Office of the Washington State Auditor
Pat McCarthy

March 19, 2018

Board of Commissioners
Jefferson Healthcare
Port Townsend, Washington

Contracted CPA Firm's Audit Report on Financial Statements and Federal Single Audit

We have reviewed the audit report issued by a certified public accounting (CPA) firm on Jefferson Healthcare's financial statements and compliance with federal grant requirements for the fiscal year ended December 31, 2016 and 2015. The District contracted with the CPA firm for this audit under an agreement with the State Auditor's Office.

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 or the compliance with federal grant agreements and, accordingly, we do not express an opinion on those financial statements or on compliance.

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

Sincerely,

Pat McCarthy

Pat McCarthy

State Auditor

Olympia, WA

Jefferson County
Public Hospital District No. 2
doing business as
Jefferson Healthcare

Basic Financial Statements and
Independent Auditors' Reports

December 31, 2016 and 2015

DINGUS | ZARECOR & ASSOCIATES PLLC
Certified Public Accountants

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Table of Contents

DINGUS | ZARECOR & ASSOCIATES PLLC
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Board of Commissioners
Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Port Townsend, Washington

Report on the Financial Statements

We have audited the accompanying financial statements of Jefferson County Public Hospital District No. 2 doing business as Jefferson Healthcare (the District) as of and for the years ended December 31, 2016 and 2015, and the related notes to the financial statements, which collectively comprise the District's basic financial statements as listed in the table of contents.

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.

Auditors' 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 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 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 auditors' 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 auditors consider 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 the District as of December 31, 2016 and 2015, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

12015 East Main Avenue | Spokane Valley, WA 99206 | 509.242.0874 | www.dzacpa.com

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 7 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 an 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 audits 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.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the District's basic financial statements. The schedule of expenditures of federal awards is presented for purposes of additional analysis as required by Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, and is not a required part of the basic financial statements.

The schedule of expenditures of federal awards is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the basic financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated May 30, 2017, on our consideration of the District'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 for the year ended December 31, 2016. We issued a similar report for the year ended December 31, 2015, dated June 2, 2016, which has not been included with the 2016 financial and compliance report. The purpose of those reports is 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 internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the District's internal control over financial reporting and compliance.

Dingus, Zarecor & Associates PLLC

Spokane Valley, Washington
May 30, 2017

Our management's discussion and analysis of Jefferson County Public Hospital District No. 2 doing business as Jefferson Healthcare's (the District) financial performance provides an overview of the District's financial activities for the years ended December 31, 2016 and 2015. Please read it in conjunction with the District's basic financial statements, which begin on page 8.

Financial Highlights

- The District's net position increased in each of the past two years by $4,569,358, or 10%, in 2016 and $10,099,993, or 30%, in 2015.
- The District reported operating income of $4,454,912 in 2016 and $9,743,296 in 2015. Operating income decreased by $5,288,384 in 2016 and increased by $7,358,193 in 2015.
- Nonoperating revenues and expenses decreased by $242,251 in 2016 compared to 2015. Nonoperating revenues and expenses increased $245,709 in 2015 compared to 2014.

Using This Annual Report

The District's basic financial statements consist of three statements — 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, including resources held by the District that are designated for specific purposes by contributors, grantors, or enabling legislation.

The Statement of Net Position and Statement of Revenues, Expenses, and Changes in Net Position

Our analysis of the District's finances begins below. One of the most important questions asked about the District's finances is, "Is the District as a whole better or worse off as a result of the year's activities?" The Statement of Net Position and the Statement of Revenues, Expenses, and Changes in Net Position report information about the District's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when the cash is received or paid.

These two statements report the District's net position and changes in it. You can think of the District's net position — the difference between assets and liabilities — as one way to measure the District's financial health, or financial position. Over time, increases or decreases in the District's net position are one indicator of whether its financial health is improving or deteriorating. You will need to consider other nonfinancial factors, however, such as changes in the District's patient base and measures of the quality of service provided to the community, as well as local economic factors to assess the overall health of the District.

The Statement of Cash Flows

The final required statement is the Statement of Cash Flows. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities. It provides answers to such questions as, "Where did cash come from?"; "What was cash used for?"; and "What was the change in the cash balance during the reporting period?"

The District's Net Position

The District's net position is the difference between its assets and liabilities reported in the Statements of Net Position on pages 8 and 9. The District's net position increased by $4,569,358, or 10%, in 2016 and $10,099,993, or 30%, in 2015, as shown in Table 1.

Table 1. Assets, Liabilities, and Net Position

	2016	2015	2014
Assets			
Current assets	**$ 45,524,679**	$ 40,782,851	$ 33,563,791
Capital assets, net	**41,068,450**	24,388,074	18,786,534
Total assets	**$ 86,593,129**	$ 65,170,925	$ 52,350,325
Liabilities			
Current liabilities	**$ 8,384,822**	$ 7,914,417	$ 10,421,482
Long-term obligations, net of current maturities	**28,071,741**	12,050,991	8,106,450
Accounts payable, capital	**1,797,147**	1,435,456	152,325
	38,253,710	21,400,864	18,680,257
Net position			
Net investment in capital assets	**10,626,814**	9,473,360	7,897,799
Restricted	**544,634**	501,716	450,147
Unrestricted	**37,167,971**	33,794,985	25,322,122
	48,339,419	43,770,061	33,670,068
Total liabilities and net position	**$ 86,593,129**	$ 65,170,925	$ 52,350,325

Current assets in 2016 include cash and cash equivalents (52% of total current assets), accounts receivable (42%), supply inventory (4%), and prepaid expenses (2%). The majority of the increase in current assets for 2016 was from Medicare and Medicaid third-party payor settlement estimates. Capital assets, net increased in 2016 with the construction of the emergency and specialty services building, a 48,000 square foot expansion to the existing hospital building.

The majority of the increase in current assets for 2015 was from Medicare and Medicaid third-party payor settlement estimates. Cash also increased because of a continued reduction in patient accounts receivable.

Operating Results and Changes in the District's Net Position

In 2016, the District's net position increased by $4,569,358, or 10%, as shown in Table 2. This increase is generally related to an increase in net patient service revenue. The District experienced growth in emergency department, outpatient services, and clinic visit revenues in 2016 by both expanding physical space available to these services and focusing on increasing access.

In 2015, the District's net position increased by $10,099,993, or 30%, as shown in Table 2. This increase is generally related to an increase in net patient service revenue. The District experienced significant growth in surgery, oncology, pharmacy, and urology revenues in 2015.

Table 2. Operating Results and Changes in Net Position

	2016	2015	2014
Operating revenues			
Net patient service revenue	**$ 85,362,227**	$ 83,077,931	$ 70,673,226
Electronic health record incentive payments	**182,750**	448,110	110,099
340b contract pharmacies	**3,202,317**	3,742,522	4,092,513
Other operating revenues	**1,133,914**	855,713	1,228,763
Total operating revenues	**89,881,208**	88,124,276	76,104,601
Operating expenses			
Salaries and benefits	**52,081,612**	48,560,176	45,921,296
Supplies	**13,387,127**	11,756,154	9,778,668
Depreciation and amortization	**4,065,182**	4,074,343	4,137,171
Other operating expenses	**15,892,375**	13,990,307	13,882,363
Total operating expenses	**85,426,296**	78,380,980	73,719,498
Operating income	**4,454,912**	9,743,296	2,385,103
Nonoperating revenues (expenses)			
Taxation	**454,759**	458,720	439,813
Investment income	**103,462**	18,334	8,525
Interest expense	**(541,665)**	(391,688)	(452,744)
Bond issuance costs	**-**	(153,300)	-
Gain (loss) on disposal of capital assets	**39,355**	(31,014)	-
Contributions	**58,535**	455,645	115,394
Total nonoperating revenues, net	**114,446**	356,697	110,988
Change in net position	**4,569,358**	10,099,993	2,496,091
Net position, beginning of year	**43,770,061**	33,670,068	31,173,977
Net position, end of year	**$ 48,339,419**	$ 43,770,061	$ 33,670,068

Operating Income

The first component of the overall change in the District's net position is operating income (loss) — the difference between net patient service revenues and the expenses incurred to perform those services. In each of the past three years, the District has reported an operating income. Operating income decreased by $5,288,384 from 2015 to 2016.

The primary components of the decrease in operating income for 2016 are:

- A decrease in the enhancement payments receivable reconciled and recorded in each year; in 2015, 2011-2015 enhancement payments were reconciled and prepared for audit, causing a large positive contractual adjustment in 2015 that did not occur in 2016.
- A decrease in the electronic health records incentive payments of $ 265,360 between 2015 and 2016.
- An increase in salaries and wages expenses of $3,069,317 from 2015 to 2016; this increase correlates with the growth in patient levels and services offered, as well as annual wage increases.
- An increase in purchased services of $1,181,497 between 2015 and 2016 related to additional information technology expenses (primarily for Epic, the District's electronic health records) and expenses for additional accreditations and audits.
- An increase in supplies expense of approximately $1,630,973 from 2015 to 2016; this increase was primarily due to purchasing noncapital items to outfit the new emergency and specialty services building.

Overall, net patient service revenue increased between 2015 and 2016 by $2,284,296. This growth was primarily related to increasing volumes in the emergency department, outpatient services, and clinics. The District prioritized the work related to increasing access for patients and identifying barriers for patients to receive care. Although the emergency and specialty services building was not entirely complete at December 31, 2016, the majority of the space was placed into service in October 2016; this additional space for the last three months of the year resulted in increased volumes to offset some of the higher supplies costs incurred during 2016 related to this construction.

Net patient service revenue also increased between 2014 and 2015. The District prioritized the work related to transitioning out of two buildings demolished in early 2015 and focused on streamlining existing service lines rather than making drastic changes elsewhere; while the addition of service lines and growth can drive an increase in the change in net position, intentional growth years can include inherent risk that was not attractive during such significant construction. The additional capital investments related to the emergency and specialty services building were not in service as of December 31, 2015, and therefore there is little additional expense included in 2015.

Another important factor to consider in evaluating operating income is the District's commitment to providing care for patients with little or no health insurance or other means for payment. This service to the community is consistent with the goals established by the District when it became a hospital district in 1975. Uncompensated care provided to these patients decreased by $83,076 in 2016, compared to a decrease of $1,709,743 in 2015. The primary cause of this decrease was the growth of the financial counseling department, staffed by financial counselors committed to partnering with patients to determine the appropriate financial assistance for their financial and medical situations. The financial counseling department did significant outreach in Jefferson County to help enroll patients in Medicaid and insurance exchange products as a first step of implementing changes driven by the Affordable Care Act.

Nonoperating Revenues and Expenses

Nonoperating revenues consist primarily of property taxes levied by the District, interest revenue, and rental income. Nonoperating revenues and expenses decreased by $242,251 in 2015 and increased by $245,709 in 2015. The District receives operating grants from various state and federal agencies for specific programs. These are discussed in detail in Note 1 to the financial statements. Operating grants received from the various state and federal programs increased from $30,014 in 2015 to $74,597 in 2016.

The District received contributions of $58,535 and $455,645 during 2016 and 2015, respectively. These contributions are primarily from the Jefferson Healthcare Hospital Auxiliary and the Hospice Foundation for Jefferson Healthcare.

The District's Cash Flows

Changes in the District's cash flows are consistent with changes in operating incomes and nonoperating revenues and expenses, discussed earlier.

Capital Assets and Debt Administration

Capital Assets

Net capital assets increased by $16,680,376, or 68%, in 2016. This net increase includes purchases (including construction in progress) of $20,548,262 and depreciation expense of $4,065,182. Net capital assets increased by $5,601,540, or 30%, in 2015. This net increase includes purchases (including construction in progress) of $9,617,843 and depreciation expense of $4,074,343. The activity in 2016 includes construction, architect, and other fees for components of the emergency and specialty services building that were both placed into service during 2016 and remained as construction in progress at year end.

The activity in 2015 includes architect and other fees for construction in progress related to the construction of the emergency and specialty services building that began in early 2015.

At the end of 2016, the District had $41,068,450 invested in capital assets, net of accumulated depreciation, as detailed in Note 6 to the financial statements.

Debt

At December 31, 2016, the District had $28,071,741 in long-term debt obligations, an increase of $16,020,750, or 133%, from December 31, 2015. The increase is primarily related to issuing bond anticipation notes as part of funding the emergency and specialty services building.

The District's formal debt issuances cannot be issued without approval of the District's Board of Commissioners. The amount of debt issued is subject to limitations that apply to the District.

Contacting the District's Financial Management

This financial report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of the District's finances and to show the District's accountability for the money it receives. If you have questions about this report or need additional information, contact the District Administration at 834 Sheridan Street, Port Townsend, Washington 98368-2443.

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Statements of Net Position
December 31, 2016 and 2015

ASSETS	2016	2015
Current assets		
Cash and cash equivalents	**$ 3,653,742**	$ 3,692,643
Receivables:		
Patients, less allowances for uncollectible accounts of $3,472,000 and $3,223,000, respectively	**10,371,480**	8,750,405
Estimated third-party payor settlements	**7,757,450**	6,132,919
Electronic health record incentive payments	**123,196**	287,458
340b contract pharmacies	**583,082**	607,389
Other	**155,988**	26,024
Inventories	**1,818,099**	1,580,708
Prepaid expenses and other assets	**810,770**	925,289
Cash and cash equivalents restricted or limited as to use	**20,240,390**	18,768,134
Taxes receivable restricted or limited as to use	**10,482**	11,882
Total current assets	**45,524,679**	40,782,851
Noncurrent assets		
Capital assets, net	**41,068,450**	24,388,074
Total assets	**$ 86,593,129**	$ 65,170,925

See accompanying notes to basic financial statements.

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Statements of Net Position (Continued)
December 31, 2016 and 2015

LIABILITIES AND NET POSITION	**2016**	**2015**
Current liabilities		
Accounts payable	**$ 3,860,940**	$ 2,958,021
Accrued payroll and related liabilities	**1,323,047**	1,143,794
Accrued paid time off	**2,628,087**	2,384,335
Accrued interest payable	**4,063**	4,488
Current portion of long-term debt	**568,685**	543,860
Current portion of capital lease obligations	**-**	879,919
Total current liabilities	**8,384,822**	7,914,417
Noncurrent liabilities		
Long-term debt net of current portion	**28,071,741**	12,050,991
Accounts payable, capital	**1,797,147**	1,435,456
Total noncurrent liabilities	**29,868,888**	13,486,447
Total liabilities	**38,253,710**	21,400,864
Net position		
Net investment in capital assets	**10,626,814**	9,473,360
Restricted under bond agreements	**544,634**	501,716
Unrestricted	**37,167,971**	33,794,985
Total net position	**48,339,419**	43,770,061
Total liabilities and net position	**$ 86,593,129**	$ 65,170,925

See accompanying notes to basic financial statements.

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Statements of Revenues, Expenses, and Changes in Net Position
Years Ended December 31, 2016 and 2015

		2016		2015
Operating revenues				
Net patient service revenue, net of provision for bad debts of $2,807,357 and $3,375,293, respectively	**$**	**85,362,227**	$	83,077,931
Electronic health record incentive payments		**182,750**		448,110
340b contract pharmacies		**3,202,317**		3,742,522
Grants		**74,597**		30,014
Other		**1,059,317**		825,699
Total operating revenues		**89,881,208**		88,124,276
Operating expenses				
Salaries and wages		**42,217,029**		39,147,712
Employee benefits		**9,864,583**		9,412,464
Professional fees		**4,841,379**		4,117,510
Purchased services		**4,950,924**		3,769,427
Supplies		**13,387,127**		11,756,154
Insurance		**676,041**		598,538
Leases and rentals		**1,404,703**		1,291,525
Depreciation and amortization		**4,065,182**		4,074,343
Repairs and maintenance		**682,861**		885,992
Utilities		**836,749**		870,369
Licenses and taxes		**628,169**		669,411
Other		**1,871,549**		1,787,535
Total operating expenses		**85,426,296**		78,380,980
Operating income		**4,454,912**		9,743,296
Nonoperating revenues (expenses)				
Taxation for maintenance and operations		**443,447**		447,559
Taxation for debt service		**11,312**		11,161
Investment income		**103,462**		18,334
Interest expense		**(541,665)**		(391,688)
Bond issuance costs		**-**		(153,300)
Gain (loss) on disposal of capital assets		**39,355**		(31,014)
Contributions		**58,535**		455,645
Total nonoperating revenues, net		**114,446**		356,697
Change in net position		**4,569,358**		10,099,993
Net position, beginning of year		**43,770,061**		33,670,068
Net position, end of year	**$**	**48,339,419**	$	43,770,061

See accompanying notes to basic financial statements.

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Statements of Cash Flows
Years Ended December 31, 2016 and 2015

	2016	2015
Increase (Decrease) in Cash and Cash Equivalents		
Cash flows from operating activities		
Cash received from and on behalf of patients	**$ 82,116,621**	$ 80,126,221
Cash received from electronic health records incentive payments	**347,012**	3,182,614
Cash received from 340b contract pharmacies	**3,226,624**	3,574,934
Cash received from other revenue	**929,353**	811,174
Cash received from operating grants	**74,597**	207,463
Cash paid to and on behalf of employees	**(51,658,607)**	(49,552,540)
Cash paid to suppliers and contractors	**(28,499,455)**	(26,136,682)
Net cash provided by operating activities	**6,536,145**	12,213,184
Cash flows from noncapital financing activities		
Cash received from contributions	**58,535**	470,645
Taxes received for maintenance and operations	**443,447**	447,559
Net cash provided by noncapital financing activities	**501,982**	918,204
Cash flows from capital and related financing activities		
Purchase of capital assets	**(20,344,512)**	(8,423,766)
Principal payments on long-term debt	**(749,015)**	(555,204)
Proceeds from issuance of long-term debt	**16,794,590**	5,379,485
Principal payments on capital lease obligations	**(879,919)**	(2,081,158)
Interest paid	**(542,090)**	(391,963)
Bond issuance costs paid	**-**	(153,300)
Taxes received for bond principal and interest	**12,712**	14,857
Net cash used in capital and related financing activities	**(5,708,234)**	(6,211,049)
Cash flows from investing activities		
Interest received	**103,462**	18,334
Net increase in cash and cash equivalents	**1,433,355**	6,938,673
Cash and cash equivalents, beginning of year	**22,460,777**	15,522,104
Cash and cash equivalents, end of year	**$ 23,894,132**	$ 22,460,777

See accompanying notes to basic financial statements.

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Statements of Cash Flows (Continued)
Years Ended December 31, 2016 and 2015

		2016		2015
Reconciliation of Cash and Cash Equivalents to the Statements of Net Position				
Cash and cash equivalents	**$**	**3,653,742**	$	3,692,643
Cash and cash equivalents restricted or limited as to use		**20,240,390**		18,768,134
Total cash and cash equivalents	**$**	**23,894,132**	$	22,460,777
Reconciliation of Operating Income to Net Cash Provided by Operating Activities				
Operating income	**$**	**4,454,912**	$	9,743,296
Adjustments to reconcile operating income to net cash provided by operating activities				
Depreciation and amortization		**4,065,182**		4,074,343
Provision for bad debts		**2,807,357**		3,375,293
Decrease (increase) in assets:				
Receivables:				
Patient accounts, net		**(4,428,432)**		(956,976)
Estimated third-party payor settlements		**(1,624,531)**		(5,370,027)
Electronic health records incentive payments		**164,262**		2,734,504
340b contract pharmacies		**24,307**		(167,588)
Other		**(129,964)**		318,148
Inventories		**(237,391)**		(32,169)
Prepaid expenses and other assets		**114,519**		(200,268)
Increase (decrease) in liabilities:				
Accounts payable		**902,919**		(157,784)
Accrued payroll and related liabilities		**179,253**		(1,195,839)
Accrued paid time off		**243,752**		48,251
Net cash provided by operating activities	**$**	**6,536,145**	$	12,213,184

See accompanying notes to basic financial statements.

1. Reporting Entity and Summary of Significant Accounting Policies:

a. Reporting Entity

Jefferson County Public Hospital District No. 2 doing business as Jefferson Healthcare (the District) is organized as a municipal corporation pursuant to the laws of the state of Washington for municipal corporations. The primary purpose of the District is to operate Jefferson Healthcare (the Hospital), the principal provider of acute healthcare services for Port Townsend and surrounding communities. Port Townsend is located on Washington State Highway 20 at the northeast corner of the Olympic Peninsula. The District also operates four rural health clinics. Three of these clinics are in Port Townsend and one is in Quilcene, Washington. The District also operates a physician clinic in Port Ludlow, Washington.

The Hospital is a critical access hospital with 25 set-up acute-care beds. Services offered by the Hospital include medical, swing bed, surgical, labor/delivery and nursery care, 24-hour emergency, laboratory, imaging services, orthopedics, oncology, physical therapy, home health, hospice, cardiac rehabilitation, clinics, and a wellness program. Members of the medical staff include specialists in emergency medicine, family practice, internal medicine, general surgery, orthopedics, cardiology, oncology, urology, radiology, and inpatient hospitalization.

As organized, the District is exempt from federal income tax. The Board of Commissioners is made up of five community members elected to six-year terms.

b. Summary of Significant Accounting Policies

Use of estimates – The preparation of 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 the 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.

Enterprise fund accounting – The District's accounting policies conform to accounting principles generally accepted in the United States of America as applicable to proprietary funds of governments. The District uses enterprise fund accounting. Revenue and expenses are recognized on the accrual basis using the economic resources measurement focus.

Cash and cash equivalents – Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. Cash receipts are deposited directly to the District's depository accounts at a bank. Periodically, such cash is transferred to the operating accounts held by the Jefferson County Treasurer (County Treasurer), and warrants are issued against these accounts.

Inventories – Inventories consist of medical supplies, drugs, and food and are stated at cost using the first-in, first-out method.

Assets restricted or limited as to use – Assets restricted or limited as to use include assets set aside by the Board of Commissioners for future capital improvements and other uses over which the Board retains control and could subsequently use for other purposes, and assets set aside for repayment of principal and interest on bond indebtedness.

1. Reporting Entity and Summary of Significant Accounting Policies (continued):

b. Summary of Significant Accounting Policies (continued)

Compensated absences – The District's employees earn paid time off (PTO) for vacation, holidays, and short-term illnesses based upon years of service. The related liability is accrued during the period in which it is earned. Depending on years of service, PTO accrues from 200 to 336 hours per year. The District's policy is to permit employees to accumulate up to a maximum of 480 hours. Upon reaching 480 hours, any excess PTO earned that would extend an employee over the stated maximum is not paid to the employee.

In December of each year, employees can elect to cash out up to 40 hours of PTO the following May and December as long as a minimum of 200 hours of PTO is retained. Employees can also elect to defer up to 50 hours of PTO into their 457 plan, as long as a minimum of 400 hours of PTO is retained.

Net position – Net position of the District is classified into three components. *Net investment in capital assets* consists of capital assets net of accumulated depreciation and reduced by the balances of any outstanding borrowings used to finance the purchase or construction of those assets. *Restricted net position* is noncapital net position that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the District. *Unrestricted net position* is the remaining net position that does not meet the definition of *net investment in capital assets* or *restricted*.

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 result from exchange transactions, including grants for specific operating activities associated with providing healthcare services — the District's principal activity. Nonexchange revenues, including taxes and contributions received for purposes other than capital asset acquisition, are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide healthcare services, other than financing 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.

Grants and contributions – From time to time, the District receives grants from the state of Washington and others as well as contributions from individuals and private organizations. Revenues from grants and contributions (including contributions of capital assets) are recognized when all eligibility requirements are met. Grants and contributions may be restricted for either specific operating purposes or for capital purposes. Amounts that are restricted to specific capital acquisitions are reported after nonoperating revenues and expenses. Grants that are for specific projects or purposes related to the District's operating activities are reported as operating revenue. Grants that are used to subsidize operating deficits are reported as nonoperating revenue. Contributions, except for capital contributions, are reported as nonoperating revenue.

Subsequent events – The District has evaluated subsequent events through May 30, 2017, the date on which the financial statements were available to be issued.

2. Bank Deposits and Investments:

Custodial credit risk is the risk that in the event of a depository institution failure, the District's deposits may not be refunded to it. The District's deposit policy for custodial credit risk is determined by Washington State law.

All cash and cash equivalents held by the County Treasurer or deposited with qualified public depositories are protected against loss by the State of Washington Public Deposit Protection Commission, as provided by RCW Chapter 39.58, subject to certain limitations. Qualified public depositories including First Federal and Union Bank, pledge securities with this commission, which are available to insure public deposits within the state of Washington. The cash on deposit with these banks is also insured through the Federal Deposit Insurance Corporation.

The Revised Code of Washington, Chapter 39, authorizes municipal governments to invest their funds in a variety of investments including federal, state, and local government certificates, notes, or bonds; the Washington State Local Government Investment Pool; savings accounts in qualified public depositories; and certain other investments. The District has elected to use the County Treasurer to be its treasurer to issue warrants and make investments. Amounts invested in the Washington State Local Government Investment Pool at December 31, 2016 and 2015, were $20,203,061 and $16,761,950, respectively. The Washington State Local Government Investment Pool consists of investments in federal, state, and local government certificates and savings accounts in qualified public depositories.

3. Patient Accounts Receivable:

Patient accounts receivable are reduced by an allowance for uncollectible accounts. In evaluating the collectibility of accounts receivable, the District analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for uncollectible accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For receivables associated with services provided to patients who have third-party coverage, the District analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which include both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the District records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

The District's allowance for uncollectible accounts for self-pay patients has not changed significantly from the prior year's. The District does not maintain a material allowance for uncollectible accounts from third-party payors, nor did it have significant writeoffs from third-party payors.

3. Patient Accounts Receivable (continued):

Patient accounts receivable reported as current assets consisted of these amounts:

	2016	2015
Patients and their insurance carriers	**$ 8,530,349**	$ 7,296,481
Medicare	**3,899,610**	3,713,703
Medicaid	**1,413,521**	963,221
	13,843,480	11,973,405
Less allowance for uncollectible accounts	**(3,472,000)**	(3,223,000)
Patient accounts receivable, net	**$ 10,371,480**	$ 8,750,405

4. Assets Restricted or Limited as to Use:

The composition of assets restricted or limited as to use was as follows:

	2016	2015
Cash and cash equivalents		
Restricted under 2013 limited tax general obligation bond agreement for principal and interest payment	**$ 75,407**	$ 74,867
Restricted under 2013 limited tax general obligation bond agreement for principal and interest payment	**462,871**	419,560
Internally designated by the Board for capital improvements, home health and hospice operations, and other purposes	**19,702,112**	18,273,707
Total cash and cash equivalents restricted or limited as to use	**$ 20,240,390**	$ 18,768,134
Taxes receivable		
Restricted under 2013 limited tax general obligation bond agreement for principal and interest payment	**$ -**	$ 130
Restricted under 2013 limited tax general obligation bond agreement for principal and interest payment	**6,356**	7,159
Internally designated by the Board for capital improvements, home health and hospice operations, and other purposes	**4,126**	4,593
Total taxes receivable restricted or limited as to use	**$ 10,482**	$ 11,882

5. Property Taxes:

The Jefferson County Treasurer acts as an agent to collect property taxes levied in the County for all taxing authorities. 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 District purposes. Washington State Constitution and Washington State Law, RCW 84.55.010, limit the rate. The District may also levy taxes at a lower rate. Further amounts of tax must be authorized by the vote of the people.

The District's portion of the regular tax levy available for maintenance and operations was $0.03620 and $0.03473 per $1,000 on a total assessed valuation of $4,610,106,207 and $4,556,651,121, for a total regular levy of $166,897 and $158,236 in 2016 and 2015, respectively.

The District's portion of the regular levy pledged for the Limited Tax General Obligation (LTGO) bond repayment was $0.05510 and $0.05687 per $1,000 on a total assessed valuation of $4,610,106,207 and $4,556,651,121, for a total pledged portion of the regular levy of $254,025 and $259,150 in 2016 and 2015, respectively.

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

6. Capital Assets:

The District capitalizes assets whose costs exceed $5,000 and with an estimated useful life of more than one year; lesser amounts are expensed. Capital assets are stated at cost or estimated fair value at the date of donation. Expenditures for maintenance and repairs are charged to operations as incurred; betterments and major renewals are capitalized. When such assets are disposed of, the related costs and accumulated depreciation or amortization are removed from the accounts and the resulting gain or loss is classified in nonoperating revenues or expenses.

All capital assets, other than land and construction in progress, are depreciated or amortized (in the case of capital leases), using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in the depreciation and amortization in the basic financial statements. Useful lives have been estimated as follows:

Land improvements	5 to 25 years
Buildings and improvements	5 to 40 years
Equipment	3 to 25 years
Leasehold improvements	3 to 15 years

6. Capital Assets (continued):

Capital asset additions, retirements, transfers, and balances were as follows:

	Balance December 31, 2015	Additions	Retirements	Transfers	Balance December 31, 2016
Capital assets not being depreciated					
Land	$ 521,255	$ -	$ -	$ 44,521	**$ 565,776**
Construction in progress	10,000,408	20,707,324	(45,454)	(29,160,938)	**1,501,340**
Total capital assets not being depreciated	10,521,663	20,707,324	(45,454)	(29,116,417)	**2,067,116**
Capital assets being depreciated					
Land improvements	931,318	-	-	3,166,688	**4,098,006**
Buildings and improvements	21,587,702	-	-	13,743,002	**35,330,704**
Equipment	23,074,330	109,351	(222,959)	12,135,317	**35,096,039**
Leasehold improvements	505,972	-	-	71,410	**577,382**
Total capital assets being depreciated	46,099,322	109,351	(222,959)	29,116,417	**75,102,131**
Less accumulated depreciation and amortization for					
Land improvements	(677,299)	(140,924)	-	-	**(818,223)**
Buildings and improvements	(13,366,929)	(1,304,389)	-	-	**(14,671,318)**
Equipment	(17,955,017)	(2,513,092)	197,296	-	**(20,270,813)**
Leasehold improvements	(233,666)	(106,777)	-	-	**(340,443)**
Total accumulated depreciation and amortization	(32,232,911)	(4,065,182)	197,296	-	**(36,100,797)**
Total capital assets being depreciated, net	13,866,411	(3,955,831)	(25,663)	29,116,417	**39,001,334**
Capital assets, net	**$ 24,388,074**	**$ 16,751,493**	**$ (71,117)**	**$ -**	**$ 41,068,450**

At December 31, 2016, construction in progress consisted primarily of the completion of the District's emergency and specialty services building and the build out of the second floor clinic space with estimated costs to complete of $500,000 and $2,310,000, respectively. Both projects are expected to be complete in 2017.

6. Capital Assets (continued):

	Balance December 31, 2014	**Additions**		**Retirements**	**Transfers**	**Balance December 31, 2015**
Capital assets not being depreciated						
Land	$ 521,255	$ -		$ -	$ -	**$ 521,255**
Construction in progress	1,648,761	8,351,647		-	-	**10,000,408**
Total capital assets not being depreciated	2,170,016	8,351,647		-	-	**10,521,663**
Capital assets being depreciated						
Land improvements	897,257	34,061		-	-	**931,318**
Buildings and improvements	21,653,797	3,477		(69,572)	-	**21,587,702**
Equipment	21,781,887	1,311,927		(19,484)	-	**23,074,330**
Leasehold improvements	500,185	5,787		-	-	**505,972**
Total capital assets being depreciated	44,833,126	1,355,252		(89,056)	-	**46,099,322**
Less accumulated depreciation and amortization for						
Land improvements	(652,380)	(24,919)	-	-	-	**(677,299)**
Buildings and improvements	(12,470,957)	(934,530)	-	38,558	-	**(13,366,929)**
Equipment	(14,936,854)	(3,037,645)	-	19,482	-	**(17,955,017)**
Leasehold improvements	(156,417)	(77,249)	-	-	-	**(233,666)**
Total accumulated depreciation and amortization	(28,216,608)	(4,074,343)		58,040	-	**(32,232,911)**
Total capital assets being depreciated, net	16,616,518	(2,719,091)		(31,016)	-	**13,866,411**
Capital assets, net	**$ 18,786,534**	**$ 5,632,556**		**$ (31,016)**	**$ -**	**$ 24,388,074**

7. Long-term Debt and Capital Lease Obligations:

A schedule of changes in the District's long-term debt and capital lease obligations is as follows:

	Balance December 31, 2015	Additions	Reductions	Balance December 31, 2016	Amounts Due Within One Year
Bonds and notes payable					
Note payable to individuals	$ 65,680	$ -	$ (15,511)	$ 50,169	$ 16,345
Note payable to individuals	5,536,299	18,991	(377,339)	5,177,951	377,340
2013 LTGO bonds	1,525,000	175,000	(345,000)	1,355,000	175,000
2015 LTGO bonds	1,250,000	3,900,000	-	5,150,000	-
Revenue bond anticipation notes	4,129,485	12,700,599	-	16,830,084	-
Bond premiums	88,387	-	(11,165)	77,222	-
Total bonds and notes payable	12,594,851	16,794,590	(749,015)	28,640,426	568,685
Capital lease obligations					
CT Scanner	189,805	-	(189,805)	-	-
Synapse	6,643	-	(6,643)	-	-
Epic Electronic Health Record Software and Implementation Services - #1	187,638	-	(187,638)	-	-
Epic Electronic Health Record Software and Implementation Services - #2, 2a	312,304	-	(312,304)	-	-
Epic Electronic Health Record Related Hardware - #3	75,395	-	(75,395)	-	-
Lawson ERP Software and Implementation Services	108,134	-	(108,134)	-	-
Total capital lease obligations	879,919	-	(879,919)	-	-
Total long-term debt and capital lease obligations	**$ 13,474,770**	**$ 16,794,590**	**$ (1,628,934)**	**$ 28,640,426**	**$ 568,685**

	Balance December 31, 2014	Additions	Reductions	Balance December 31, 2015	Amounts Due Within One Year
Bonds and notes payable					
Note payable to individuals	$ 80,400	$ -	$ (14,720)	$ 65,680	$ 15,511
Note payable to individuals	5,876,614	-	(340,315)	5,536,299	358,349
Note payable to bank	24,005	-	(24,005)	-	-
2013 LTGO bonds	1,690,000	-	(165,000)	1,525,000	170,000
2015 LTGO bonds	-	1,250,000	-	1,250,000	-
Revenue bond anticipation notes	-	4,129,485	-	4,129,485	-
Bond premiums	99,551	-	(11,164)	88,387	-
Total bonds and notes payable	7,770,570	5,379,485	(555,204)	12,594,851	543,860
Capital lease obligations					
CT Scanner	469,167	-	(279,362)	189,805	189,805
Synapse	83,215	-	(76,572)	6,643	6,643
PACS	41,782	-	(41,782)	-	-
IV Pumps	7,124	-	(7,124)	-	-
Epic Electronic Health Record Software and Implementation Services - #1	808,296	-	(620,658)	187,638	187,638
Epic Electronic Health Record Software and Implementation Services - #2, 2a	931,197	-	(618,893)	312,304	312,304
Epic Electronic Health Record Related Hardware - #3	254,826	-	(179,431)	75,395	75,395
Lawson ERP Software and Implementation Services	365,470	-	(257,336)	108,134	108,134
Total capital lease obligations	2,961,077	-	(2,081,158)	879,919	879,919
Total long-term debt and capital lease obligations	**$ 10,731,647**	**$ 5,379,485**	**$ (2,636,362)**	**$ 13,474,770**	**$ 1,423,779**

7. Long-term Debt and Capital Lease Obligations (continued):

Long-term debt – The terms and due dates of the District's long-term debt are as follows:

- Note payable, dated October 23, 2004, in the original amount of $200,000, for the purchase of land. The note is due in monthly installments of $1,567, including interest at 5.5%, through November 2019. The note is secured by the related land.
- Note payable, dated July 2, 2012, in the original amount of $6,630,000, for the purchase of a building. The note is due in monthly installments of $53,036, including interest at 5.175%, through July 2027. The note is secured by the related land and building.
- Limited Tax General Obligation Refunding Bonds, dated April 16, 2013, in the original amount of $2,050,000, for the purpose of refinancing the District's existing Limited Tax General Obligation Bonds, dated June 1, 2004. The bonds are payable annually on December 1 in the remaining principal amounts ranging from $175,000 to $220,000 through 2023. The bonds are subject to redemption prior to their stated maturities. Interest at remaining rates from 3.0% to 4.0% is due semiannually on June 1 and December 1. The District has irrevocably pledged to include in its budget and levy taxes annually on all of the property within the District subject to taxation in amounts that will be sufficient to pay the principal and interest on the bonds as they become due.
- Limited Tax General Obligation Refunding Bonds, adopted May 6, 2015, in the original amount of $5,150,000, for the construction of the District's emergency and specialty services building. The District is obligated to make interest-only payments at variable rates of 1.05% to 1.236% through the date in which the draws mature which is 36 months from initial closing, or no later than May 31, 2018.
- Revenue bond anticipation note, adopted May 6, 2015, in the amount not to exceed $19,675,000, for the construction of the District's emergency and specialty services building. At December 31, 2016, the balance outstanding was $16,830,084. The District is obligated to make interest-only payments at variable rates of 1.06% to 1.3856% through the date in which the draws mature which is 36 months from initial closing, or no later than May 31, 2018.

Aggregate annual principal and interest payments over the terms of long-term debt are as follows:

Years Ending	LTGO Bonds		Revenue Bonds and Notes Payable		Total Long-Term Debt	
December 31,	Principal	Interest	Principal	Interest	Principal	Interest
2017	$ 175,000	$ 109,638	$ 393,685	$ 467,877	$ 568,685	$ 577,515
2018	252,473	178,431	662,242	676,361	914,715	854,792
2019	301,755	207,007	816,686	758,888	1,118,441	965,895
2020	305,520	197,542	834,821	723,713	1,140,341	921,255
2021	314,412	186,050	871,149	687,385	1,185,561	873,435
2022-2026	1,085,234	768,877	4,961,930	2,830,742	6,047,164	3,599,619
2027-2031	779,392	623,918	3,007,008	1,974,755	3,786,400	2,598,673
2032-2036	920,218	483,093	3,108,006	1,502,507	4,028,224	1,985,600
2037-2041	1,086,678	316,631	3,656,843	953,669	4,743,521	1,270,300
2042-2046	1,010,940	133,836	2,988,782	374,565	3,999,722	508,401
2047-2048	273,378	6,825	757,052	18,903	1,030,430	25,728
	$ 6,505,000	**$ 3,211,848**	**$ 22,058,204**	**$ 10,969,365**	**28,563,204**	**$ 14,181,213**

8. Long-Term Debt Commitment:

The District was awarded a 30-year loan in the amount of $17,545,000 from the United States Department of Agriculture Rural Development (USDA).

The USDA loan will be used to refinance the construction loan when construction is complete. The District will refinance the remaining $7,280,000 construction loan balance with financing from KeyBank.

9. Commitments Under Noncancelable Operating Leases:

Following is a summary of future minimum obligations under noncancelable operating leases for equipment and buildings:

Years	Amount
2017	$ 887,081
2018	708,566
2019	407,311
2020	173,615
2021	87,564
	$ 2,264,137

10. Net Patient Service Revenue:

The District recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the District recognizes revenue on the basis of its standard rates for services provided (or on the basis of discounted rates, if negotiated or provided by policy). On the basis of historical experience, a significant portion of the District's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the District records a significant provision for bad debts related to uninsured patients in the period the services are provided. The District's provisions for bad debts and writeoffs have not changed significantly from the prior year. The District has not changed its charity care or uninsured discount policies during 2016 or 2015. Patient service revenue, net of contractual adjustments and discounts (but before the provision for bad debts), recognized in the period from these major payor sources, is as follows:

	2016	2015
Patient service revenue (net of contractual adjustments and discounts):		
Medicare	$ **43,548,095**	$ 43,051,614
Medicaid	**13,954,163**	15,076,723
Other third-party payors	**29,283,132**	27,526,725
Patients	**2,311,323**	1,808,367
	89,096,713	87,463,429
Less:		
Charity care	**(927,129)**	(1,010,205)
Provision for bad debts	**(2,807,357)**	(3,375,293)
Net patient service revenue	$ **85,362,227**	$ 83,077,931

The District has agreements 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* – The District has been designated a critical access hospital by Medicare and is reimbursed for inpatient and outpatient services and rural health clinic visits on a cost basis as defined and limited by the Medicare program. Physician services outside the rural health clinic are paid on a fee schedule. Home health and hospice services are reimbursed on a prospective rate per episode of care. The District is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the District and audits thereof by the Medicare administrative contractor.

- *Medicaid* – Inpatient and outpatient services provided to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology. The District is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the District and review thereof by the Washington State Health Care Authority. Rural health clinic services are paid on a prospectively set rate per visit.

10. Net Patient Service Revenue (continued):

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

Laws and regulations governing Medicare, Medicaid, and other 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. Net patient service revenue increased by approximately $401,000 and $359,000 in 2016 and 2015, respectively, due to differences between original estimates and final settlements or revised estimates. Net service revenue also decreased by approximately $805,000 and increased by approximately $3,400,000 in 2016 and 2015, respectively, due to settlement estimates for rural health clinic Medicaid managed care encounters.

The District provides charity care to patients who are financially unable to pay for the healthcare services they receive. The District’s policy is not to pursue collection of amounts determined to qualify as charity care. Accordingly, the District does not report these amounts in net operating revenues or in the allowance for uncollectible accounts. The District determines the costs associated with providing charity care by aggregating the applicable direct and indirect costs, including salaries and wages, benefits, supplies, and other operating expenses, based on data from its costing system. The costs of caring for charity care patients for the years ended December 31, 2016 and 2015, were approximately $459,000 and $483,000, respectively. The District did not receive any gifts or grants to subsidize charity services during 2016 and 2015.

11. Electronic Health Records Incentive Payments:

The District recognized Medicaid electronic health records (EHR) incentive payments during the year ended December 31, 2016, and both Medicare and Medicaid EHR incentive payments during the year ended December 31, 2015. The EHR incentive payments are provided to incent hospitals and eligible providers to become meaningful users of EHR technology, not to reimburse providers for the cost of acquiring EHR assets. EHR incentive payments are therefore reported as operating revenue.

The District recognizes the Medicare incentive payment on the date that the District has successfully complied with meaningful use criteria during the entire EHR reporting period. The District attested to stage two meaningful use with Centers for Medicare and Medicaid Services (CMS) for the 90-day period ended December 30, 2016.

The Medicare incentive payment recognized is an estimate and subject to audit by CMS. The Medicare EHR incentive payment is based on the days reported in the Medicare cost report and the undepreciated cost of the EHR equipment submitted to CMS. The final payment will be based on days reported in the current Medicare cost report. Medicare incentive payments of $269,374 were recognized as revenue in 2015.

The District recognized the first of its four Medicaid incentive payments in 2012, the year that certified EHR technology was adopted, implemented, or upgraded or when such technology was meaningfully used under the Medicare EHR incentive program. The subsequent three payments were issued when meaningful use is demonstrated under Medicare. Medicaid incentive payments of $123,196 were recognized as revenue in 2015. No future payments are expected.

Medicaid incentive payments of $182,750 and $55,540 relating to eligible providers in the rural health clinics were recognized as revenue in 2016 and 2015, respectively.

12. Deferred Compensation Plan and Pension Plan:

The District has a deferred compensation plan created in accordance with Internal Revenue Code §457. The name of the plan is Jefferson Healthcare §457 Deferred Compensation Plan (the Compensation Plan). The Compensation 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 unforeseeable emergency. Employee contributions to the Compensation Plan totaled approximately $2,196,000 and $2,220,000 for the years ended December 31, 2016 and 2015, respectively.

The District provides a 401(a) profit-sharing pension plan for all employees with at least two years of service. The name of the plan is Jefferson Healthcare Employee's Retirement Plan (the Profit-Sharing Plan). The District makes nonelective contributions to the Profit-Sharing Plan of 5% for all eligible employees' salaries annually. The District funds all retirement contributions and employees are not allowed to contribute to the Profit-Sharing Plan. Contributions to the Profit-Sharing Plan totaled approximately $1,578,000 and $1,495,000 for the years ended December 31, 2016 and 2015, respectively.

The District has an additional deferred compensation plan for members of the Hospital's strategic leadership group (SLG) in their first two years of employment, prior to being eligible to participate in the Profit-Sharing Plan described above. The name of the plan is Jefferson Healthcare Strategic Leadership Group Deferred Compensation Plan (the SLG Compensation Plan). The District makes nonelective contributions to the SLG Compensation Plan of 11% for all eligible employees' salaries annually. The District funds all retirement contributions and employees are not allowed to contribute to the SLG Compensation Plan. Contributions to the Plan totaled approximately $39,000 and $22,000 for the years ended December 31, 2016 and 2015, respectively. Once an SLG member has attained two years of service, employer contributions are then made to the Profit-Sharing Plan described above.

The plans are administered by the District. The District has the authority to amend the plans.

13. Risk Management and Contingencies:

Medical malpractice claims – The District has professional liability insurance coverage with Coverys. The policy provides protection on a "claims-made" basis whereby claims filed in the current year are covered by the current policy. If there are occurrences in the current year, these will only be covered in the year the claim is filed if claims-made coverage is obtained in that year or if the District purchases insurance to cover prior acts. The current professional liability insurance provides $1,000,000 per claim of primary coverage with an annual aggregate limit of $5,000,000. The policy has no deductible.

The District also has excess professional liability insurance with Coverys on a "claims-made" basis. The excess malpractice insurance provides $6,000,000 per claim of primary coverage with an aggregate limit of $6,000,000. The policy has no deductible.

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; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the four preceding years.

13. Risk Management and Contingencies (continued):

Self-insurance risk pools – The District has a self-insured workers' compensation plan and a self-insured unemployment plan for its employees. The District participates in the Public Hospital District Workers' Compensation Trust and the Public Hospital District Unemployment Trust, which are risk transfer pools administered by the Washington State Hospital Association. The District pays its share of actual workers' compensation claims, unemployment claims, maintenance of reserves, and administrative expenses. In 2016 and 2015, the Public Hospital District Workers' Compensation Trust assessed its financial condition and decided that it has excess financial reserves that it would return to the member districts through a dividend distribution. Payments by the District charged to workers' compensation expense were approximately $112,000 net of a $289,161 dividend distribution and $272,000 net of a $64,954 dividend in 2016 and 2015, respectively. Payments by the District charged to unemployment expense were approximately $189,000 and $116,000 in 2016 and 2015, respectively. No unemployment dividend distributions were made in 2016 and 2015.

Industry regulations **–** The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditations, and government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity continues with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the District is in compliance with fraud and abuse statutes, as well as other applicable government laws and regulations.

While no regulatory inquiries have been made, 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.

14. Concentration of Risk:

Patient accounts receivable – The District grants credit without collateral to its patients, most of whom are local residents, and are insured under third-party payor agreements. The majority of these patients are geographically concentrated in and around eastern Jefferson County.

The mix of receivables from patients was as follows:

	2016	**2015**
Medicare	**39 %**	41 %
Medicaid	**16**	15
Other third-party payors	**28**	27
Patients	**17**	17
	100 %	100 %

14. Concentration of Risk (continued):

Physicians – The District is dependent on local physicians practicing in its service area to provide admissions and utilize hospital services on an outpatient basis. A decrease in the number of physicians providing these services or changes in their utilization patterns may have an adverse effect on hospital operations.

Collective bargaining unit – The District has three collective bargaining agreements with the United Food and Commercial Workers LOCAL 21:

- Effective November 1, 2015, the District renewed its contract with the labor union for its professional, technical, service and maintenance, business office, and medical records employees. The contract is effective through October 31, 2018.
- Effective November 1, 2015, the District renewed its contract with the labor union for its clinic employees. The contract is effective through October 31, 2018.
- Effective November 1, 2015, the District renewed its contract with the labor union for its nursing employees. The contract is effective through October 31, 2018.

As of December 31, 2016 and 2015, approximately 60% and 62%, respectively, of the Districts' employees were represented by the union under these collective bargaining agreements with United Food and Commercial Workers LOCAL 21.

15. Subsequent Event

In February 2017 the District purchased a medical office building located in Port Townsend, Washington, for $2,680,923 utilizing cash reserves.

SINGLE AUDIT

AUDITORS' SECTION

DINGUS | ZARECOR & ASSOCIATES PLLC
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT 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*

Board of Commissioners
Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Port Townsend, Washington

We have audited, in accordance with the auditing standards generally accepted in the United States of America 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 Jefferson County Public Hospital District No. 2 doing business as Jefferson Healthcare (the District) as of and for the year ended December 31, 2016, and the related notes to the financial statements, which collectively comprise the District's basic financial statements as listed in the table of contents, and have issued our report thereon dated May 30, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the District'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 the District's internal control. Accordingly, we do not express an opinion on the effectiveness of the District'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 a 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.

12015 East Main | Spokane Valley, WA 99206 | 509.242.0874 | www.dzacpa.com

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the District's financial statements are free from 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 results 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.

Dingus, Zarecor & Associates PLLC

Spokane Valley, Washington
May 30, 2017

DINGUS | ZARECOR & ASSOCIATES PLLC
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE FOR EACH MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE UNIFORM GUIDANCE

Board of Commissioners
Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Port Townsend, Washington

Report on Compliance for the District's Major Federal Program

We have audited Jefferson County Public Hospital District No. 2 doing business as Jefferson Healthcare's (the District) compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on the District's major federal program for the year ended December 31, 2016. The District's major federal program is identified in the summary of auditors' results section of the accompanying schedule of audit findings and questioned costs.

Management's Responsibility

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

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for the District's major federal program 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 of America; 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 the District'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 the District's major federal program. However, our audit does not provide a legal determination of the District's compliance.

Opinion on the District's Major Federal Program

In our opinion, the District complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended December 31, 2016.

12015 East Main | Spokane Valley, WA 99206 | 509.242.0874 | www.dzacpa.com

Report on Internal Control over Compliance

Management of the District 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 the District's internal control over compliance with the types of requirements that could have a direct and material effect on its major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for its 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 the District'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 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. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Purpose of this Report

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.

Dingus, Zarecor & Associates PLLC

Spokane Valley, Washington
May 30, 2017

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Schedule of Audit Findings and Questioned Costs
Year Ended December 31, 2016

Section I — Summary of Auditors' Results

Financial Statements:

Type of auditors' report issued:	***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 program:				
• Material weakness(es) identified?	____	yes	X	no
• Significant deficiency(ies) identified?	____	yes	X	none reported
Type of auditors' report issued on compliance for major federal program:	***Unmodified***			
Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)?	____	yes	X	no

Identification of major programs:

CFDA Number(s)	*Name of Federal Program or Cluster*
10.766	Community Facilities Loans and Grants

Dollar threshold used to distinguish between type A and type B programs: $750,000

Auditee qualified as low-risk auditee?	____	yes	X	no

Section II — Financial Statement Findings

No matters were reported. Therefore, no corrective action plan is necessary, nor has one been prepared.

Section III — Federal Award Findings and Questioned Costs

No matters were reported. Therefore, no corrective action plan is necessary, nor has one been prepared.

AUDITEE'S SECTION

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Schedule of Expenditures of Federal Awards
Year Ended December 31, 2016

Federal Grantor/Pass-through Grantor/Program or Cluster Title	Federal CFDA Number	Total Federal Expenditures
U.S. Department of Agriculture		
Community Facilities Loans and Grants	10.766	$ 16,352,068
Total expenditures of federal awards		**$ 16,352,068**

See accompanying independent auditors' report. The accompanying notes are an integral part of this schedule.

1. **Basis of Presentation:**

   The accompanying schedule of expenditures of federal awards (Schedule) includes the federal award activity of Jefferson County Public Hospital District No. 2 doing business as Jefferson Healthcare (the District) under programs of the federal government for the year ended December 31, 2016. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administration Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Because the Schedule presents only a selected portion of the operations of the District, it is not intended to and does not present the net position, changes in net position, or cash flows of the District.

2. **Summary of Significant Accounting Policies**:

   Expenditures reported on this Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in the Uniform Guidance, wherein certain types of expenditures are not allowable or are limited as to reimbursement. The District has elected not to use the 10% de minimis indirect cost rate as allowed under the Uniform Guidance.

3. **Loan Guarantee:**

   Nonmonetary assistance in the form of a loan guarantee is included in the accompanying schedule of expenditures of federal awards. Loans made during the year for the District's construction of a new critical access facility are included in the federal expenditures presented in this Schedule. The construction is being funded by interim financing from KeyBank. A United States Department of Agriculture Rural Development (USDA) Direct Loan will repay the bond anticipation notes when construction is completed. The related USDA loan balance was $14,700,084 at December 31, 2016.

Jefferson County Public Hospital District No. 2
doing business as Jefferson Healthcare
Schedule of Prior Year Audit Findings
Year Ended December 31, 2016

The audit for the year ended December 31, 2015, reported no audit findings, nor were there any unresolved findings from periods ended December 31, 2014, or prior. Therefore, there are no matters to report in this schedule for the year ended December 31, 2016.