercy Health’s responses to the noncompliance findings identified in our audit are described in the accompanying schedule of findings and questioned costs and corrective action plan. Mercy Health’s responses were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the responses.

Report on Internal Control Over Compliance

Management of Mercy Health is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered Mercy Health’s internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Mercy Health’s internal control over compliance.

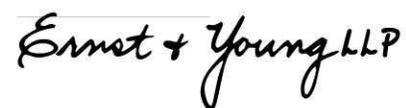
A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we identified the following deficiencies in internal control over compliance, as described in the accompanying schedule of findings and questioned costs that we consider to be significant deficiencies.

Finding No.	CFDA No.	Program Name	Compliance Requirement
2018-001	97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)	Reporting
2018-002	97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)	Equipment and Real Property Management
2018-003	97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)	Reporting

Mercy Health’s responses to the internal control over compliance findings identified in our audit are described in the accompanying schedule of findings and questioned costs and corrective action plan. Mercy Health’s responses were not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the responses.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.



December 19, 2018

Mercy Health

Schedule of Findings and Questioned Costs

For the Year Ended June 30, 2018

Section I – Summary of Auditor’s Results

Financial Statements

Type of report the auditor issued on whether the financial statements audited were prepared in accordance with GAAP:

Unmodified

Internal control over financial reporting:

Material weakness(es) identified?

 Yes X **No**

Significant deficiency(ies) identified?

 Yes X **None reported**

Noncompliance material to financial statements noted?

 Yes X **No**

Federal Awards

Internal control over major federal programs:

Material weakness(es) identified?

 Yes X **No**

Significant deficiency(ies) identified?

 X **Yes** **None reported**

Type of auditor’s report issued on compliance for major federal programs:

Unmodified

Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)?

 X **Yes** **No**

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section I – Summary of Auditor’s Results (continued)

Identification of major federal programs:

CFDA Number	Name of Federal Program or Cluster
93.243	Substance Abuse and Mental Health Services Projects of Regional and National Significance
97.036	Disaster Grants – Public Assistance (Presidentially Declared Disasters)

Dollar threshold used to distinguish between Type A and Type B programs:

\$ 750,000

Auditee qualified as low-risk auditee?

X **Yes** **No**

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section II – Financial Statement Findings

None identified.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section

Finding 2018-001 (Reporting)

Information on the federal program

United States Department of Homeland Security
Pass-Through Entity: State of Missouri Emergency Management Agency
CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)
Location: Jefferson County
Award Number: PA-07-MO-4238
Award Period: 2016–2018

Criteria or specific requirement (including statutory, regulatory or other citation)

The Uniform Guidance 2 CFR section 200.303 states, “The non-Federal entity must:

- (a) Establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award. These internal controls should be in compliance with guidance in “Standards for Internal Control in the Federal Government” issued by the Comptroller General of the United States or the “Internal Control Integrated Framework”, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).”

Condition

Mercy Health did not provide a complete and accurate listing of all federal awards in the schedule of expenditures of federal awards (the Schedule).

Cause

Mercy Health’s internal controls in place over the preparation of the Schedule were not sufficient to properly accumulate all expenditures of federal awards in the correct fiscal year. Review of federal expenditures and invoices was not timely to record all expenditures required for the preparation of the Schedule.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

Effect or potential effect

Failure to properly record federal expenditures could result in the improper preparation of the Schedule in accordance with the Uniform Guidance and the improper selection of federal award programs being identified as major programs.

Questioned costs

None.

Context

Federal expenditures totaling \$87,400, net of the 75% FEMA match, were not reported in the Schedule in the correct fiscal year. The expenditures were previously approved by FEMA and incurred during fiscal year 2017; however, they were not reported until fiscal year 2018.

Identification as a repeat finding, if applicable

This is not a repeat finding.

Recommendation

Mercy Health should review its internal controls over the process of accumulating and reporting expenditures of federal awards. A suggestion to improve the current process is to have a comprehensive review of federal expenditures in the beginning and end of the fiscal year for proper cutoff. In addition, Mercy Health should communicate the importance of timely review and reporting of federal expenditures to locations administering the award.

Views of responsible officials

Mercy Health concurs with the finding. Refer to Mercy Health's corrective action plan.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

Finding 2018-002 (Equipment and Real Property Management)

Information on the federal program

United States Department of Homeland Security

Pass-Through Entity: State of Missouri Emergency Management Agency

CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)

Location: Joplin

Award Number: FEMA-1980-DR-MO

Award Period: 2011–2018 (subject to pre-Uniform Guidance requirements)

Criteria or specific requirement (including statutory, regulatory or other citation)

For federal awards issued prior to the effective date of the Uniform Guidance, Office of Management and Budget (OMB) Circular A-110, Section 34 states, “A physical inventory of equipment shall be taken and the results reconciled with the equipment records at least once every two years. Any differences between quantities determined by the physical inspection and those shown in the accounting records shall be investigated to determine the causes of the difference. The recipient shall, in connection with the inventory, verify the existence, current utilization, and continued need for the equipment.”

OMB Circular A-133 Subpart C Section .300 states that, “The auditee shall

- (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.”

Condition

Mercy Health did not perform a complete biannual physical inventory of its federal equipment, certain equipment items could not be located at the time of observation procedures performed as part of the audit, and certain property records were not accurately maintained. Mercy Health did not have equipment purchases in the current year, and equipment disposals were recorded in accordance with the compliance requirements.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

Cause

Mercy Health did not have adequate internal controls around equipment management, causing certain federal equipment to be excluded from the routine physical inventory. Clinical Engineering was using its routine maintenance checks process to perform physical inventories; however, not all FEMA equipment was subject to the routine maintenance process, causing certain equipment to be excluded from the inventory.

Mercy Health did not have a tracking system for some mobile equipment items. GPS devices were not affixed to the equipment items due to sterilization purposes.

Mercy Health did not have adequate internal controls to maintain accurate property records, causing certain equipment information to be incorrect.

Effect or potential effect

Since physical inventory observation for all FEMA equipment was not performed routinely, equipment could be lost, stolen, or damaged and not identified timely for resolution. This could lead to the FEMA equipment being incorrectly reflected in Mercy Health's books and records.

Questioned costs

None.

Context

We identified 78 equipment items out of 490 equipment items that were not subject to routine physical inventory observations. The total dollar value of equipment items not subject to physical inventory was \$2,153,989 of \$26,658,091 total FEMA equipment claims paid to Mercy Health under the federal award through June 30, 2018. In addition, during our observation, we identified three equipment items out of a sample of 40 items with total value of \$32,305 that could not be located, as they are mobile items that move throughout a hospital, and two items out of the sample of 40 items with a total value of \$16,600, where the asset tag number did not agree to property records.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

Identification as a repeat finding, if applicable

The finding is a repeat of prior year Finding 2017-001 and prior year Finding 2016-002.

Recommendation

Mercy Health should revise its established policies, procedures, and controls to ensure that the required physical inventory observation occurs for all federally purchased equipment items, track the location of mobile federal equipment, and maintain accurate property records in accordance with OMB Circular A-110, Section 34.

Views of responsible officials

Mercy Health concurs with the finding. Refer to Mercy Health's corrective action plan.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

Finding 2018-003 (Reporting)

Information on the federal program

United States Department of Homeland Security
Pass-Through Entity: State of Missouri Emergency Management Agency
CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)
Location: Jefferson County
Award Number: PA-07-MO-4238
Award Period: 2016–2018 (subject to Uniform Guidance requirements)

Criteria or specific requirement (including statutory, regulatory or other citation)

The Uniform Guidance 2 CFR section 200.328 related to monitoring and reporting program performance states,

“(a) *Monitoring by the non-Federal entity.* The non-Federal entity is responsible for oversight of the operations of the Federal award supported activities. The non-Federal entity must monitor its activities under Federal awards to assure compliance with applicable Federal requirements and performance expectations are being achieved. Monitoring by the non-Federal entity must cover each program, function or activity.

(b)...(c) *Construction performance reports.* For the most part, onsite technical inspections and certified percentage of completion data are relied on heavily by Federal awarding agencies and pass-through entities to monitor progress under Federal awards and subawards for construction. The Federal awarding agency may require additional performance reports only when considered necessary.”

The Uniform Guidance 2 CFR section 200.303 states, “The non-Federal entity must:

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

- (a) Establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the Federal award. These internal controls should be in compliance with guidance in “Standards for Internal Control in the Federal Government” issued by the Comptroller General of the United States or the “Internal Control Integrated Framework”, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).”

Condition

Mercy Health did not submit all required quarterly performance reports during the fiscal year, and performance reports that were submitted did not have evidence to validate the percentage of completion at that point in time.

Cause

Turnover of the project manager in the department caused Mercy Health to not submit all required reports and to not have evidence supporting the percentage of completion.

Effect or potential effect

Reports submitted may contain inaccurate information, lack supporting documentation, or may not be timely filed.

Questioned costs

None.

Context

We tested two quarterly performance reports, which were the only two reports submitted during the fiscal year. We identified an incomplete population, as the performance report is a quarterly requirement and, therefore, should consist of four reports. For the two reports tested, Mercy Health could not provide evidence to substantiate the percentage of completion, which is a required data element in the performance report. Reporting requirements during the year only consisted of the four performance reports.

Mercy Health

Schedule of Findings and Questioned Costs (continued)

Section III – Federal Award Findings and Questioned Costs Section (continued)

Identification as a repeat finding, if applicable

This is not a repeat finding.

Recommendation

Mercy Health should follow its reporting policy to ensure reports are timely and accurately submitted, especially when experiencing turnover of program personnel.

Views of responsible officials

Mercy Health concurs with the finding. Refer to Mercy Health's corrective action plan.

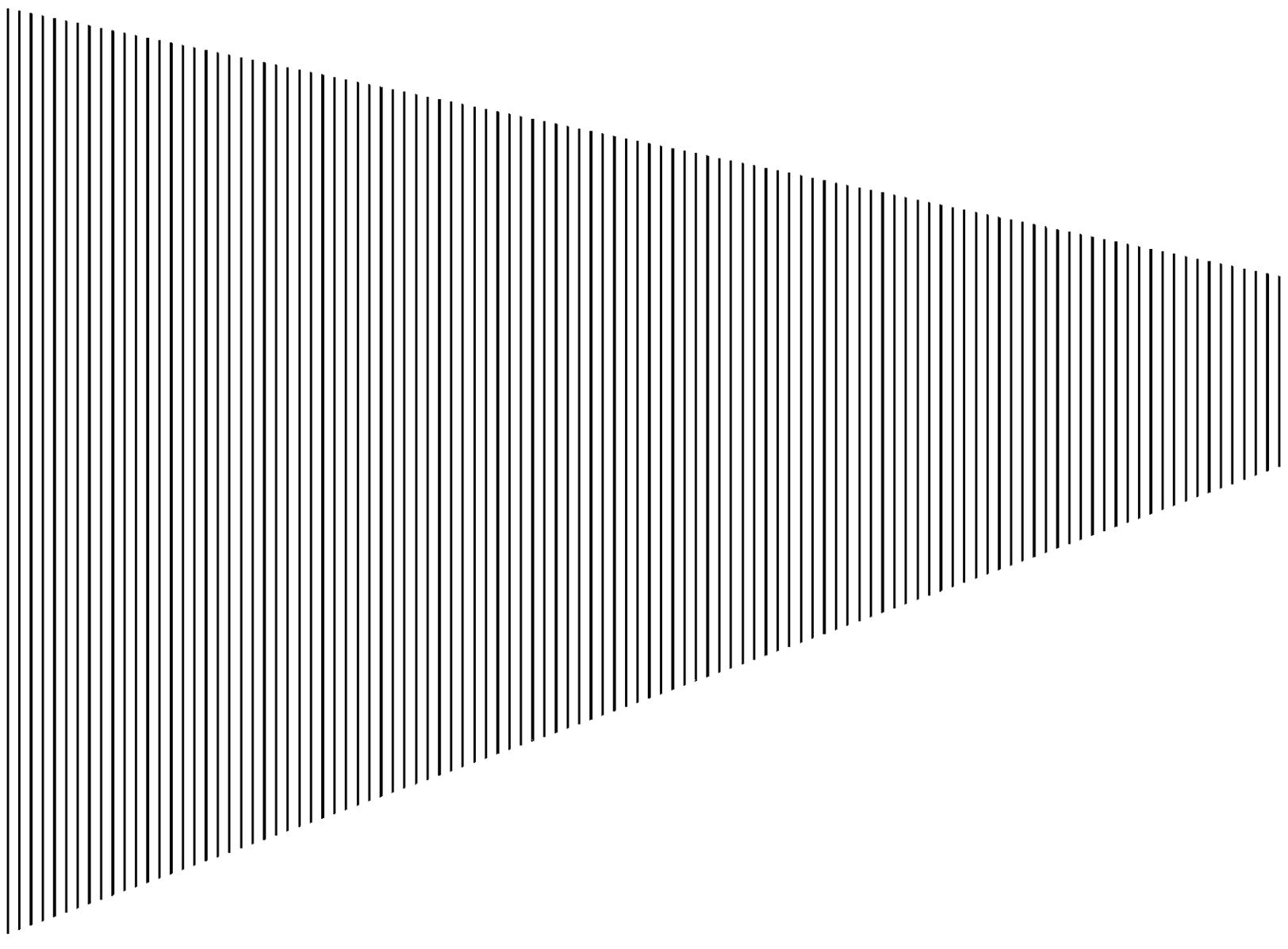
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Mercy Health

Summary Schedule of Prior Audit Findings

Financial Statement Findings – Years Ended June 30, 2017 and 2016

There were no financial statement findings for the years ended June 30, 2017 and 2016.

Federal Award Findings and Questioned Costs – Year Ending June 30, 2017

Finding 2017-001

Information on the Federal Program

United States Department of Homeland Security, Federal Emergency Management Agency
Pass-Through Entity: State of Missouri Emergency Management Agency
CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)
Location: Joplin
Award Number: FEMA-1980-DR-MO
Award Period: 2011 – 2017

Finding

A significant deficiency in the design of internal controls caused certain inventory to not be subject to routine physical inventory. Clinical Engineering (now known as Healthcare Technology Management) was using its routine maintenance checks process to also perform physical inventories; however, as not all FEMA equipment was subject to the routine maintenance process, certain inventory was not subject to a count.

Current Year Status

Mercy Health's Healthcare Technology Management (HTM) department has primary responsibility for tracking medical equipment items (i.e. monitoring, diagnostic, and therapeutic equipment) purchased using the FEMA funds. In FY2018, the staff, who have oversight of the FEMA equipment, worked to identify all FEMA equipment purchases with a purchase (replacement) price of \$5,000 or more in the HTM database. For most items, they were able to utilize an unused asset field for ongoing tracking of these devices, including those not previously having been part of the routine maintenance/inventory check process. The initial identification of the assets within the HTM database was largely completed by June 30, 2018. Since it took the majority of FY2018 to identify all of the items with a replacement price of \$5,000 or more within the database, it did not allow an opportunity to ensure all items were physically inspected at least

Mercy Health

Summary Schedule of Prior Audit Findings (continued)

once in the last two years. For FY2019, the HTM department will have a process to run a report from their database each quarter to double check that all items have a physical inventory check at least once every two years. If they find that an item did not have an inventory check in the required time frames, then that item will be put on a high priority list to be inventoried within the next quarter. The Grants and Research Center of Excellence (COE) will also meet with the HTM team at the end of each quarter to ensure compliance with the regulatory requirement.

Federal Award Findings and Questioned Costs – Year Ending June 30, 2016

Finding 2016-001

Information on the Federal Program

United States Department of Health and Human Services

Pass-Through Entity: N/A

CFDA No.: 93.243, Substance Abuse and Mental Health Services: Projects of Regional and National Significance

Location: Mercy Family Center (MFC)

Award Numbers: 2U79SMO58776-07 REVISED and 2U79SMO58776-08

Award Period: 9/30/14-9/30/16

Finding

Mercy Health had not properly applied all of the principles of OMB Circular A-110, Section .45 as identified above. MFC did not follow Mercy Health federal procurement procedure which caused purchases to be made without completion of a cost or price analysis.

Current Year Status

Mercy Health's Grants and Research COE continues to provide education and compliance monitoring with MFC to ensure better compliance with the procurement requirements. MFC has taken the proper steps since the FY2016 audit finding to be in compliance with the regulations.

Finding 2016-002

Information on the Federal Program

United States Department of Homeland Security, Federal Emergency Management Agency

Pass-Through Entity: State of Missouri Emergency Management Agency

CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)

Location: Joplin

Award Number: FEMA-1980-DR-MO

Award Period: 2011–2016

Mercy Health

Summary Schedule of Prior Audit Findings (continued)

Finding

A significant deficiency in the design of internal controls caused certain inventory to not be subject to routine physical inventory. HTM was using its routine maintenance checks process to also perform physical inventories; however, as not all FEMA equipment was subject to the routine maintenance process, certain inventory was not subject to a count.

Current Year Status

See Finding 2017-001 for status.



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Mercy Health

Corrective Action Plan

Federal Award Findings and Questioned Costs – Year Ending June 30, 2018

Finding 2018-001 (Reporting)

Information on the federal program

United States Department of Homeland Security
Pass-Through Entity: State of Missouri Emergency Management Agency
CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)
Location: Jefferson County
Award Number: PA-07-MO-4238
Award Period: 2016–2018

Finding

Mercy Health did not provide a complete and accurate listing of all federal awards in the schedule of expenditures of federal awards (the Schedule).

Views of Responsible Officials and Planned Corrective Actions

Mercy Health took corrective action measures during FY2019 to verify that there were no expenditures that were incurred in FY2018 but did not post in the general ledger until FY2019, and therefore, should have been reported on the FY2018 Schedule. The Grants and Research Center of Excellence will continue to provide education to the department responsible for tracking the FEMA related funds on ensuring that they are reporting expenditures on an accrual basis.

Responsible Parties: Mercy Health’s Facilities Planning, Design and Construction department and the Grants and Research Centers of Excellence

Date of Completion: October 18, 2018

Finding 2018-002 (Equipment and Real Property Management)

Information on the Federal Program

United States Department of Homeland Security
Pass-Through Entity: State of Missouri Emergency Management Agency
CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)
Location: Joplin
Award Number: FEMA-1980-DR-MO
Award Period: 2011–2018 (subject to pre-Uniform Guidance requirements)



Finding

Mercy Health did not perform a complete biannual physical inventory of its federal equipment, certain equipment items could not be located at the time of observation procedures performed as part of the audit, and certain property records were not accurately maintained. Mercy Health did not have equipment purchases in the current year, and equipment disposals were recorded in accordance with the compliance requirements.

Mercy Health did not have adequate internal controls around equipment management, causing certain federal equipment to be excluded from the routine physical inventory. Clinical Engineering was using its routine maintenance checks process to perform physical inventories; however, not all FEMA equipment was subject to the routine maintenance process causing certain equipment to be excluded from the inventory.

Mercy Health did not have a tracking system for some mobile equipment items. GPS devices were not affixed to the equipment items due to sterilization purposes.

Mercy Health did not have adequate internal controls to maintain accurate property records, causing certain equipment information to be incorrect.

Views of Responsible Officials and Planned Corrective Actions

Mercy Health's Healthcare Technology Management (HTM) department has primary responsibility for tracking medical equipment items (i.e. monitoring, diagnostic, and therapeutic equipment) purchased using the FEMA funds. In FY2018, the staff, who have oversight of the FEMA equipment, worked to identify all FEMA equipment purchases with a purchase (replacement) price of \$5,000 or more in the HTM database. For most items, they were able to utilize an unused asset field for ongoing tracking of these devices, including those not previously part of the routine maintenance/inventory check process. The initial identification of the assets within the HTM database was largely completed by June 30, 2018. Since it took the majority of FY2018 to identify all of the items with a replacement price of \$5,000 or more within the database, it did not allow an opportunity to ensure all items were physically inspected at least once in the last two years. For FY2019, the HTM department will have a process to run a report from their database each quarter to double check that all items have a physical inventory check at least once every two years. If they find that an item did not have an inventory check in the required time frames, then that item will be put on a high priority list to be inventoried within the next quarter.

For items that are transit - moving with a patient throughout their stay at the hospital - the HTM team will work with the hospital and clinic departments to locate and update the physical inventory for those items. Specifically, all department managers will be asked to review the equipment tags in their location to locate the specific item that needs to be inventoried. Then, either someone from HTM or Finance will do a physical observation of the item to update the records within the database. The Grants and Research Center of Excellence will also meet with the HTM team at the end of each quarter to ensure compliance with the regulatory requirement by reviewing the updated inventory list and identifying any items that are near or have reached their physical inventory date requirement.

Responsible Parties: Mercy Health's Healthcare Technology Management Department and the Grants and Research Centers of Excellence



Date of Completion: June 30, 2019 and ongoing

Finding 2018-003 (Reporting)

Information on the Federal Program

United States Department of Homeland Security

Pass-Through Entity: State of Missouri Emergency Management Agency

CFDA No.: 97.036, Disaster Grants – Public Assistance (Presidentially Declared Disasters)

Location: Jefferson County

Award Number: PA-07-MO-4238

Award Period: 2016–2018

Finding

Mercy Health did not submit all required quarterly performance reports during the fiscal year, and performance reports that were submitted did not have evidence to validate the percentage of completion at that point in time.

Views of Responsible Officials and Planned Corrective Actions

Mercy Health has updated the contact information with the Missouri State Emergency Management Agency (SEMA) so that the letter requesting the report is routed to the correct contact person. Mercy Health has also updated its internal processes to ensure the quarterly reports are submitted each quarter for fiscal year 2019. This process includes preparation of the report by Mercy Health’s Facilities Planning, Design and Construction’s Project Manager assigned to the Jefferson construction project with supporting documentation for the calculations of the percentage of completion. Once the report is prepared, it is then sent for review and signature to Mercy Health’s Authorized Representative, which is currently the Chief Financial Officer East Communities. The Project Manager is using Outlook reminders of report due dates to ensure reports are completed timely.

Responsible Parties: Project Manager of Mercy Health’s Facilities Planning, Design and Construction; Chief Financial Officer East Communities

Date of Completion: December 31, 2018



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Report of Independent Auditors on Compliance

The Board of Directors
Mercy Health

We have audited, in accordance with auditing standards generally accepted in the United States, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the accompanying consolidated financial statements of Mercy Health, which comprise the consolidated balance sheets as of June 30, 2018 and 2017, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements, and have issued our report, with an unmodified opinion thereon, dated October 1, 2018.

In connection with our audit, nothing came to our attention that caused us to believe that Mercy Health failed to comply with the terms, covenants, provisions or conditions of Louisiana Revised Statute 24:513A.(3) and Act 706 of the 2014 Legislative Session relating to the Schedule of Compensation, Benefits and Other Payments to Agency Head or Chief Financial Officer between the State of Louisiana and Mercy Health, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced terms, covenants, provisions or conditions of Louisiana Revised Statute 24:513A.(3) and Act 706 of the 2014 Legislative Session relating to the Schedule of Compensation, Benefits and Other Payments to Agency Head or Chief Financial Officer, insofar as they relate to accounting matters.

The purpose of this report is solely to communicate, in connection with the audit of the financial statements, on compliance with aspects of Louisiana Revised Statute 24:513A.(3) and Act 706 of the 2014 Legislative Session relating to the Schedule of Compensation, Benefits and Other Payments to Agency Head or Chief Financial Officer between the State of Louisiana and Mercy Health. Accordingly, this report is not suitable for any other purpose.

Ernst + Young LLP

October 1, 2018

Mercy Health

Schedule of Compensation, Benefits and Other Payments to Agency
Head or Chief Executive Officer

For the Year Ended June 30, 2018

Agency Name: Mercy Family Center

Agency Head Name: Rex Menasco, Executive Director

Purpose	Dollar Amount
1. Salary	\$0
2. Benefits-insurance	\$0
3. Benefits-retirement	\$0
4. Benefits-other (describe)	\$0
5. Benefits-other (describe)	\$0
6. Benefits-other (describe)	\$0
7. Car allowance	\$0
8. Vehicle provided by government (enter amount reported on W-2)	\$0
9. Per diem	\$0
10. Reimbursements	\$0
11. Travel	\$0
12. Registration fees	\$0
13. Conference travel	\$0
14. Housing	\$0
15. Unvouchered expenses (example: travel advances, etc.)	\$0
16. Special meals	\$0
17. Other	\$0

X Please check here if the Agency Head does not receive any compensation, benefits, and other payments. (Act 462 of the 2015 Legislative Session allows nongovernmental entities or not-for-profit (quasipublic) entities to report on the Act 706 schedule only those payments to the agency head that are derived from the public funds.)