



Office of the Washington State Auditor
Pat McCarthy

September 28, 2017

Board of Commissioners
Snohomish County Public Hospital District No. 3
dba Cascade Valley Hospital and Clinics
Arlington, Washington

Contracted CPA Firm's Audit Report on Financial Statements

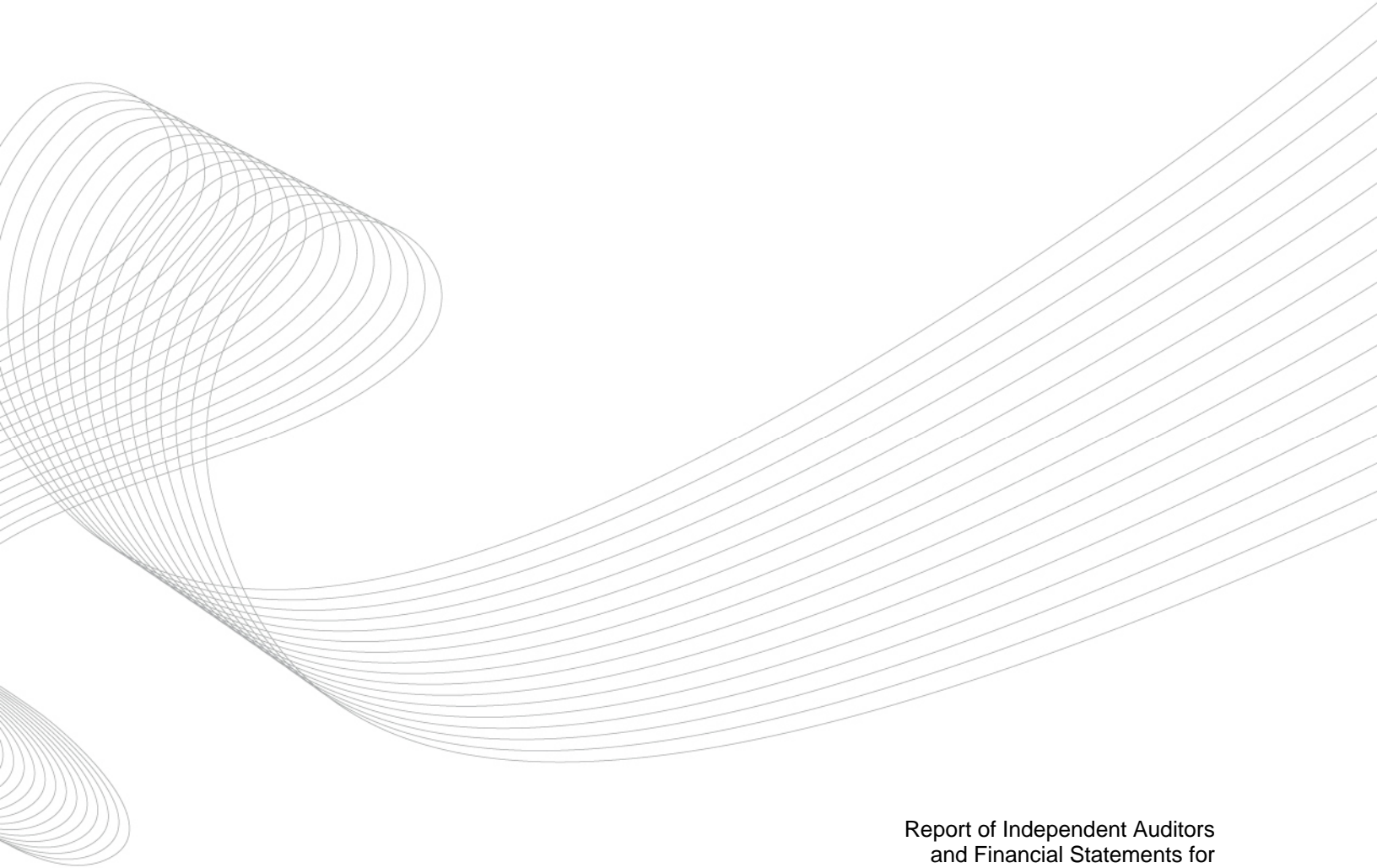
We have reviewed the audit report issued by a certified public accounting (CPA) firm on the Snohomish County Public Hospital District No. 3's (doing business as Cascade Valley Hospital and Clinics) financial statements for the fiscal years ended December 31, 2016 and 2015. The District contracted with the CPA firm for this audit.

Based on this review, we have accepted this report in lieu of the audit required by RCW 43.09.260. The State Auditor's Office did not audit the accompanying financial statements and, accordingly, we do not express an opinion on those financial statements.

This report is being published on the State Auditor's Office website as a matter of public record.

Sincerely,

Pat McCarthy
State Auditor
Olympia, WA



Report of Independent Auditors
and Financial Statements for

**Public Hospital District No. 3,
Snohomish County, Washington**

December 31, 2016 and 2015

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Commissioners
Public Hospital District No. 3,
Snohomish County, Washington

Report on the Financial Statements

We have audited the accompanying financial statements of Public Hospital District No. 3, Snohomish County, Washington (the District), which comprise the statements of net position as of December 31, 2016 and 2015, and the related statements of revenues, expenses, and changes in net position and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from 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 financial position of Public Hospital District No. 3, Snohomish County, Washington, as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the accompanying management's discussion and analysis on pages 3 through 15 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in the appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

A handwritten signature in black ink that reads "Moss Adams LLP". The signature is written in a cursive, flowing style.

Everett, Washington
June 29, 2017

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS

This discussion and analysis provides an overview of the financial position and activities of Public Hospital District No. 3, Snohomish County, Washington (the District), doing business as Cascade Valley Hospital and Clinics. It should be read in conjunction with the financial statements and accompanying notes that follow.

Financial Highlights

The District's total net position decreased from 2015 to 2016 by \$19,701,000 due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of an affiliation agreement effective June 1, 2016. The District's total net position increased from 2014 to 2015 by \$2,985,000.

The District invested in capital assets to improve medical facilities and equipment in the amounts of \$793,000, \$2,012,000, and \$638,000 in 2016, 2015, and 2014, respectively.

The District's total operating revenue was only \$20.5 million in 2016 due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016.

Overview of the Financial Statements

The District's financial statements consist of a statement of net position; a statement of revenues, expenses, and changes in net position; and a statement of cash flows. These financial statements and related notes provide information about the activities of the District. The statement of net position includes all the District's assets, liabilities, and net position, as well as a detail of those assets available for general purposes and those restricted for a specific purpose. The statement of revenues, expenses, and changes in net position reports the revenues and expenses during the year. The statement of cash flows reports the cash provided by the District's operating activities, as well as other cash sources such as tax revenue, financing activities, and investment activities.

Organizational Structure

The District is a public hospital district and a municipal corporation formed under the provisions of Chapter 70.44 of the Revised Code of Washington ("RCW"). The District is located in the northeastern portion of the County. Arlington, the major city in the District, is located 20 miles northeast of Everett and 55 miles northeast of Seattle. The District serves an estimated population of approximately 60,000. The District is governed by a board of five publicly-elected commissioners.

Until June 1, 2016, the District operated Cascade Valley Hospital and Clinics, which included Cascade Valley Hospital (the "Hospital"). The Hospital is a licensed 48-bed facility located on a campus of approximately 17 acres in the city of Arlington, Washington. In addition to the Hospital, until June 1, 2016, the District also operated a freestanding surgery center (the Cascade Valley Arlington Surgery Center) and five medical clinics. As of June 1, 2016, the District leased the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington ("Skagit PHD No. 1"), which does business as Skagit Regional Health. The initial term of the lease is 30 years.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Organizational Structure (continued)

Description of the Agreement with Skagit PHD No. 1

In accordance with an affiliation agreement with Skagit PHD No. 1 (the "Affiliation Agreement"), which was dated December 2, 2015, Skagit PHD No.1 began operating the Hospital on June 1, 2016. The Affiliation Agreement is structured as a long-term lease (the "Lease") between the District and Skagit PHD No. 1. Pursuant to the Affiliation Agreement, the District leased substantially all of its assets, including the Hospital, certain other clinic facilities, the District's interest as lessor in certain land leases, and intangible assets, to Skagit PHD No. 1 for a term of 30 years. Skagit PHD No. 1 will pay the District an annual base rent of \$10.00 and is responsible for costs and expenses associated with the leased assets, including maintenance and capital improvements.

Financial Arrangement

Pursuant to the Affiliation Agreement, the District will transfer all of its cash and cash equivalents in excess of a retained amount to Skagit PHD No.1 by June 2017. The retained amount is equal to the District's known and contingent liabilities and debts plus a minimum cash balance of \$1,000,000. Thereafter, the District will continue to levy and collect excess and regular property tax levies, as well as collect revenues from a lease of a medical office building owned by Smokey Point LLC. Smokey Point LLC is owned 50% by the District and 50% by Skagit PHD No. 1. The Smokey Point LLC building is a two story, 40,000 square foot ambulatory center. Approximately one quarter of the space is leased to UW Medicine which operates a primary care physician practice and a maternal fetal medicine clinic. The rest of the building is leased to Skagit PHD No. 1, which operates an outpatient chemotherapy unit, an urgent care clinic, occupational medicine clinic and laboratory, and imaging services. The District's excess property tax levy funds will be used solely for the purpose of paying the debt service on the District's outstanding unlimited tax general obligation bonds. The proceeds from the District's regular property tax levy and the Smokey Point LLC lease will be used to pay the District's expenses, including the annual debt service on the District's outstanding limited tax general obligation bonds, and to fund the minimum cash balance of \$1,000,000. To the extent the amount collected by the District from its regular property tax levy and the Smokey Point LLC lease exceeds the District's existing obligations in any year, and the District's cash balance is equal to \$1,000,000, the excess funds will be transferred to Skagit PHD No. 1.

In accordance with the Affiliation Agreement, the transferred funds will be deposited in Pool A of the PHD No. 3 Support Fund (Pool A). The funds in Pool A will be used by Skagit PHD No. 1 to (1) support the provision of health care services rendered in Snohomish County; (2) pay for capital improvements and equipment located in Snohomish County; (3) pay for health information technology and other capital investments that may be located outside of Snohomish County if it serves both Skagit PHD No. 1 facilities and the Hospital facilities, provided that only that portion of the costs of such improvement and equipment that reasonably relate to the District's usage of the capital investment shall be allocated to the District; and (4) to cover any losses incurred by Skagit PHD No. 1 in the operation of Hospital services.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS

Organizational Structure (continued)

At the end of each fiscal year, Skagit PHD No. 1 will deposit into a special fund designated as Pool B of the PHD No. 3 Support Fund (Pool B) a portion of Skagit PHD No. 1's net cash flow generated from Skagit PHD No. 1's operations, calculated according to a formula set forth in the Affiliation Agreement, but in no case less than 1.5% of the annual net revenue generated by Skagit PHD No. 1's operation of the Hospital services still in operation, which will be calculated based on a three-year rolling average. The funds in Pool B may generally be used and expended by Skagit PHD No. 1 in the following order of priority: (1) to cover any Hospital operating losses, as defined in the Affiliation Agreement, to the extent the loss is not covered by any remaining funds in Pool A; (2) to reimburse Skagit PHD No. 1 for expenses incurred in prior years to cover such operating losses that were not reimbursed in prior years because there were insufficient funds in Pool A or Pool B; (3) to reimburse Skagit PHD No. 1 for expenses incurred by Skagit PHD No. 1 in prior years to fund capital improvements or equipment located at the Hospital facilities or for health information technology or other capital investments located elsewhere to the extent it serves both Skagit PHD No. 1 and Hospital facilities, but only for such portion that reasonably relates to the District's usage of the health information technology or other capital investment, to the extent that such expenses were not reimbursed in prior years because there were insufficient funds available in Pool A or Pool B; (4) to reimburse Skagit PHD No. 1 for expenses incurred by Skagit PHD No. 1 in the current year to fund Hospital capital improvements, as defined by the Affiliation Agreement; and (5) subject to certain limitations, for other expenditures that support the provision of health care services in Snohomish County.

Required Services

The Affiliation Agreement obligates Skagit PHD No. 1 to provide certain required services in North Snohomish County (identified by zip codes 98223, 98241, 98292, 98271, 98270, 98258, 98252) for 5-, 10-, and 30-year periods. Skagit PHD No. 1 has the right to determine the appropriate level of required services to meet the needs of the residents of North Snohomish County, such as the number of medical/surgical beds, ICU beds, observation beds, emergency department bays, operating rooms, procedure rooms, examination and treatment rooms, and staffing levels, provided it does so reasonably after appropriate evaluation and analysis of any impact a reduction in level of service may have on the residents of North Snohomish County.

During the five-year period following affiliation (the "Five-Year Period"), Skagit PHD No. 1 must provide OB/GYN, pediatric physician, and related Cascade Valley Hospital facilities services at any location within North Snohomish County, which Skagit PHD No. 1 reasonably believes will appropriately serve the needs of the residents of North Snohomish County. Skagit PHD No. 1 must, however, continue to provide or cause to be provided primary care services at the Darrington and Granite falls clinics during the Five-Year Period.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Organizational Structure (continued)

During the 10-year period following the affiliation (the "Ten-Year Period"), Skagit PHD No. 1 must provide inpatient and outpatient surgery, general inpatient acute services, and orthopedic general surgeons in North Snohomish County. In order to satisfy the Ten-Year Period commitment, Skagit PHD No. 1 is required to continuously maintain and operate the Hospital as a general acute care hospital duly licensed by the state of Washington and certified under the Medicare and Medicaid programs, with at least the following services: general inpatient acute services, inpatient surgery, a 24-hour emergency department, observation unit, ancillary medical services to the extent required to maintain state acute care hospital licensure, and an organized medical staff consisting, at a minimum, of primary care physicians, orthopedic surgeons, and general surgeons. Skagit PHD No. 1 is granted the right during the Ten-Year Period to modify or reduce the level of service provided at the Hospital provided: (1) it continues to provide an appropriate level of such services in North Snohomish County to meet the needs of residents; and (2) it has given notice to the District and allowed the District to provide input before said service is eliminated, relocated, modified, or reduced. Nonetheless, if Skagit PHD No. 1 elects to discontinue outpatient surgery services at the Hospital during the Ten-Year Period, Skagit PHD No. 1 must provide such services during the remainder of the Ten-Year Period at an alternative location within North Snohomish County at appropriate levels to meet the needs of residents.

During the 30-year period following affiliation, the District must provide a 24-hour emergency department, observation unit, ancillary medical services, and primary care physicians in North Snohomish County. After the Ten-Year Period, Skagit PHD No. 1 is entitled to relocate the required services that were subject to the Ten-Year Period commitment and that continue to be subject to the Thirty-Year period commitment to any location within North Snohomish County that it reasonably believes will appropriately meet the needs of the residents of North Snohomish County.

In the event that Skagit PHD No. 1 intends to eliminate, reduce, relocate, or change any required service in a manner not described above, it must give the District 90 days advance notice of such intent (the "Change Notice"). The Change Notice must include a detailed statement of the reasons for the intended action and must be accompanied by an analysis prepared by a qualified independent health care consultant analyzing the potential impact on the accessibility and availability of health care services for residents of North Snohomish County. The District is granted the right to determine, in its sole and absolute discretion, whether it will permit Skagit PHD No. 1 to proceed with the requested change. The District must notify Skagit PHD No. 1 within 90 days of receipt of the Change Notice whether it will permit or deny the requested change. If the District fails to respond in writing within 90 days of receipt of the Change Notice, the District will be deemed to have approved the proposed service change.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS

Organizational Structure (continued)

Termination and Unwinding

The Affiliation Agreement permits termination of the Affiliation Agreement and an unwinding of the affiliation upon the happening of certain conditions. The Affiliation Agreement may be terminated: (1) by mutual written consent of the District and Skagit PHD No. 1; (2) by either the District or Skagit PHD No. 1 in the event of an uncured breach of the Affiliation Agreement or the Lease by the other party; (3) by Skagit PHD No. 1 in the event that a catastrophic event occurs that was not caused by Skagit PHD No. 1 and makes it no longer viable to continue operating Hospital services as originally contemplated; (4) by either the District or Skagit PHD No. 1 if the District requires Skagit PHD No. 1 to purchase the leased facilities and assets as set forth in a certain provision of the Affiliation Agreement governing damages to the facilities related to Skagit PHD No. 1's negligence; and (5) after six years, by Skagit PHD No. 1, if Skagit PHD No. 1 has incurred sustained operating losses, as defined in the Affiliation Agreement, in the operation of Hospital services.

To effect an unwind, Skagit PHD No. 1 will transfer all of the facilities and assets owned by Skagit PHD No. 1 to the District following a process consistent with how they were originally transferred. In addition, Skagit PHD No. 1 will transfer to the District any remaining cash balance in Pool A or Pool B and will assign in part or grant sublicenses under any electronic health records software license, maintenance and support services agreements in effect at Hospital facilities immediately prior to termination.

All of the commitments by the District to provide any cash or similar support to Skagit PHD No. 1 will terminate after the date Skagit PHD No. 1 provides written notice of termination of the Affiliation Agreement or concurrent with the termination of the definitive agreements for any other reason; provided that the District will remain obligated to provide any cash or similar support on a pro rata basis for the applicable period of time prior to the notice of termination.

Volume and Statistics

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Inpatient admissions	602	1,543	1,598
Inpatient days	2,198	5,112	5,047
Outpatient observation patients	338	957	992
Emergency room visits	8,511	19,775	18,793
Surgery cases - hospital	627	1,766	1,690
Surgery cases - surgery center	226	514	538
Newborn deliveries	56	185	201
Hospital outpatient visits (excludes emergency)	10,203	27,123	25,169
Clinic visits	11,156	26,802	26,881
Full-time equivalent employees	285	323	317

**PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)**

Volume and Statistics (continued)

The increase in total admissions, emergency room visits, surgery cases, and outpatient visits from 2014 to 2015 was due to more people being insured effective January 1, 2014, due to The Patient Protection and Affordable Care Act of 2010.

The decrease in volumes from 2015 to 2016 is due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016.

Statements of Net Position

The following is a presentation of certain financial information derived from the District's statements of net position (amounts in thousands):

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Assets			
Cash and investments	\$ 12,301	\$ 23,773	\$ 21,104
Net accounts receivable	983	8,213	6,810
Other receivables	504	866	1,358
Assets limited as to use	6,313	7,094	6,878
Net capital assets	33,583	36,569	38,495
Other assets	<u>5,754</u>	<u>8,193</u>	<u>8,565</u>
Total assets	<u>59,438</u>	<u>84,708</u>	<u>83,210</u>
Deferred outflow of resources			
Deferred loss on refunding	<u>996</u>	<u>-</u>	<u>-</u>
Total assets and deferred outflow of resources	<u>\$ 60,434</u>	<u>\$ 84,708</u>	<u>\$ 83,210</u>
Liabilities			
Current liabilities	\$ 4,152	\$ 7,013	\$ 6,706
Long-term obligations, net of current portion	48,172	49,583	51,373
Estimated medical malpractice costs	-	297	297
Other liabilities	<u>17</u>	<u>21</u>	<u>24</u>
Total liabilities	<u>52,341</u>	<u>56,914</u>	<u>58,400</u>
Net position			
Net investment in capital assets	(4,152)	(2,070)	(1,414)
Restricted for debt service	1,175	1,997	1,818
Restricted for capital purchases	114	-	-
Unrestricted	<u>10,956</u>	<u>27,867</u>	<u>24,406</u>
Total net position	<u>8,093</u>	<u>27,794</u>	<u>24,810</u>
Total liabilities and net position	<u>\$ 60,434</u>	<u>\$ 84,708</u>	<u>\$ 83,210</u>

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS

Statements of Net Position (continued)

The decrease in cash from 2015 to 2016 was due to the excess cash that was transferred to Skagit PHD No. 1 in 2016 per the Affiliation Agreement that will be deposited in Pool A of the "PHD No. 3 Support Fund." Cash was also paid to Skagit PHD No. 1 for the value of the accrued paid time off for the employees that transferred employment from PHD No. 3 to Skagit PHD No. 1.

The increase in cash in 2015 from 2014 was due to the increase in patient volumes and the management of the operating expenses, even with the increase in volume.

The decrease in net patient accounts receivable from 2015 to 2016 was due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016.

Net patient accounts receivable increased by \$1,349,000 in 2015 from 2014 due to the ongoing implementation of the electronic medical record system for nursing documentation, dual coding requirements and the subsequent ICD-10 implementation, and some medical leave issues experienced by some coders.

The decrease in current liabilities from 2015 to 2016 is due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016.

The decrease in the long-term obligations in 2016 is due to the issuance of \$35,015,000 par value of Unlimited Tax General Obligation Refunding Bonds, 2016, to provide the funds with which to pay the cost of advance refunding the District's Unlimited Tax General Obligation Bonds, 2007, and paying the administrative costs of such refunding and the costs of issuance and sale of the bonds, as well as paying the annual payments on the 2010A and 2010B limited tax general obligation bonds.

The decrease in the long-term obligations in 2015 and 2014 is due primarily to the annual payments on the 2007 unlimited tax general obligation bonds and the 2010A and 2010B limited tax general obligation bonds.

The decrease in total net position from 2015 to 2016 was due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016. The majority of the change was from the accounting for the transfer of the excess cash that was transferred to Skagit PHD No. 1 in 2016 per the Affiliation Agreement that will be deposited in Pool A of the "PHD No. 3 Support Fund." The cash that was also paid to Skagit PHD No. 1 for the value of the accrued paid time off for the employees that transferred employment from PHD No. 3 to Skagit PHD No. 1 was part of the loss on transfer of assets for 2016.

**PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)**

Statements of Revenues, Expenses, and Changes in Net Position

The following is a summary of operations in 2016 compared with 2015 and 2014 (amounts in thousands):

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Operating revenue			
Gross patient service charges	\$ 52,738	\$ 126,925	\$ 109,861
Discounts, bad debts, and charity	(34,114)	(77,707)	(63,165)
Revenue from taxes for maintenance and operations	1,423	1,455	1,435
Cafeteria and other	<u>484</u>	<u>3,032</u>	<u>3,289</u>
Total operating revenue	<u>20,531</u>	<u>53,705</u>	<u>51,420</u>
Operating expenses			
Salaries and wages	10,682	24,995	24,785
Benefits	2,274	5,348	4,940
Purchased services	3,127	6,971	5,904
Supplies	2,747	6,417	6,068
Licenses and taxes	91	356	479
Other operating expenses	<u>6,235</u>	<u>7,965</u>	<u>8,306</u>
Total operating expenses	<u>25,156</u>	<u>52,052</u>	<u>50,482</u>
Operating income (loss)	(4,625)	1,653	938
Net nonoperating income	1,381	1,262	967
Donation for capital purchases	-	69	43
Loss on transfer of assets	<u>(16,457)</u>	<u>-</u>	<u>-</u>
Change in net position	(19,701)	2,984	1,948
Net position, beginning of year	<u>27,794</u>	<u>24,810</u>	<u>22,862</u>
Net position, end of year	<u>\$ 8,093</u>	<u>\$ 27,794</u>	<u>\$ 24,810</u>

**PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
MANAGEMENT'S DISCUSSION AND ANALYSIS**

Statements of Revenues, Expenses, and Changes in Net Position (continued)

The following is a breakdown of charges among the various operations of the District (amounts in thousands). Although there was no general price increase in 2016, selective departmental price increases were implemented during the year.

	2016	2015	2014
Gross patient service charges			
Hospital inpatient	\$ 15,164	\$ 36,383	\$ 34,582
Hospital outpatient	34,183	82,650	68,352
Surgery center	376	784	823
Clinics	3,016	7,108	6,104
	\$ 52,739	\$ 126,925	\$ 109,861
Hospital inpatient charges per inpatient day	\$ 6,899	\$ 7,117	\$ 6,852
Clinic charges per visit	270	265	227

The decrease in gross patient charges from 2015 to 2016 was due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016.

Hospital inpatient charges per inpatient day decreased by 3.1% in 2016, and increased by 3.7% in 2015, and 1.8% in 2014 due to the selective departmental price increases that were implemented in 2016, 2015, and 2014.

The increase in hospital outpatient charges in 2014 through 2016 was due to the increase in volume in the emergency room and other outpatient services and the selective rate increase that was implemented during those years.

Discounts, bad debts, and charity for the District as a percentage of gross patient charges were 57.5% for 2014, 61.2% for 2015 and then increased to 64.7% in 2016.

Effective July 1, 2005, the State Medical Assistance Administration implemented a new payment methodology for Medicaid inpatient hospital claims and the payment for uncompensated care, titled Certified Public Expenditures (CPE) Program. Although the state's intent in administering the program was that the net payments to the District remain unchanged, the District has recorded a liability of \$919,000 in 2016 related to estimated overpayments.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Statements of Revenues, Expenses, and Changes in Net Position (continued)

The decrease in operating expenses from 2015 to 2016 was due to the District leasing the Hospital and its clinics to Public Hospital District No. 1, Skagit County, Washington, per the terms of the Affiliation Agreement effective June 1, 2016.

Salaries remained flat from 2014 to 2015. Any wage increases have been offset by managing overtime for staff and relatively low staff turnover. The cost of benefits as a percentage of salaries and wages was 19.9% in 2014, which increased to 21.4% in 2015, and then decreased slightly to 21.3% in 2016. The reason for the decrease in 2014 was due to a significant reduction in the unemployment expense due to receiving a \$283,000 dividend from the Public Hospital District Unemployment Trust.

Purchased services increased by \$1,067,000, or 18.1%, in 2015 due to the increased outside registry used to fill staffing needs and for two projects that utilized outside consulting services.

The 5.8% increase in supplies from 2014 to 2015 is due to the increase in supply costs due to the increase in hospital surgeries, and the increase in supply costs for laboratory tests and pharmaceutical supply costs.

Licenses and taxes consist primarily of Washington State Business and Occupation taxes.

Net nonoperating income includes interest income on the various cash and investment accounts, gain or loss on disposal of assets, bond amortization, the tax income and interest expense associated with the unlimited tax general obligation bonds, and the gain and/or loss from the joint venture clinic with Skagit County Public Hospital District No. 1.

The major change in the increase in net nonoperating income of \$119,000 in 2016 and \$295,000 in 2015 was due to the 50% share of the expense from the Cascade Skagit Health Alliance Clinic, which was a loss of \$123,000, compared with the loss for 2015 and 2014, which was \$585,000 and \$740,000, respectively. This expense is partially offset by the 50% share of the income from the investment in Smokey Point Medical Center, LLC, which was \$205,000 in 2016, \$270,000 in 2015, and \$237,000 in 2014. Additionally, there were approximately \$400,000 of expenses incurred related to the 2016 bond issuance.

Another change in net position was the loss on transfer of assets to Skagit PHD No. 1. of \$16.5 million in 2016 per the Affiliation Agreement for the assets that were deposited in Pool A of the "PHD No. 3 Support Fund" and for the cash collected on the patient accounts receivable generated prior to June 1, 2016. The cash that was also paid to Skagit PHD No. 1 for the value of the accrued paid time off for the employees that transferred employment from PHD No. 3 to Skagit PHD No. 1 was part of the loss on transfer of assets for 2016.

**PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
MANAGEMENT'S DISCUSSION AND ANALYSIS**

Statements of Cash Flows

The following is a summary of 2016 compared with 2015 and 2014 (amounts in thousands):

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Cash flows from operating activities	\$ 3,249	\$ 3,995	\$ 4,952
Net cash from noncapital financing activities	1,421	1,459	1,440
Net cash from capital and related financing activities	(17,618)	(3,541)	(2,358)
Net cash from investing activities	<u>691</u>	<u>981</u>	<u>924</u>
Net change in cash and cash equivalents	<u>\$ (12,257)</u>	<u>\$ 2,894</u>	<u>\$ 4,958</u>

The reason for the large decrease in net cash from capital and related financing activities in 2016 is due to the transfer of the excess cash that was transferred to Skagit PHD No. 1 in 2016 per the Affiliation Agreement that will be deposited in Pool A of the "PHD No. 3 Support Fund." The cash that was also paid to Skagit PHD No. 1 for the value of the accrued paid time off for the employees that transferred employment from PHD No. 3 to Skagit PHD No. 1 was part of the loss on transfer of assets for 2016.

Capital Assets

Capital assets purchased during the first five months of 2016 totaled \$793,000. All of the capital assets purchased were for the replacement and/or upgrade of existing medical equipment.

Capital assets purchased during 2015 totaled \$2,012,062. All of the capital assets purchased were for the replacement and/or upgrade of existing medical equipment.

Capital assets purchased during 2014 totaled \$639,000. Only \$70,000 was expended for the hospital EHR project. The amount expended for the replacement and/or upgrade of existing medical equipment was \$569,000.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Debt

Total long-term debt, as of the end of 2016, is \$49,966,000, compared with \$51,328,000 in 2015.

In 2016, new debt of \$35,015,000 in the form of Unlimited Tax General Obligation Refunding Bonds, 2016, was issued to provide the funds with which to pay the cost of advance refunding the District's Unlimited Tax General Obligation Bonds, 2007, and paying the administrative costs of such refunding and the costs of issuance and sale of the bonds.

In 2010, new debt of \$2,030,000 in the form of limited tax general obligation and refunding bonds, Series 2010A (federally tax exempt), was issued to retire the 2000 limited tax general obligation bonds. The remaining amount at the end of 2016 is \$318,000.

Also in 2010, new debt of \$12,180,000 in the form of limited tax general obligation bonds, Series 2010B (federally taxable Build America Bonds), was issued for the purpose of constructing and operating Cascade Skagit Health Alliance Clinic. The amount of debt remaining at the end of 2016 is \$11,910,000.

Four capital leases were also entered into in 2010 for medical equipment. They were for a CAT scanner (\$785,000), a chemistry analyzer (\$128,000), a second chemistry analyzer (\$88,000), and a microbiology analyzer (\$54,000). All four capital leases were paid off in 2015.

New debt was issued in 2007 for the hospital expansion and renovation project. This debt was in the form of unlimited tax general obligation bonds and was advanced refunded in November 2016 with the issuance of the 2016 unlimited tax general obligation refunding bonds.

The District in 2017 and Beyond

The District will continue to levy and collect its regular tax levy and its portion of the rental income on the Smokey Point LLC building co-owned with Skagit PHD No. 1. In addition, the District receives the subsidy on its 2010B Bonds. These items are recorded as income.

The District will use this income to pay its operating expenses and to make the principal and interest payments on the 2010 Limited Tax General Obligation Bonds. Operating expenses, bond interest and depreciation expense on the buildings and equipment owned by the District and leased to Skagit PHD No. 1 are recorded as expenses.

The District will maintain a minimum cash balance of \$1,000,000 plus an amount sufficient to pay operating expenses plus principal and interest on bonds payments for the coming year. All cash in excess of those amounts is transferred to Skagit PHD No. 1 to be used for Cascade Valley Hospital and Clinic expenses.

In addition, the District will levy annually and collect property taxes in a sufficient amount to make principal and interest payments on the Bonds. These transactions will be recorded on the District's books as separate line items.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON MANAGEMENT'S DISCUSSION AND ANALYSIS

The District in 2017 and Beyond (continued)

Now that the operations of Cascade Valley Hospital and Clinics have transitioned to Skagit Regional Health, Public Hospital District No. 3, Snohomish County, has primarily become a landlord and is evaluating the potential of offering other medical services within Snohomish County as defined and allowed in the Affiliation Agreement.

Contacting the District

This financial report is designed to provide patients, taxpayers, and creditors with a general overview of the District's finances. If you have questions or need additional financial information, contact the District's Chief Financial Officer at Public Hospital District No. 3, 875 Wesley Street, Suite 240, Arlington, WA 98223.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
STATEMENTS OF NET POSITION

ASSETS AND DEFERRED OUTFLOW OF RESOURCES

	December 31,	
	<u>2016</u>	<u>2015</u>
CURRENT ASSETS		
Cash	\$ 1,029,039	\$ 1,511,883
Short-term investments	11,272,450	22,261,183
Patient accounts receivable, net of estimated uncollectibles of \$40,000 in 2016 and \$1,555,000 in 2015	927,392	8,158,882
Other receivables	504,271	866,585
Taxes receivable from tax levies for maintenance and operations	55,138	54,007
Supplies inventory	-	1,216,979
Prepaid expenses and other assets	10,804	936,433
Assets limited as to use required for current liabilities	<u>1,043,369</u>	<u>1,445,081</u>
Total current assets	14,842,463	36,451,033
 ASSETS LIMITED AS TO USE, net of amounts required for current liabilities	 5,269,463	 5,648,912
 CAPITAL ASSETS		
Land	333,947	333,947
Construction in progress	-	137,556
Depreciable capital assets, net of accumulated depreciation	33,248,812	36,097,990
 INVESTMENT IN JOINT VENTURE	 <u>5,742,835</u>	 <u>6,038,239</u>
Total assets	59,437,520	84,707,677
 DEFERRED OUTFLOW OF RESOURCES		
Deferred loss on refunding	<u>996,076</u>	<u>-</u>
Total assets and deferred outflow of resources	<u><u>\$ 60,433,596</u></u>	<u><u>\$ 84,707,677</u></u>

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
STATEMENTS OF NET POSITION

LIABILITIES AND NET POSITION

	December 31,	
	2016	2015
CURRENT LIABILITIES		
Accounts payable	\$ 285,877	\$ 1,587,423
Accrued liabilities		
Wages and benefits	43,717	2,425,585
Interest	176,431	213,961
Other	1,261,857	518,965
Estimated third-party payor settlements	589,336	521,702
Current portion of long-term debt obligations	1,795,000	1,745,000
Total current liabilities	4,152,218	7,012,636
LONG-TERM DEBT OBLIGATIONS, net of current portion	48,171,338	49,583,065
ESTIMATED MEDICAL MALPRACTICE COSTS	-	296,668
RENT PAYABLE	16,658	20,825
Total liabilities	52,340,214	56,913,194
NET POSITION		
Net investment in capital assets	(4,151,999)	(2,069,644)
Restricted for		
Debt service	1,174,703	1,996,962
Capital projects	113,899	-
Unrestricted	10,956,779	27,867,165
Total net position	8,093,382	27,794,483
Total liabilities and net position	\$ 60,433,596	\$ 84,707,677

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION

	Years Ended December 31,	
	2016	2015
OPERATING REVENUES		
Net patient service revenue (net of provision for bad debts of \$1,482,598 in 2016 and \$4,246,012 in 2015)	\$ 18,624,586	\$ 49,217,871
Revenue from tax levies for maintenance and operations	1,422,589	1,455,343
Cafeteria and other revenue	483,866	3,032,474
Total operating revenues	20,531,041	53,705,688
OPERATING EXPENSES		
Salaries and wages	10,681,826	24,995,461
Employee benefits	2,273,505	5,347,791
Purchased services	3,126,870	6,970,913
Professional fees	665,178	921,892
Supplies	2,747,472	6,416,860
Utilities	331,113	735,279
Leases and rentals	268,774	606,007
Other direct expenses	202,913	445,978
Licenses and taxes	91,054	356,294
Insurance	283,727	600,086
Depreciation and amortization	3,780,137	3,937,573
Interest	703,991	717,499
Total operating expenses	25,156,560	52,051,633
Operating income (loss)	(4,625,519)	1,654,055
NONOPERATING INCOME (EXPENSE)		
Revenue from tax levies for general obligation bonds	3,233,637	3,279,295
Interest income	191,127	171,121
Interest expense for general obligation bonds	(1,734,739)	(1,880,718)
Other income (expense)	(390,109)	6,472
Refundable grant expense	(123,211)	(584,574)
Income from investment in Smokey Point Medical Center, LLC	204,596	270,350
Net nonoperating income	1,381,301	1,261,946
EXCESS OF REVENUE OVER EXPENSES BEFORE DONATIONS FOR CAPITAL PURCHASES AND TRANSFERS	(3,244,218)	2,916,001
DONATIONS FOR CAPITAL PURCHASES	-	68,547
LOSS ON TRANSFER OF ASSETS	(16,456,883)	-
CHANGE IN NET POSITION	(19,701,101)	2,984,548
NET POSITION, beginning of year	27,794,483	24,809,935
NET POSITION, end of year	\$ 8,093,382	\$ 27,794,483

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
STATEMENTS OF CASH FLOWS

Increase (Decrease) in Cash and Cash Equivalents

	Years Ended December 31,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from and on behalf of patients	\$ 25,923,710	\$ 48,354,753
Payments to suppliers and contractors	(8,179,874)	(17,077,136)
Payments to employees and vendors	(15,337,199)	(30,311,022)
Other receipts and payments, net	842,013	3,028,307
Net cash from operating activities	3,248,650	3,994,902
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Cash from tax levies considered a noncapital financing activity	1,421,458	1,458,720
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of capital assets	(793,403)	(2,012,062)
Principal payments on long-term debt obligations	(1,705,000)	(1,642,150)
Interest payments on long-term obligations	(1,730,920)	(2,649,894)
Proceeds from issuance of general obligation bonds	35,015,000	-
Proceeds from bond premium	4,009,113	-
Escrow payment for refunding of general obligation bonds	(40,422,256)	-
Cash paid for bond issuance costs	(418,520)	-
Cash from tax levies for general obligation bonds	3,229,446	3,287,745
Donations for capital purchases	-	68,547
Refundable grant payment	(123,211)	(599,903)
Cash paid in transfer of assets	(14,706,824)	-
Other	28,411	6,470
Net cash from capital and related financing activities	(17,618,164)	(3,541,247)
CASH FLOWS FROM INVESTING ACTIVITIES		
Distribution from joint venture	500,000	810,000
Interest received	191,127	171,121
Net cash from investing activities	691,127	981,121
NET CHANGE IN CASH AND CASH EQUIVALENTS	(12,256,929)	2,893,496
CASH AND CASH EQUIVALENTS, beginning of year	30,739,916	27,846,420
CASH AND CASH EQUIVALENTS, end of year	\$ 18,482,987	\$ 30,739,916
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE STATEMENTS OF NET POSITION		
Cash	\$ 1,029,039	\$ 1,511,883
Short-term investments considered cash equivalents	11,272,450	22,261,183
Assets limited as to use considered cash equivalents	6,181,498	6,966,850
Total cash and cash equivalents	\$ 18,482,987	\$ 30,739,916

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
STATEMENTS OF CASH FLOWS (continued)

Increase (Decrease) in Cash and Cash Equivalents

	<u>Years Ended December 31,</u>	
	<u>2016</u>	<u>2015</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH		
FROM OPERATING ACTIVITIES		
Operating income (loss)	\$ (4,625,519)	\$ 1,654,055
Adjustments to reconcile operating income to net cash		
from operating activities		
Interest expense considered a capital financing activity	703,991	717,499
Revenue from tax levies considered a noncapital		
financing activity	(1,422,589)	(1,455,343)
Depreciation and amortization	3,780,137	3,937,573
Change in assets and liabilities		
Patient accounts receivable	7,231,490	(1,349,117)
Other receivables	362,314	434,796
Supplies inventory, prepaid expenses, and other assets	392,549	(151,182)
Accounts payable	(1,301,546)	(43,763)
Estimated third-party payor settlements	67,634	51,203
Accrued liabilities, estimated malpractice costs,		
and rent payable	<u>(1,939,811)</u>	<u>199,181</u>
NET CASH FROM OPERATING ACTIVITIES	<u>\$ 3,248,650</u>	<u>\$ 3,994,902</u>

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON

NOTES TO FINANCIAL STATEMENTS

Note 1 - Organization

Public Hospital District No. 3, Snohomish County, Washington (the District), serving Arlington, Washington, and surrounding communities, is organized as a municipal corporation pursuant to the laws of the state of Washington. The District delivers health care services to the community through seven operating divisions and an administrative division. Cascade Valley Hospital (the Hospital) is a licensed 48-bed acute-care hospital facility. Cascade Valley Surgery Center is an ambulatory surgery center located near the Hospital campus. The District also operates five medical clinics providing women's health services, orthopedic services, and primary care to the community. In March 2012, the District and Public Hospital District No. 1 of Skagit County, Washington, which operates Skagit Regional Health (PHD No. 1), began joint operations of the Cascade Skagit Health Alliance (CSHA), a department of PHD No. 1. The providers at the facility offer primary and specialty care including family medicine, internal medicine, urgent care, pediatrics, occupational medicine, and women's health. The facility also has lab and imaging services. The two districts entered into a refundable grant agreement to fund operations until patient volumes are at a profitable level. The majority of the District's patients are geographically concentrated in North Snohomish County.

On April 6, 2015, the District approved a letter of intent with UW Medicine and PHD No. 1 to proceed with negotiations around a long-term alliance with PHD No. 1 with respect to clinical and other ventures and a lease of the District's health care facilities by the PHD No. 1. The three parties approved the UW Medicine Affiliation Agreement (UW Affiliation Agreement) on May 29, 2015.

Pursuant to the UW Affiliation Agreement, UW Medicine will serve as PHD No. 1's and the District's complex tertiary and quaternary health system for specialty care services not available in mutually designated communities and provided by UW Medicine. UW Medicine will be available as a resource for these services and is committed to providing rapid and efficient access to advanced medical care that could not otherwise be provided locally.

The District and PHD No. 1 also entered into an Affiliation Agreement Regarding the Lease and Operation of the District Hospital (the District), dated December 4, 2015 (the Affiliation Agreement). In accordance with the Affiliation Agreement, PHD No. 1 began operating the District on June 1, 2016. The Affiliation Agreement is structured as a long-term lease (the Lease) between PHD No. 1 and the District. PHD No. 1 leased substantially all of its assets, certain other clinic facilities, the District's interest as lessor in certain leases, and intangible assets to PHD No. 1 for a term of 30 years. PHD No. 1 will pay the District an annual base rent of \$10 and is responsible for all costs and expenses associated with the leased assets, including maintenance and capital improvements.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON

NOTES TO FINANCIAL STATEMENTS

Note 1 - Organization (continued)

Pursuant to the Affiliation Agreement, the District will transfer all of its cash and cash equivalents in excess of a retained amount to PHD No. 1 by June 2017. The retained amount is equal to the District's known and contingent liabilities and debts plus a minimum cash balance of \$1,000,000. Thereafter, the District will continue to levy and collect excess and regular property tax levies, as well collect revenues from a lease of a medical office building owned by Smokey Point LLC. Smokey Point LLC is owned 50% by the District and 50% by PHD No. 1. The proceeds from the District's regular property tax levy and the Smokey Point LLC lease will be used to pay the District's expenses, including the annual debt service on outstanding limited tax general obligations, and to fund the minimum cash balance of \$1,000,000. To the extent the amount collected by the District from its regular property tax levy and the Smokey Point LLC lease exceeds the District's existing obligations in any year, and the District cash balance is equal to \$1,000,000, the excess funds will be transferred to PHD No. 1 annually. Cash transferred by the District to PHD No. 1 during 2016 was \$14,706,824. Prepaid assets of \$474,637 and inventory of \$1,275,422 were also transferred, which resulted in a loss on transfer of assets of \$16,456,883. Due to the transfer of operations, 2016 expenses related to its hospital and clinic operations totaling approximately \$20,500,000 will no longer be incurred; and 2016 revenues associated with the Hospital and clinic operations totaling approximately \$18,900,000 will no longer be received.

The Affiliation Agreement provides provisions for certain operating commitments and specific provisions in event the agreement is discontinued.

Subsequent to year end, the District paid \$2,000,000 of the annual excess cash and cash equivalents in excess of the retained amount calculated at \$4,300,000 as pursuant to the Affiliation Agreement.

Note 2 - Summary of Significant Accounting Policies

Accounting standards - The District reports its financial information in a form that complies with the pronouncements of the Governmental Accounting Standards Board (GASB).

Accrual basis - The accompanying financial statements have been prepared on the accrual basis of accounting using the economic resources measurement focus. Under this method of accounting, revenues are recognized when earned and expenses are recorded when liabilities are incurred without regard to receipts or disbursement of cash.

Use of estimates - The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America 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.

Cash and cash equivalents - The District defines cash on deposit, investments in the local government investment pool (LGIP) included in short-term investments and assets limited as to use, and other highly liquid investments with initial maturity periods of three months or less to be cash and cash equivalents for purposes of the statements of cash flows.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 2 - Summary of Significant Accounting Policies (continued)

Patient accounts receivable - Receivables arising from revenue for services to patients are reduced by an allowance for estimated uncollectible amounts based on past experience and other circumstances, which may affect the ability of patients to meet their obligations. Accounts deemed uncollectible are charged against this allowance.

Supplies inventory - Inventories of medicine and hospital supplies are valued at the lower of cost, determined on a first-in, first-out basis, or net realizable value.

Assets limited as to use and short-term investments - Assets limited as to use and investments include assets set aside by the Board of Commissioners for future capital improvements, other uses over which the Board retains control, and bond funds. The Snohomish County Treasurer is the ex-officio treasurer of the District. Excess cash is invested in certificates of deposit, a county investment pool, or a state government investment pool. Cash and pooled investments are covered by the Federal Deposit Insurance Corporation (FDIC) or by collateral held in a multiple financial institution collateral pool administered by the Washington Public Deposit Protection Commission (PDPC).

Amounts required to meet current liabilities have been classified as current assets in the accompanying statements of net position.

Capital assets - Capital asset acquisitions are recorded at cost. Donated assets are recorded at fair market value at the date of contribution, which is thereafter treated as cost. Depreciation is provided over the estimated useful lives of the assets using the straight-line method as follows:

Land improvements	5 - 12 years
Buildings	10 - 31 years
Fixed equipment	5 - 20 years
Movable equipment	3 - 20 years

Expenditures for maintenance and repairs are charged to operations as incurred. Betterments and major renewals are capitalized. Expenditures that materially increase value, change capacities, or extend useful lives of buildings and equipment are capitalized. The District's capitalization policy is \$1,000 and a useful life of three years.

Interest on borrowed funds less any interest earned on temporarily invested funds is capitalized on construction projects as a cost of the related project from the date of borrowing until the construction period ends and the related asset is placed in service. Capitalized interest is depreciated over the life of the related asset.

Investment in joint venture - The District has an investment in a joint venture that provides health care services (Note 7). The District accounts for this investment using the equity method, under which its share of net income is reported in nonoperating income.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON

NOTES TO FINANCIAL STATEMENTS

Note 2 - Summary of Significant Accounting Policies (continued)

Estimated medical malpractice costs - The District has purchased claims-made liability insurance coverage that covers only asserted malpractice claims. The District recognizes expenses associated with reported claims, and estimated claims incurred but not reported, in the period in which the incidents are estimated to have occurred rather than when a claim is asserted. Expenses associated with these incidents are based on assumptions of settlement costs.

Restricted resources - When the District has both restricted and unrestricted resources available to finance a particular program, it is the District's policy to use restricted resources before unrestricted resources.

Net position - Net position of the District is classified into three components. The *net investment in capital assets* component of net position consists of capital assets, net of accumulated depreciation, reduced by outstanding balances of the related debt that is attributable to the acquisition, construction, or improvement of those assets. The *restricted* component of net position represents noncapital assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the District, including amounts deposited with the county treasurer as required by bond indentures. The *unrestricted* component of net position is the remaining net amount of assets and liabilities that is not included in the determination of net investment in capital assets or the restricted component of net position.

Operating revenues and expenses - The District's statements of revenues, expenses, and changes in net position distinguish between operating and nonoperating revenues and expenses. Operating revenues primarily result from exchange transactions associated with providing health care services, the District's principal activity prior to the Affiliation Agreement. Nonexchange revenues, including taxes, grants, and contributions received for purposes other than capital asset acquisition, are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, other than financing costs paid by specific tax proceeds.

Property taxes are levied by the county on the District's behalf and are intended to finance the District's activities of the same calendar year. Amounts levied are based on assessed property values. Tax levy proceeds used to fund operating costs of the District are reported as operating revenue. Tax levy proceeds pledged for repayment of general obligation bonds are reported as nonoperating income.

Net patient service revenue - The District has agreements with third-party payors that provide for payments to the District at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

When reimbursement settlements are received, or when information becomes available regarding changes in recorded reimbursement, variations from amounts previously established as preliminary settlements are accounted for as a contractual adjustment in the period the settlements are received, or when information regarding reimbursement changes becomes available.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 2 - Summary of Significant Accounting Policies (continued)

Charity care - The District provides care to patients who meet certain criteria under its charity care policy, without charge or at amounts less than its established rates. Because the District does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Charges forgone, based on established rates, for charity care were \$363,638 and \$557,387 during 2016 and 2015, respectively.

Federal income tax - No provision has been made for federal income taxes, because the District is a municipal corporation and is exempt from federal income tax.

New accounting pronouncements - In February 2015, the GASB issued Statement No. 72, *Fair Value Measurement and Application*, which is effective for the year ending December 31, 2016. The statement provides guidance for determining the fair value measurement for financial reporting purposes. This statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. This Statement established a three level hierarchy of inputs to valuation techniques used to measure fair value and requires disclosures to be made about fair value measurements, the level of fair value hierarchy, and valuation techniques. The District adopted this statement for the year ended December 31, 2016.

In December 2015, the GASB issued Statement No. 79, *Certain External Investment Pools and Pool Participants*. This statement addresses accounting and financial reporting for certain external investment pools and pool participants. Specifically, it establishes criteria for an external investment pool to qualify for making the election to measure all of its investments at amortized cost for financial reporting purposes. An external investment pool qualifies for that reporting if it meets all of the applicable criteria established in this statement. The specific criteria address (1) how the external investment pool transacts with participants; (2) requirements for portfolio maturity, quality, diversification, and liquidity; and (3) calculation and requirements of a shadow price. Significant noncompliance prevents the external investment pool from measuring all of its investments at amortized cost for financial reporting purposes. Professional judgment is required to determine if instances of noncompliance with the criteria established by this statement during the reporting period, individually or in the aggregate, were significant. This guidance is effective for the District in the year ended December 31, 2016. The District has reviewed and evaluated this statement and has determined there is no material impact to the financial statements for the year ended December 31, 2016.

Fair value measurements - The District categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; and Level 3 inputs are significant unobservable inputs. The District has no investments measured at fair value at December 31, 2016.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON

NOTES TO FINANCIAL STATEMENTS

Note 2 - Summary of Significant Accounting Policies (continued)

Subsequent events - Subsequent events are events or transactions that occur after the statement of net position date but before financial statements are available to be issued. The District recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the statement of net position, including the estimates inherent in the process of preparing the financial statements. The District's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the statement of net position but arose after the statement of net position date and before the financial statements are available to be issued.

The District has evaluated subsequent events through June 29, 2017, which is the date the financial statements are available to be issued.

Note 3 - Patient Service Revenue

The District has arrangements with third-party payors that provide for payments to the District at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

Medicare - Inpatient acute-care services rendered to Medicare program beneficiaries are paid at predetermined, specific rates for each hospital discharge. Discharges are classified according to a list of diagnosis-related groups (DRGs). Each DRG has a payment weight assigned to it, based on the average resources used to treat Medicare patients in that DRG. The District's classification of DRGs and the appropriateness of their admission are subject to an independent review by a peer review organization. Outpatient services to Medicare beneficiaries are paid prospectively based on ambulatory payment classifications (APCs). The District's cost reports have been reviewed and/or audited by the Medicare fiscal intermediary through 2014. Net revenue under the Medicare program totaled \$6,335,581 and \$14,747,752 for 2016 and 2015, respectively. Net unsecured patient accounts receivable due from Medicare were \$205,466 and \$1,672,774 at December 31, 2016 and 2015, respectively.

Medicaid - Beginning July 1, 2005, a new inpatient Medicaid reimbursement methodology, called Certified Public Expenditures (CPE), was implemented for all noncritical access Washington State governmental hospitals. Under this program, the District is paid for inpatient Medicaid services based on costs including certain costs of uncompensated care. The estimated costs for inpatient care are calculated as a ratio of cost to charges from a base year (two years before the service year). Under the program, the District will be reimbursed the higher of the full cost of service or "baseline" reimbursement that would have been received based on the pre-July 1, 2005, inpatient payment system. Final settlements related to CPE have been received by the District through the Washington State fiscal year ended 2008. As of December 31, 2016 and 2015, the District has recorded a payable of approximately \$919,000 and \$375,000 for estimated overpayments, which is included in other accrued liabilities. Outpatient services are paid on a percentage of allowed charges based on a ratio of the District's operating expenses to total revenue for outpatient services. Net revenue under the Medicaid program totaled \$2,752,616 and \$9,332,378 for 2016 and 2015, respectively. Net unsecured patient accounts receivable due from Medicaid were \$38,736 and \$1,072,928 at December 31, 2016 and 2015, respectively.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 3 - Patient Service Revenue (continued)

The District's estimates of final settlements to or from Medicare and Medicaid have been recorded in the accompanying statements of net position. 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. Differences between the net amounts accrued and subsequent settlements are recorded in operations at the time of settlement.

Other third-party payors - The District has agreements with other third-party payors that reimburse the District under various payment arrangements. The basis for payment to the District under these agreements includes per diem payments, prospectively determined rates, and discounts from established charges.

The following are the components of net patient service revenue for the years ended December 31:

	2016	2015
Gross patient service charges	\$ 52,739,016	\$ 126,924,953
Adjustments to patient service charges		
Contractual discounts	32,268,194	72,903,683
Provision for bad debts	1,482,598	4,246,012
Charity care	363,638	557,387
	34,114,430	77,707,082
Net patient service revenue	\$ 18,624,586	\$ 49,217,871

Note 4 - Deposits, Investments, and Assets Limited as to Use

Under resolution, the Hospital pledges to levy taxes annually in an amount sufficient to pay the principal of and interest on the unlimited tax general obligation bonds. Upon collection, the funds are to be deposited in the bond fund. In addition, the Board of Commissioners has internally designated remaining assets to provide benefit to the community.

The District makes investments in accordance with Washington State law. Eligible investments include obligations secured by the U.S. Treasury, other obligations of the United States or its agencies, certificates of deposit with approved institutions, insured money market funds, commercial paper, registered warrants of local municipalities, the Washington State Local Government Investment Pool, eligible bankers' acceptances, and repurchase agreements (up to 30 days).

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 4 - Deposits, Investments, and Assets Limited as to Use (continued)

As a political subdivision of the state, the District categorizes deposits and investments to give an indication of the risk assumed at year-end. Category 1 includes deposits and investments that are insured, registered, or held by the District's agent in the District's name. Category 2 includes uninsured and unregistered investments that are held by the broker's or dealer's trust department or agent in the District's name. Category 3 includes uninsured and unregistered deposits and investments for which the securities are held by the broker or dealer, or its trust department or agent, but not in the District's name.

At December 31, 2016 and 2015, all deposits and investments of the District are categorized as Category 1 and consist of the following:

	<u>2016</u>	<u>2015</u>
Unrestricted cash	<u>\$ 1,029,039</u>	<u>\$ 1,511,883</u>
Short-term investments		
Investment in LGIP	<u>11,272,450</u>	<u>22,261,183</u>
Assets whose use is limited		
Restricted for investment in joint venture		
Investment in LGIP	5,138,129	5,097,031
Restricted bond fund		
Investment in LGIP	1,043,369	1,869,819
Taxes receivable	<u>131,334</u>	<u>127,143</u>
	<u>6,312,832</u>	<u>7,093,993</u>
Total deposits and investments	<u>\$ 18,614,321</u>	<u>\$ 30,867,059</u>

The District participates in the Washington State Local Government Pool and Snohomish County Investment Pools (LGIP). The Office of the State Treasurer of Washington (OST) manages and operates the LGIP. Participation by local governments is voluntary. The investment policies of the LGIP are the responsibility of the OST, and any proposed changes are reviewed by the LGIP Advisory Committee. The LGIP is comparable to a Rule 2a-7 money market fund recognized by the Securities and Exchange Commission (17 CFR 270.2a-7). Rule 2a-7 funds are limited to high-quality obligations with limited maximum and average maturities, the effect of which is to minimize both market and credit risk. The objectives of the State Treasurer's investment practices for the LGIP, in priority order, will be safety, liquidity, and return on investment. Separate financial statements for the LGIP are available from the OST. The LGIP is not subject to risk evaluation.

Credit risk - Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The District's investment policy limits the types of securities to those authorized by statute; therefore, credit risk is very limited. Obligations of the U.S. government and agencies are not considered to have credit risk.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 4 - Deposits, Investments, and Assets Limited as to Use (continued)

Deposits - All of the District's deposits are either insured or collateralized. The District's insured deposits are covered by the FDIC. Collateral protection is provided by the PDPC.

Custodial credit risk - Custodial credit risk is the risk that, in the event of a failure of the counterparty, the District will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. All U.S. government securities are held by the District's safekeeping custodian acting as an independent third party and carry no custodial credit risk.

Concentration of credit risk - Concentration of credit risk is the risk of loss attributed to the magnitude of the District's investment in a single issuer. The District mitigates credit risk by limiting the percentage of the portfolio invested with any one issuer.

Interest rate risk - Interest rate risk is the risk that changes in interest rates of debt instruments will adversely affect the fair value of an investment. The District manages interest rate risk by having policy limitations on the maximum maturity of any one security to less than 36 months from settlement date to maturity date unless matched to a specific cash flow requirement.

Note 5 - Deferred Compensation and Pension Plans

The District has a deferred compensation plan and pension plans created in accordance with Internal Revenue Code §457, §401(a), and §414(h). The plans are available to eligible employees and collectively provide for District matching contributions of a maximum of 7% of the employee's gross compensation earned in the prior year. Current District policy is to fund contributions. Plan provisions and contribution requirements are established by the District and may be amended by the District's Board of Commissioners.

Under the §401(a) plan, the District contributes up to 7% of the employee's eligible compensation as long as the employee contributes a minimum of 4%. The District contributes up to 7%, not to exceed the maximum federal amount for the year. Employees are not allowed to contribute to the §401(a) plan. All employee contributions are made to the §457(b) plan.

The §457(b) plan is available to eligible employees and permits them to defer a portion of their salary until withdrawn in future years. The deferred compensation is not available to employees until termination, retirement, death, or an unforeseeable emergency.

The §414(h) plan allows a limited group of employees to make an irrevocable election prior to the beginning of the plan year. The maximum contribution is the §415 limit minus any employer §401(a) contributions. These pick-up contributions are completely voluntary and are in addition to any District contributions made to the §401(a) plan and any contributions that are made to the §457(b) deferred compensation plan. Generally, the benefits may only be distributed at termination of employment or death.

The District's contributions to the employee plans totaled approximately \$893,000 in 2016 and \$1,626,000 in 2015. Contributions made by employees to the benefit plans totaled approximately \$529,000 in 2016 and \$998,000 in 2015. For more information on the plans, contact the District's human resources office.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 6 - Capital Assets

The schedule of capital asset activity for the years ended December 31, 2016 and 2015, was as follows:

	Beginning Balance January 1, 2016	Additions	Retirements	Account Transfers	Ending Balance December 31, 2016
ASSETS AT COST					
NONDEPRECIABLE					
CAPITAL ASSETS					
Land	\$ 333,947	\$ -	\$ -	\$ -	\$ 333,947
Construction in progress	137,556	143,668	-	(281,224)	-
Total nondepreciable capital assets	471,503	143,668	-	(281,224)	333,947
DEPRECIABLE					
CAPITAL ASSETS					
Land improvements	3,373,522	-	-	84,822	3,458,344
Buildings	33,485,433	-	-	-	33,485,433
Equipment	35,238,190	649,735	(446,389)	191,297	35,632,833
LESS ACCUMULATED DEPRECIATION					
Land improvements	1,499,622	199,293	-	-	1,698,915
Buildings	14,774,045	1,361,312	-	-	16,135,357
Equipment	19,725,488	2,219,532	(446,389)	-	21,498,631
DEPRECIABLE CAPITAL ASSETS, net	36,097,990	(3,130,402)	-	281,224	33,248,812
CAPITAL ASSETS, net	\$ 36,569,493	\$ (2,986,734)	\$ -	\$ -	\$ 33,582,759

	Beginning Balance January 1, 2015	Additions	Retirements	Account Transfers	Ending Balance December 31, 2015
ASSETS AT COST					
NONDEPRECIABLE					
CAPITAL ASSETS					
Land	\$ 333,947	\$ -	\$ -	\$ -	\$ 333,947
Construction in progress	181,579	141,982	-	(186,005)	137,556
Total nondepreciable capital assets	515,526	141,982	-	(186,005)	471,503
DEPRECIABLE					
CAPITAL ASSETS					
Land improvements	3,365,306	8,216	-	-	3,373,522
Buildings	33,475,789	7,410	-	2,234	33,485,433
Equipment	34,660,878	1,854,454	(1,460,913)	183,771	35,238,190
LESS ACCUMULATED DEPRECIATION					
Land improvements	1,300,710	198,912	-	-	1,499,622
Buildings	13,356,930	1,417,115	-	-	14,774,045
Equipment	18,864,859	2,321,542	(1,460,913)	-	19,725,488
DEPRECIABLE CAPITAL ASSETS, net	37,979,474	(2,067,489)	-	186,005	36,097,990
CAPITAL ASSETS, net	\$ 38,495,000	\$ (1,925,507)	\$ -	\$ -	\$ 36,569,493

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 7 - Investment in Joint Venture

Smokey Point Medical Center, LLC - Together with PHD No. 1, the District formed Smokey Point Medical Center, LLC (SPMC), a limited liability company, which owns buildings, land, and equipment leased to operate the CSHA clinics. The District has a 50% interest in SPMC at December 31, 2016 and 2015. During the years ended December 31, 2016 and 2015, the District recognized income of \$204,595 and \$289,245, respectively, for its share of the net income realized by Smokey Point Medical Center, LLC. The District's recorded investment in Smokey Point Medical Center, LLC was \$5,742,835 and \$6,038,239 at December 31, 2016 and 2015, respectively. The District received dividends of \$500,000 and \$810,000 in the years ending December 31, 2016 and 2015, respectively.

Financial information for the District's joint venture is summarized below:

	<u>2016</u>	<u>2015</u>
Current assets	\$ 204,595	\$ 207,487
Noncurrent assets, net	<u>11,990,524</u>	<u>12,337,847</u>
	<u>\$ 12,195,119</u>	<u>\$ 12,545,334</u>
Current liabilities	\$ -	\$ 1,792
Equity	<u>11,990,524</u>	<u>12,543,542</u>
	<u>\$ 11,990,524</u>	<u>\$ 12,545,334</u>
Revenue	\$ 1,310,000	\$ 1,484,100
Expenses	<u>863,019</u>	<u>905,610</u>
Net income	<u>\$ 446,981</u>	<u>\$ 578,490</u>

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 8 - Long-Term Debt Obligations and Other Noncurrent Liabilities

Interest rates and maturities of long-term debt obligations of the District at December 31, 2016 and 2015, consisted of the following:

	<u>2016</u>	<u>2015</u>
Bonds refunded during 2016.	\$ -	\$ 38,639,137
Limited tax general obligation and refunding bonds, 2010A, 3.00%, due serially on December 1, in the amount of \$315,000 in 2017, plus interest paid semiannually, net of unamortized premium of \$6,580 and \$8,928 in 2016 and 2015, respectively.	321,580	628,928
Limited tax general obligation bonds, 2010B, 3.55% to 6.33%, due serially on December 1, in amounts from \$155,000 in 2017 to \$885,000 in 2035, plus interest paid semiannually.	11,910,000	12,060,000
Unlimited tax general obligation and refunding bonds, 2016, 2.00% to 5.00%, due serially on December 1, in amounts from \$1,325,000 in 2017 to \$3,385,000 in 2031, plus interest paid semiannually, net of unamortized premium of \$3,969,758 in 2016.	<u>37,734,758</u>	<u>-</u>
Long-term debt	49,966,338	51,328,065
Less current portion	<u>1,795,000</u>	<u>1,745,000</u>
Long-term portion	<u>\$ 48,171,338</u>	<u>\$ 49,583,065</u>

During 2016, the District issued the 2016 unlimited tax general obligation and refunding bonds to carry out a tax-exempt refunding of the 2007 bonds. The refunding resulted in the recognition of an accounting loss of \$1,005,951, which will be deferred and amortized over the life of the 2016 bonds, which were set to mature in 2031. The loss is classified as a deferred outflow of resources on the statement of net position. The refunding decreased the District's aggregate debt service payments by \$5,059,688 over the next 15 years and resulted in an economic gain (difference between the present values of the old and new debt service payments) of \$3,846,076.

To refund and defease the 2007 bonds, the District irrevocably deposited a portion of the 2016 unlimited tax general obligation bond proceeds into an escrow fund held by an escrow agent. As a result of the refinancing, the 2007 unlimited tax general obligation bonds have been legally satisfied and are no longer outstanding.

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 8 - Long-Term Debt Obligations and Other Noncurrent Liabilities (continued)

Changes in the District's noncurrent liabilities during the years ended December 31, 2016 and 2015, are summarized below:

	January 1, 2016	Additions	Reductions	December 31, 2016	Amounts Due Within One Year
LONG-TERM DEBT					
Unlimited tax general obligation bonds, 2007	\$ 38,639,137	\$ -	\$ 38,639,137	\$ -	\$ -
Limited tax general obligation and refunding bonds, 2010A	628,928	-	307,348	321,580	315,000
Limited tax general obligation bonds, 2010B	12,060,000	-	150,000	11,910,000	155,000
Unlimited tax general obligation and refunding bonds, 2016	-	39,024,113	1,289,355	37,734,758	1,325,000
Total long-term debt	51,328,065	39,024,113	40,385,840	49,966,338	1,795,000
OTHER NONCURRENT LIABILITIES					
Estimated medical malpractice costs	296,668	-	296,668	-	-
Rent payable	20,825	-	4,167	16,658	-
Total noncurrent liabilities	\$ 51,645,558	\$ 39,024,113	\$ 40,686,675	\$ 49,982,996	\$ 1,795,000
	January 1, 2015	Additions	Reductions	December 31, 2015	Amounts Due Within One Year
LONG-TERM DEBT					
Unlimited tax general obligation bonds, 2007	\$ 39,856,805	\$ -	\$ 1,217,668	\$ 38,639,137	\$ 1,290,000
Limited tax general obligation and refunding bonds, 2010A	926,275	-	297,347	628,928	305,000
Limited tax general obligation bonds, 2010B	12,180,000	-	120,000	12,060,000	150,000
Capital lease obligations	52,150	-	52,150	-	-
Total long-term debt	53,015,230	-	1,687,165	51,328,065	1,745,000
OTHER NONCURRENT LIABILITIES					
Estimated medical malpractice costs	296,668	-	-	296,668	-
Rent payable	24,992	-	4,167	20,825	-
Total noncurrent liabilities	\$ 53,336,890	\$ -	\$ 1,691,332	\$ 51,645,558	\$ 1,745,000

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 8 - Long-Term Debt Obligations and Other Noncurrent Liabilities (continued)

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

	<u>Principal</u>	<u>Interest</u>
2017	\$ 1,795,000	\$ 1,404,814
2018	1,890,000	1,369,988
2019	2,010,000	1,321,674
2020	2,135,000	1,270,000
2021	2,260,000	1,214,713
2022 - 2026	13,830,000	4,915,592
2027 - 2031	18,730,000	2,537,099
2032 - 2036	<u>3,340,000</u>	<u>538,915</u>
	45,990,000	<u>\$ 14,572,795</u>
Plus amount representing net unamortized bond premium and discount	<u>3,976,338</u>	
	<u>\$ 49,966,338</u>	

The District has pledged to levy taxes and set aside net revenue of the District, if necessary, sufficient to make principal and interest payments on the general obligation bonds. Further, assets limited as to use collateralize these obligations.

Note 9 - Commitments and Contingencies

Operating leases - The District leases operating space and miscellaneous equipment under noncancelable operating leases expiring at various dates through 2020.

Future minimum lease payments under noncancelable operating leases are as follows:

2017	\$ 24,192
2018	24,192
2019	<u>16,128</u>
	<u>\$ 64,512</u>

Rental expense under all operating leases for the years ended December 31, 2016 and 2015, was \$268,774 and \$606,007, respectively.

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

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON
NOTES TO FINANCIAL STATEMENTS

Note 9 - Commitments and Contingencies (continued)

Compliance with laws and regulations - The health care industry is subject to numerous laws and regulations from federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditations, government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity with respect to investigations and allegations regarding possible violations of these laws and regulations by health care providers, including those related to medical necessity, coding, and billing for services, has increased substantially. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. The District has implemented a voluntary corporate compliance program that includes guidance for all District employees' adherence to applicable laws and regulations. Management believes that the District is in compliance with the fraud and abuse regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

Risk management - The District is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; and natural disasters. Commercial insurance coverage is purchased for claims arising from such matters, and no claims have exceeded such coverage in any of the preceding years.

Note 10 - Concentration of Credit Risk

The District grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of gross receivables from patients and third-party payors at December 31, 2016 and 2015, was as follows:

	2016	2015
Medicare	46%	26%
Medicaid	15%	21%
Blue Cross	2%	5%
Regence	0%	4%
Other third-party payors	12%	23%
Patient	25%	21%
	100%	100%

PUBLIC HOSPITAL DISTRICT NO. 3, SNOHOMISH COUNTY, WASHINGTON

NOTES TO FINANCIAL STATEMENTS

Note 11 - Property Taxes

The county treasurer acts as an agent to collect property taxes levied in the county. Taxes are levied annually, on January 1, on property values listed as of the prior May 31. Assessed values are established by the county assessor at 100% of fair market value. A revaluation of all property is required every four years.

Taxes are due in two equal installments on April 30 and October 31. Collections are distributed monthly to the District by the county treasurer.

The District is permitted by law to levy up to \$0.75 per \$1,000 of assessed valuation for general purposes. The Washington State Constitution and Washington State Law, RCW 84-55-010, limit the rate. The District may also levy taxes at a lower rate. Additional amounts of tax need to be authorized by a vote of the residents of the District.

For 2016 and 2015, the District's regular levy was \$0.35 and \$0.37 per \$1,000 on a total assessed valuation of \$3,637,391,514 and \$3,404,681,027, for a total regular levy of \$1,290,913 and \$1,266,980, respectively. There is a voter-approved tax levy for service of the unlimited tax general obligation bonds. For 2016 and 2015, the tax levy for bond service was \$0.86 and \$0.91 per \$1,000 on a total assessed valuation of \$3,608,373,689 and \$3,370,377,012, for a total additional levy of \$3,114,596 and \$3,053,975, respectively.

Property taxes are recorded as receivables when levied. Because state law allows for sale of property for failure to pay taxes, no estimate of uncollectible taxes is made.