



**Office of the Washington State Auditor
Pat McCarthy**

December 31, 2018

Board of Commissioners
Skagit Regional Health
Mount Vernon, 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 Skagit Regional Health's financial statements for the fiscal years ended December 31, 2017 and 2016. The District contracted with the CPA firm for this audit and requested that we accept in lieu of performing our own audit.

Based on this review, we have accepted this report in lieu of the audit required by RCW 43.09.260. The Office of the Washington State Auditor 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 Office of the Washington State Auditor website as a matter of public record.

Sincerely,

Pat McCarthy
State Auditor
Olympia, WA



REPORT OF INDEPENDENT AUDITORS
AND FINANCIAL STATEMENTS

PUBLIC HOSPITAL DISTRICT NO. 1 OF
SKAGIT COUNTY, WASHINGTON

December 31, 2017 and 2016



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Report of Independent Auditors

To the Board of Commissioners
Public Hospital District No. 1 of Skagit County, Washington

Report on the Financial Statements

We have audited the accompanying financial statements of Public Hospital District No. 1 of Skagit County, Washington (the District) as of and for the years ended December 31, 2017 and 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.

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 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 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. 1 of Skagit County, Washington, as of December 31, 2017 and 2016, 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.

Other Matter***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 19 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, which 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated April 20, 2018, 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. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the District's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the District's internal control over financial reporting and compliance.



Everett, Washington
April 20, 2018

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis

This discussion and analysis provides an overview of the financial position and financial activities of Public Hospital District No. 1 of Skagit County, Washington (the District). The District, doing business as Skagit Valley Hospital (SVH), added the clinic division on July 1, 2010. The clinic division, which is known as Skagit Regional Clinics (SRC), was acquired when Skagit Valley Hospital employed the physicians of the former Skagit Valley Medical Center (SVMC) and started operations. On January 1, 2011, the District created the system name Skagit Regional Health (SRH). This name encompasses both SVH and the SRC operations. On June 1, 2016 the District began leasing the facilities of Public Hospital District No. 3 of Snohomish County and providing hospital and clinic services under the name Cascade Valley Hospital and Clinics (CVH).

Please read this discussion and analysis in conjunction with the accompanying financial statements and accompanying notes, which follow this section.

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. 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 cash is received or paid. These two statements report the District's net position and changes in it. Over time, increases or decreases in the District's net position are one indicator of whether its financial health is improving or deteriorating.

Financial Highlights

- SRH's total operating revenue grew by 6.5%, or \$22.8 million, from \$350.6 million in 2016 to \$373.5 million in 2017. Over the same period, total operating expenses grew by 8.7%, or \$30.7 million, from \$354.7 million in 2016 to \$385.3 million in 2017.
- SRH ended 2017 with net operating loss of \$11.9 million and net nonoperating income and changes in net position of \$11.4 million. Net position decreased by \$.4 million to \$154.9 million in 2017.
- The District issued \$62.7 million of series 2016 revenue and refunding bonds in November 2016. Approximately \$42.7 million of the proceeds of the bonds were used to carry out the refunding of the District's 2005 and 2007 series hospital revenue bonds. The remaining \$20.0 million in bond proceeds has been used to pay or reimburse costs to acquire, construct, remodel, renovate, equip, and furnish the District's health facilities in conformance with the District's 2016–2018 capital budgets.
- The District is making a strategic investment of approximately \$72 million for the five-year span of 2016–2020 to build a new Electronic Health Record (EHR) and selected Epic as the vendor in 2015. The new EHR represents a clinical tool to improve system interoperability, connectivity with patients, access to information, and data sharing across the District's entire system, including SVH, SRC, and CVH. The EHR became operable across the system in October 2017.
- The District Board voted unanimously, on Nov. 17, 2017, to select Brian Ivie, a highly experienced health care leader, as the new President, Chief Executive Officer (CEO), and Superintendent of SRH. Former President and CEO Mike Liepman retired in December of 2017 after more than five years of service with The District and a 41-year career in health care. Ivie most recently served as President and CEO of three health care facilities operated by Dignity Health in the Sacramento California area.

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Financial Highlights (continued)

- Paul Ishizuka, MBA, CPA, joined Skagit Regional Health in October 2017 as Chief Financial Officer (CFO). Ishizuka takes on the role held by CFO Tom Litaker who retired at the end of October 2017 after serving the District for 23 years. Ishizuka most recently served as CFO for Samaritan Healthcare in Moses Lake, WA, since 2015. Prior to Samaritan, he served in a variety of senior executive roles for the University of Washington including Medical Center Financial Officer for UW Medicine and CFO for University of Washington Medical Center in Seattle.
- The District approved a letter of intent dated April 6, 2015, with the University of Washington, acting through UW Medicine, and Public Hospital District No. 3 of Snohomish County (PHD No. 3), d/b/a Cascade Valley Hospital and Clinics in Arlington, Washington, to proceed with negotiations around a long-term alliance with UW Medicine with respect to clinical and other ventures and a lease by the District of CVH's health care facilities. The three parties (the Parties) approved the affiliation agreement (the Agreement) on May 29, 2015. The Agreement establishes the general principles and conditions that will guide the clinical integration between UW Medicine, SVH, and CVH. This Agreement is not a merger, acquisition, corporate restructure, or lease and does not constitute a change in governance or change in mission for any organization. This Agreement defines a process for joint efforts to seek clinical integration to increase efficiency in the delivery of patient care, monitor and utilize health care services to provide quality patient outcomes, and make care more affordable to the extent consistent with applicable law. The Parties are committed to working with each other to seek to increase their level of clinical integration, including but not limited to standardized clinical protocols, patient safety programs, connectivity of electronic health information, cost and quality benchmarks, collection of quality and cost data, and a commitment to providing continuity of care for patients by remaining within the clinically integrated programs for their entire episode of care.
- Pursuant to this Agreement, UW Medicine will serve as SVH's and CVH'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. 3 also entered into an Affiliation Agreement regarding the lease and operation of Cascade Valley Hospital and Clinics, dated December 4, 2015 (the Affiliation Agreement). Under the terms of the Affiliation Agreement and effective as of the closing date, June 1, 2016, the District began leasing and operating all of PHD No. 3's health care facilities including its hospital and clinic facilities. Please see the "Affiliation Agreement with Snohomish County PHD No. 3" at the end of this Management Discussion and Analysis for further information on the Affiliation Agreement.

Public Hospital District No. 1 of Skagit County, Washington

Management's Discussion and Analysis (continued)

Financial Highlights (continued)

Following are key operating statistics for the years ended December 31, 2017, 2016, and 2015:

	<u>Comments</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Utilization Statistics				
Skagit Valley Hospital				
Admissions - Acute Care		6,043	5,249	5,129
Admissions - Behavioral Health		382	338	325
Admissions - Obstetrics		1,054	1,188	1,182
Average Length of Stay		4	4.56	4.31
Patient Days - Acute		27,156	25,890	23,620
Patient Days - Behavioral Health		3,836	2,890	2,895
Patient Days - Obstetrics		1,942	2,108	2,081
Occupancy		65.9%	61.6%	57.2%
Emergency Room Visits	(1)	34,571	34,514	33,433
Billable Clinic Visits	(2)	260,904	297,720	294,348
Cascade Valley Hospital and Clinics				
Admissions - Acute Care	(3)	937	553	
Admissions - Obstetrics		170	113	
Average Length of Stay		4	4	
Patient Days - Acute		4,277	2,718	
Patient Days - Obstetrics		290	178	
Occupancy		26.1%	28.2%	
Emergency Room Visits	(1)	19,822	10,911	
Billable Clinic Visits	(2)	20,814	13,454	

(1) Includes those patients who are later admitted

(2) Office visits resulting in a charge

(3) Skagit Regional Health began operating Cascade Valley Hospital on June 1st of 2016, volume represents only those months operated by SRH

Public Hospital District No. 1 of Skagit County, Washington

Management's Discussion and Analysis (continued)

Financial Highlights (continued)

	Comments	2017	2016	2015
Select Patient Volumes - Skagit Valley Hospital	(4)			
Skagit Valley Hospital				
Family Birth Center - Deliveries		989	1,106	1,116
Surgery - Total Minutes		520,494	544,973	506,978
Surgery - Cases		5,086	5,430	5,180
Surgery - Inpatient Cases		1,131	1,184	1,123
Surgery - Outpatient Cases		3,955	4,246	4,057
Emergency Room - Visits	(5)	27,454	28,124	27,386
Special Imaging - Procedures		2,489	2,593	2,574
CT Scan - Procedures		20,053	18,230	16,397
Radiology - Procedures		69,119	68,127	61,664
MRI - Procedures		8,567	7,198	7,075
Nuclear Medicine - Procedures		2,815	2,632	2,336
Physical Therapy - Visits		14,664	15,279	15,614
Occupational Therapy - Visits		4,626	5,295	4,263
Speech Therapy - Visits		8,083	7,860	7,530
Wound Care - Visits		8,153	8,409	8,280
Endoscopy - Cases		5,646	4,703	4,946
Kidney Dialysis - Outpatient Procedures		13,643	15,054	18,234
Peritoneal Dialysis - Procedures		4,538	5,602	6,475
Oncology Medical - Visits		16,919	15,895	13,395
Oncology Medical - Visits - Arlington		2,614	2,662	2,764
Oncology Radiation - Visits		12,075	11,586	9,547
Sleep Therapy - Studies		1,140	880	966
Skagit Regional Clinics				
Urgent Care Clinic - Billable Clinic Visits		61,417	62,356	57,086
Cardiology - Billable Clinic Visits		16,263	19,354	17,808
Family Practice Clinic - Billable Clinic Visits		57,380	56,417	54,396
Pediatrics Clinic - Billable Clinic Visits		19,879	15,497	16,737
Residency Clinic - Billable Clinic Visits		18,488	10,834	10,379
Cascade Valley Hospital and Clinics				
Family Birth Center - Deliveries		158	97	
Surgery - Total Minutes	(6)	113,272	69,688	
Surgery - Cases		1,666	905	
Surgery - Inpatient Cases		455	236	
Surgery - Outpatient Cases		1,211	669	
Emergency Room - Visits	(5)	18,236	10,669	

(4) Volumes include all patients unless otherwise noted.

(5) Excludes those patients who are later admitted.

(6) Does not include minutes in the ambulatory surgical center

Public Hospital District No. 1 of Skagit County, Washington
Management's Discussion and Analysis (continued)

Performance Overview

The following is a comparison of 2017 actual revenues, expenses, and changes in net position results to 2016 and 2015 results (in thousands):

	2017	2016	2015
Operating revenues			
Net patient service revenue	\$ 349,024	\$ 329,786	\$ 287,604
Other operating revenues	22,193	18,600	17,014
Income from joint ventures	2,254	2,205	2,681
	<u>373,471</u>	<u>350,591</u>	<u>307,299</u>
Total operating revenues			
Operating expenses			
Wages and benefits	208,874	182,460	149,812
Professional fees	22,416	21,001	21,308
Supplies	51,203	51,063	43,927
Purchased services, maintenance, and other	77,676	72,161	55,973
Insurance and taxes	5,444	6,131	5,075
Depreciation	14,289	15,034	14,897
Interest and amortization	5,435	6,801	6,184
	<u>385,337</u>	<u>354,651</u>	<u>297,176</u>
Total operating expenses			
Operating income (loss)	(11,866)	(4,060)	10,123
Net nonoperating income	3,333	2,792	1,914
Gain on transfer of assets	7,827	15,531	-
Capital contributions	287	758	431
	<u> </u>	<u> </u>	<u> </u>
Increase (decrease) in net position	(419)	15,021	12,468
Net position, beginning of year	155,332	140,311	127,843
	<u> </u>	<u> </u>	<u> </u>
Net position, end of year	<u>\$ 154,913</u>	<u>\$ 155,332</u>	<u>\$ 140,311</u>

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Health Care Outlook

In keeping with industry trends, Skagit Regional Health continues along the journey to achieving the Triple Aim. We have continued our participation with the UW Medicine Accountable Care Network (ACN) and now participate in three commercial products where focus on cost containment, clinical quality and patient satisfaction are paramount. In 2017, the UWACN and its members renegotiated the terms of the Boeing agreement, which now extends through December 2021. The Washington State Health Care Authority entered Skagit County in 2017 and we experienced small gains in associated patient volumes. SRH continues to participate in the Premera agreement as well, which has not yet incurred volumes that generate risk for the organization.

Skagit Regional Health believes part of our future success depends on performing well in value based agreements. As such, the organization applied for and was accepted into the Medicare ACO program for participation beginning in 2018. The ACO is named Cascadia Care Network (CCN) and begins its operations with a focus on employed providers. As the CCN infrastructure is built, we anticipate opening up the ACO to other independent practices. We expect the 2018 and 2019 to be learning years and that by 2020 CCN will be positioned for shared savings.

Operating Revenue

Net Patient Revenue

Net patient revenue consists of gross patient charges less contractual adjustments, charity care, and a provision for bad debt. Contractual adjustments represent the difference between gross patient charges at established rates and expected contracted payments from third-party payors with which the District has entered into agreements. In addition, the District provides care to patients, at no charge or reduced rates, who meet certain criteria under its charity care policies. The District also estimates the collectability of accounts receivable and records a provision for bad debt. The resulting net patient revenue is highly dependent on the District's payor mix.

Public Hospital District No. 1 of Skagit County, Washington

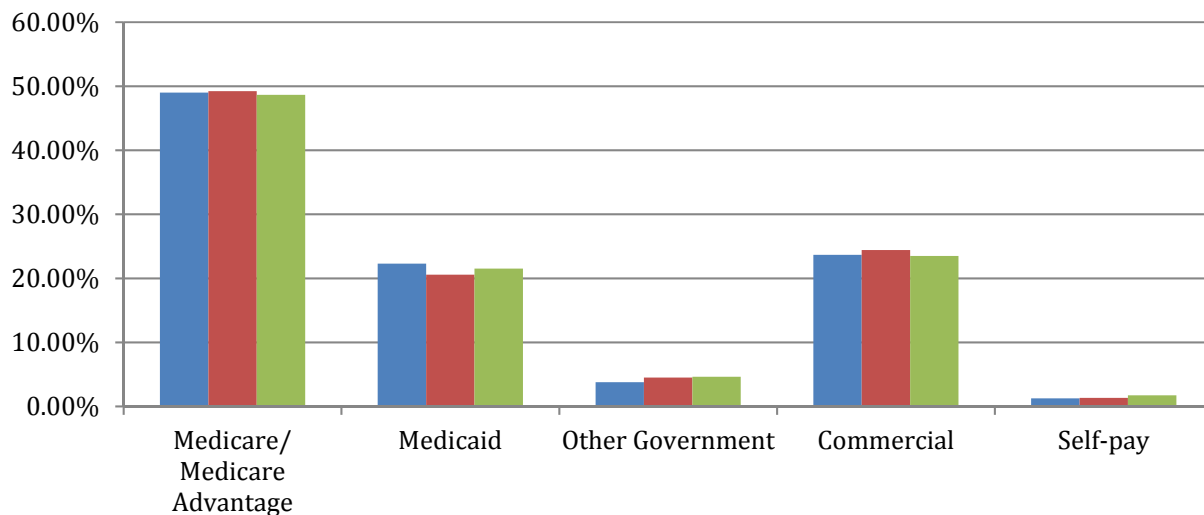
Management's Discussion and Analysis (continued)

Operating Revenue (continued)

The table and graph below illustrate the three-year trend in SRH's payor mix, based on gross patient charges, for the years ended December 31, 2015 through 2017.

Payor Mix Trend

Payor Mix	Years Ended December 31,		
	2015	2016	2017
Medicare	35.70%	36.25%	35.66%
Medicare Advantage	13.30%	12.97%	12.97%
Subtotal: Medicare	49.00%	49.22%	48.63%
Medicaid	22.30%	20.56%	21.51%
Other Government	3.78%	4.49%	4.63%
Commercial	23.67%	24.40%	23.49%
Self Pay	1.25%	1.33%	1.74%
	100.00%	100.00%	100.00%



Public Hospital District No. 1 of Skagit County, Washington

Management's Discussion and Analysis (continued)

Operating Revenue (continued)

Reduction in uninsured associated with the Affordable Care Act has leveled off and the uninsured self-pay payors have increased after a low of 1.25% in 2015. The District continues to see the effects of the aging population in Skagit County through increased Medicare and lower commercial payor mix. The addition of CVH, located in northern Snohomish County, which has higher exposure to a younger population with higher rates of commercial, Medicaid, and uninsured self-pay payors, helped offset the Medicare increase in Skagit County. However, both markets saw a decrease in commercial payor mix.

2017 saw net patient revenue at SRH grow by \$19,238 from \$329,786 in 2016 to \$349,024 in 2017. A full year of operations at CVH accounted for approximately \$16,138 of this increase. Volume and rate increases at SVH, partially offset increased revenue adjustments related to the deteriorating payor mix added \$2,461 in 2017. At SRC, growth in the orthopedic, urgent care, family medicine, and gastroenterology practices offset decreases in internal medicine and dermatology, resulting in a \$639 increase from 2016 to 2017.

Net patient revenue of \$329,786 in 2016 increased by \$42,182, over the 2015 net revenue of \$287,604. Growth in surgery minutes, emergency room visits, and adult and pediatric patient days along with the addition of CVH account for this growth.

Other Operating Revenue

Other operating revenue increased by \$3,593, or 19.3%, from \$18,600 in 2016 to \$22,193 in 2017. The 340B contracted pharmacy program continued to expand, adding several new specialty pharmacies and increasing revenue from the program by \$3,617 in 2017 over 2016. Revenue from the 340B contract program totaled \$7,177 in 2017. Other operating revenue increased by \$1,586, or 9.3%, in 2016 from \$17,014 in 2015. Meaningful use incentive payments for installation and use of electronic health records in the hospital and clinics increased by \$813, from \$1,327 in 2015 to \$2,140 in 2016. Professional fee revenue for oncology providers increased by \$375, or 17.1%, in 2016. Income generated for the District from its ownership in several joint ventures increased by \$49, from \$2,205 in 2016 to \$2,254 in 2017. In 2016, income from joint ventures decreased by \$476, from \$2,681 in 2015.

Total operating revenue for 2017 was \$373,471, an increase of \$22,880, or 6.5%, over the 2016 total operating revenue of \$350,591. The increase in 2016 over the 2015 total of \$307,299 is \$43,292, or 14.1%.

Operating Expenses

Total operating expenses in 2017 increased by \$30,685, or 8.7%, from \$354,651 in 2016 to \$385,336 in 2017. Total operating expenses increased by \$57,475 in 2016 from \$297,176 in 2015.

SRH wages and benefits increased by \$32,648, or 21.8%, from \$149,812 in 2015 to \$182,460 in 2016, and by \$26,414, or 14.5%, to \$208,874 in 2017. Excluding providers, the District employed 1,842 full time equivalents (FTEs) in 2017, an increase of 172 from the 1,669 FTEs employed in 2016 and a two-year increase of 440 from 1,402 FTEs employed in 2015. The full year impact of operations at CVH added 114 FTEs, while the remaining increase is related to staffing for the post go-live Epic EHR implementation. Growth from 2015 to 2016 is principally related the addition of CVH and organizational growth.

Public Hospital District No. 1 of Skagit County, Washington

Management's Discussion and Analysis (continued)

Operating Expenses (continued)

At year-end 2017, SRH employed 154 providers at 131 FTEs, comprising 106 doctors at 91 FTEs, which includes 30 residents at 30 FTEs and 48 mid-level providers at 40 FTEs. In 2016, SRH employed 183 providers at 167 FTEs.

The salary and benefits dollar increases not associated with the added FTEs are accounted for by contracted union and non-contracted staff, and provider annual increases.

Professional fees increased by \$1,415, from \$21,001 in 2016 to \$22,416 in 2017. Nurse registry, outsourced medical, and non-medical support staff increased by \$1,708. Outsourcing of the CVH Anesthesia program and a staffing shortage, filled with registry personnel, in Case Management were the largest drivers of this increase. Consulting, legal, and audit fees decreased from \$2,293 in 2016 to \$2,160 in 2017. SRH physician fees decreased by \$165 to \$14,762 in 2017 from \$14,927 in 2016. Increases in Orthopedic, Pulmonary, and Women's Health locum's expenses were offset by reductions in Mental Health and Gastroenterology, and restructuring of the outsourced ER physicians program.

Professional fees decreased by \$307, from \$21,308 in 2015 to \$21,001 in 2016. Consulting, legal, and audit fees decreased from \$2,882 in 2015 to \$2,293 in 2016. Expenses in 2015 related to the integration with CVH and the selection of the Epic EHR system decreased in 2016 as we completed the affiliation with CVH and selected the EHR vendor. SRH physician fees decreased by \$154 to \$14,927 in 2016 from \$15,081 in 2015. The restructuring of the hospitalist program transferred locum's expenses of \$1,672 out of professional fees to purchased services. Increases in locums in the gastroenterology practice, sleep medicine, and the addition of CVH accounted for the remaining change in physician's fees.

Supply expense, including pharmaceutical, medical devices and equipment, and medical and non-medical supplies, increased by \$400, from \$46,824 in 2016 to \$47,224 in 2017. Increases in spending on 340B pharmaceuticals related to the added specialty pharmacies and the impact of operating CVH for a full year was mostly offset by reductions in the operating room medical supplies and special imaging devices. The addition of CVH supply expense, growth in patient volumes, and inflation in supply acquisition costs, increased supply expense increased by \$6,354, from \$40,470 in 2015.

Other supply expense, which includes minor equipment, cleaning, food, and office expenses, increased from \$3,457 in 2015 to \$4,239 in 2016 and to \$3,979 in 2017. The increase in 2016 was due to minor equipment purchases related to the ongoing upgrade of information technology infrastructure and the addition of CVH. 2017 saw a reduction in minor equipment expense after a buildup in 2016, which was partially offset by the additional supply cost of operating CVH for a full year.

Purchased services, maintenance, rental and lease, utilities, and other expense increased \$5,515, from \$72,161 in 2016 to \$77,676 in 2017. This increase is related to a mix of one-time go-live support and ongoing maintenance, licensing, and hosting expenses related to for the Epic EHR. Additional increases are related to backfill support for legacy systems, and the impact of operating CVH for a full year. Purchased services, maintenance, rental and lease, utilities, and other expense increased \$16,188, from \$55,973 in 2015. Of this variance, the addition of CVH added \$3,786, and the outsourcing of the hospitalist program added \$5,145, a portion of which was transferred from professional fees. Other increases include travel related to the Epic EHR implementation training, review, and cleanup of accounts receivable by an outside agency, and rent expense for the new business services center.

Public Hospital District No. 1 of Skagit County, Washington

Management's Discussion and Analysis (continued)

Operating Expenses (continued)

Insurance and taxes expense was \$5,444 in 2017, a decrease of \$687 from 2016. Insurance premium and deductible reserves decreased by \$718. This is primarily related to reductions on reserves for historical periods prior to 2013 that had no self-insured retention aggregate limit. Excise and property taxes increased by \$31 related to the full year of operations at CVH. In 2016, insurance and tax expense increased by \$1,056 from \$5,075 in 2015. This increase is related to the addition of CVH to the District's insurance policies and increased tax expense related to the addition of CVH revenue.

Depreciation expense of \$14,289 was \$745 lower than the 2016 expense of \$15,034. Depreciation related to the Epic EHR added \$1,110 for three months of depreciation beginning with the go-live date of October 1st 2017. This increase was offset by several of the movable equipment assets that were acquired in the 2007 hospital expansion along with additional assets acquired in the final closing of the SVMC acquisition reaching full depreciation in 2016 and early 2017. Upgrades of the information technology infrastructure in 2016 were the main driver of the increase in depreciation from 2015 to 2016.

Interest and amortization expense decreased by \$1,366 to \$5,435 in 2017 from \$6,801 in 2016 after an increase of \$617 from 6,184 in 2015. Savings from the refunded portion of the 2016 Revenue and Refunding along with one-time costs associated with the issuance of the 2016 Revenue and Refunding bonds account for the decrease in 2017 and the increase from 2015 to 2016.

Net Nonoperating Income and Changes in Net Position

Net nonoperating income and change in net position decreased by \$7,163, from \$18,323 in 2016 to \$11,160 in 2017 and increased in 2016 by \$16,410, from \$1,499 in 2015. The transfer of assets including prepaid assets, inventory, and excess cash increased \$15,531 in 2016 and decreased by \$7,704 in 2017. The remaining increase is related to improved investment returns on the restricted funds in both 2017 and 2016 along with increased net gain on sale of fixed assets in 2016. Donations received for capital contributions were \$287 in 2017, compared with \$758 in 2016, a decrease of \$471. The majority of the donations were gifts from the hospital foundation for various projects.

Public Hospital District No. 1 of Skagit County, Washington
Management's Discussion and Analysis (continued)

Statements of Net Position (in thousands)

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Current assets			
Cash and short-term investments	\$ 19,112	\$ 23,622	\$ 24,160
Accounts receivable, net	57,289	62,503	48,930
Other current assets	<u>16,299</u>	<u>16,737</u>	<u>14,129</u>
Total current assets	92,700	102,862	87,219
Assets whose use is limited, net of current portion	126,288	136,166	116,203
Capital assets, net	153,742	134,317	123,799
Investments in joint ventures	<u>12,707</u>	<u>13,305</u>	<u>13,770</u>
Total assets	385,437	386,650	340,991
Deferred outflows of resources	<u>4,434</u>	<u>4,851</u>	<u>4,527</u>
Total assets and deferred outflows of resources	<u><u>\$ 389,871</u></u>	<u><u>\$ 391,501</u></u>	<u><u>\$ 345,518</u></u>
Current liabilities	\$ 55,193	\$ 52,585	\$ 38,001
Long-term debt, net of current portion	175,728	179,581	163,828
Estimated professional liability	<u>4,037</u>	<u>4,003</u>	<u>3,378</u>
Total liabilities	<u>234,958</u>	<u>236,169</u>	<u>205,207</u>
Net position			
Net investment in capital assets	5,388	2,451	(5,125)
Restricted for debt service	12,838	13,192	12,176
Unrestricted	<u>136,687</u>	<u>139,689</u>	<u>133,260</u>
Total net position	<u>154,913</u>	<u>155,332</u>	<u>140,311</u>
Total liabilities and net position	<u><u>\$ 389,871</u></u>	<u><u>\$ 391,501</u></u>	<u><u>\$ 345,518</u></u>

Public Hospital District No. 1 of Skagit County, Washington

Management's Discussion and Analysis (continued)

Statements of Net Position (in thousands) (continued)

Assets

Total current assets of \$92,700 at December 31, 2017, were \$10,162 lower than at year-end 2016. This decrease is made up of a \$4,510 decrease in cash and short-term investments, a decrease of \$5,214 in net accounts receivable, and a decrease of \$438 in other current assets. From 2015 to 2016, total current assets increased by \$15,643 primarily due to increased AR related to the addition of CVH and delays in payments associated with the change in ownership.

Net patient accounts receivable average days outstanding at year-end 2017 were 50.8, versus 62.2 days in 2016. The decrease in 2017 is due to improvements in payments associated CVH which experienced an initial delay in 2016 associated with the change in ownership that increased average days outstanding at year-end 2016. Additionally, an effort to reduce AR from legacy billing systems prior to the commencement of the Epic EHR contributed to the reduced days outstanding.

Assets whose use is limited decreased from \$136,166 in 2016 to \$126,288 in 2017 after increasing from \$116,203 in 2015. The 2016 increase and subsequent 2017 decrease relates to the project fund portion of the 2016 Revenue and Refunding Bonds and use of those funds for various capital projects including the Epic EHR.

Net capital assets increased in 2017 by \$19,425, from \$134,317 to \$153,742. This increase is made up of \$33,713 of new capital assets, offset by \$1,065 in retirements and a \$13,223 increase in accumulated depreciation. Of the new capital assets, \$25,301 is related to the Epic EHR. In 2016, net capital assets increased by \$10,518, from \$123,799 in 2015. This increase is made up of \$25,552 of net new capital assets, offset by a \$1,321 in retirements and a \$13,713 increase in accumulated depreciation.

The investment in joint ventures decreased by \$598 to \$12,707 at the end of 2017, after decreasing by \$465 in 2016. Distributions from the joint ventures accounted for the change in 2016 and 2017.

Liabilities

Current liabilities increased \$2,608, from \$52,585 in 2016 to \$55,193 in 2017. This increase is made up of an increase in the current portion of long-term debt of \$3,413, an increase of \$167 in payables, and a decrease of \$972 in payment due to third-party payors. Financing of the Epic EHR License as well go-live support is the main drive for the increase in current portion of long-term debt. Current liabilities in 2016 increased by \$30,962 over 2015, the addition of CVH employees and expenses are the drivers behind this increase.

Long-term debt, net of current portion decreased by \$3,853 in 2017 to \$175,728 from \$179,581 in 2016 on normal scheduled principal payments. The issuance of the 2016 Revenue and Refunding Bonds increased long-term debt, net of current portion, by \$15,753 in 2016, from \$163,828 at year-end 2015.

Professional malpractice liability reserve increased by \$34 in 2017, from \$4,003 to \$4,037. This increase is based on an actuarial estimate of the professional malpractice liability, based on historic claims and changes in volume. In 2016, professional liabilities reserves increased by \$625, from \$3,378 in 2015 related to the exposure added with CVH.

Decrease in net position is made up of operating loss of \$11,865, net nonoperating income and changes in net position of \$11,160, as well as grant funds and donations of \$287.

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Affiliation Agreement with Snohomish County PUD No. 3

In accordance with the Affiliation Agreement, which was dated December 4, 2015, the District began operating Cascade Valley Hospital on June 1, 2016. The Affiliation Agreement is structured as a long-term lease (the Lease) between Snohomish PHD No. 3 d/b/a Cascade Valley Hospital and Clinics and the District. Pursuant to the Affiliation Agreement, Snohomish PHD No. 3 leased substantially all of its assets, including Cascade Valley Hospital, certain other clinic facilities, Snohomish PHD No. 3's interest as lessor in certain land leases, and intangible assets, to the District for a term of 30 years. The District will pay Snohomish PHD No. 3 an annual base rent of \$10.00 and is responsible for all costs and expenses associated with the leased assets, including maintenance and capital improvements.

Financial Arrangement

Pursuant to the Affiliation Agreement, Snohomish PHD No. 3 will transfer all of its cash and cash equivalents in excess of a retained amount to the District by June 2017. The retained amount is equal to Snohomish PHD No. 3's known and contingent liabilities and debts plus a minimum cash balance of \$1,000,000. Thereafter, Snohomish PHD No. 3 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 Snohomish PHD No. 3. 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 the District, which operates an outpatient chemotherapy unit, an urgent care clinic, an occupational medicine clinic, and laboratory and imaging services. Snohomish PHD No. 3's excess property tax levy funds will be used solely for the purpose of paying the debt service on Snohomish PHD No. 3's outstanding unlimited tax general obligation bonds. The proceeds from the Snohomish PHD No. 3 regular property tax levy and the Smokey Point LLC lease will be used to pay Snohomish PHD No. 3's expenses, including the annual debt service on Snohomish PHD No. 3'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 Snohomish PHD No. 3 from its regular property tax levy and the Smokey Point LLC lease exceeds Snohomish PHD No. 3's existing obligations in any year, and the Snohomish PHD No. 3 cash balance is equal to \$1,000,000, the excess funds will be transferred to the District.

In accordance with the Affiliation Agreement, the transferred funds will be deposited in Pool A of the "PHD No. 3 Support Fund." The funds in Pool A will be used by the District 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 the District facilities and the Cascade Valley Hospital facilities, provided that only that portion of the costs of such improvement and equipment that reasonably relate to Snohomish PHD No. 3's usage of the capital investment shall be allocated to Snohomish PHD No. 3; and (4) to cover any losses incurred by the District in the operation of Cascade Valley Hospital services.

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Affiliation Agreement with Snohomish County PUD No. 3 (continued)

At the end of each fiscal year, the District will deposit into a special fund designated as Pool B of the "PHD No. 3 Support Fund" a portion of the District's net cash flow generated from the District'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 the District's operation of the Cascade Valley 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 the District in the following order of priority: (1) to cover any Cascade Valley 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 the District 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 the District for expenses incurred by the District in prior years to fund capital improvements or equipment located at the Cascade Valley Hospital facilities or for health information technology or other capital investments located elsewhere to the extent it serves both the District and Cascade Valley Hospital facilities, but only for such portion that reasonably relate to Snohomish PHD No. 3'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 the District for expenses incurred by the District in the current year to fund Cascade Valley 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 the District to provide certain required services in North Snohomish County (identified by zip codes 98223, 98241, 98292, 98271, 98270, 98258, 98252) for five, 10, and 30-year periods. The District 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), the District must provide OB/GYN, pediatric physician, and related Cascade Valley Hospital facilities services at any location within North Snohomish County, which the District reasonably believes will appropriately serve the needs of the residents of North Snohomish County. The District 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. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Affiliation Agreement with Snohomish County PUD No. 3 (continued)

During the 10-year period following the affiliation (the Ten-Year Period), the District 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, the District is required to continuously maintain and operate Cascade Valley 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. The District is granted the right during the Ten-Year Period to modify or reduce the level of service provided at Cascade Valley 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 Snohomish PHD No. 3 and allowed Snohomish PHD No. 3 to provide input before said service is eliminated, relocated, modified, or reduced. Nonetheless, if the District elects to discontinue outpatient surgery services at Cascade Valley Hospital during the Ten-Year Period, the District must provide such services during 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 Thirty-Year Period following the 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, the District 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 the District intends to eliminate, reduce, relocate, or change any required service in a manner not described above, it must give Snohomish PHD No. 3 90 days' advance written 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. Snohomish PHD No. 3 is granted the right to determine, in its sole and absolute discretion, whether it will permit the District to proceed with the requested change. Snohomish PHD No. 3 must notify the District within 90 days of receipt of the Change Notice whether it will permit or deny the requested change. If Snohomish PHD No. 3 fails to respond in writing within 90 days of receipt of the Change Notice, Snohomish PHD No. 3 will be deemed to have approved the proposed service change.

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Affiliation Agreement with Snohomish County PUD No. 3 (continued)

Dispute Resolution

Subject to the parties' right to equitable relief, all controversies, claims, and disputes arising in connection with the Affiliation Agreement must be settled by mutual consultation between the parties, but failing amicable settlement must be settled finally by arbitration, conducted in Seattle, Washington, in accordance with the rules and procedures promulgated by Judicial Dispute Resolution before one arbitrator. The decision of the arbitrator is final and binding on the parties.

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 Snohomish PHD No. 3; (2) by either the District or Snohomish PHD No. 3 in the event of an uncured breach of the Affiliation Agreement or the Lease by the other party; (3) by the District in the event that a catastrophic event occurs that was not caused by the District and makes it no longer viable to continue operating Cascade Valley Hospital services as originally contemplated; (4) by either the District or Snohomish PHD No. 3 if Snohomish PHD No. 3 requires the District 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 the District's negligence; and (5) after six years, by the District if the District has incurred sustained operating losses, as defined in the Affiliation Agreement, in the operation of Cascade Valley Hospital services.

To effect an unwind, the District will transfer all of the facilities and assets owned by Snohomish PHD No. 3 back to Snohomish PHD No. 3 following a process consistent with how they were originally transferred. In addition, the District will transfer to Snohomish PHD No. 3 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 Cascade Valley Hospital facilities immediately prior to termination.

All of the commitments by Snohomish PHD No. 3 to provide any cash or similar support to the District will terminate after the date the District provides written notice of termination of the Affiliation Agreement or concurrent with the termination of the definitive agreements for any other reason, provided that Snohomish PHD No. 3 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. The Affiliation Agreement provides provisions for certain operating commitments and specific provisions in event the agreement is discontinued.

2016 Hospital Revenue Improvement and Refunding Bonds

In November 2016, the District issued \$62,730,000 in Revenue Improvement and Refunding Bonds. Approximately \$42,730,000 of these proceeds were used to carry out the advanced refunding of the District's 2005 and 2007 hospital revenue bonds. The remaining \$20,000,000 in bond proceeds was used to pay or reimburse costs to acquire, construct, remodel, renovate, equip, and furnish the District's health facilities in conformance with the District's 2016–2018 capital budgets, including the Epic Electronic Health Record System.

Public Hospital District No. 1 of Skagit County, Washington Management's Discussion and Analysis (continued)

Contacting the District's Financial Management

This financial report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of Skagit Regional Health's finances and to show the District's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the District's financial management at Skagit Regional Health Business Center, 1415 East Kincaid Street, Mount Vernon, Washington 98273.

Public Hospital District No. 1 of Skagit County, Washington

Statements of Net Position

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES

	December 31,	
	2017	2016
CURRENT ASSETS		
Cash	\$ 1,142,196	\$ 715,306
Short-term investments	17,970,128	22,907,058
Patient accounts receivable, less allowance for uncollectible accounts of \$9,044,158 and \$5,296,083	48,585,898	56,079,787
Other receivables	8,703,345	6,423,608
Assets limited as to use, required for current liabilities	6,936,466	6,590,128
Supplies inventory	5,311,720	5,284,512
Prepaid expenses and other assets	3,790,423	4,642,816
Interest receivable	260,031	219,383
Total current assets	92,700,207	102,862,598
ASSETS LIMITED AS TO USE		
Board-designated for capital improvements	104,646,170	103,899,659
Board-designated for professional liability	1,644,447	1,650,802
Restricted for CVH project funds A & B	14,093,301	8,995,456
Restricted bond reserve funds held by trustee	9,499,263	9,500,507
Restricted for construction project fund	2,784	15,017,531
Restricted for bond redemption fund	3,338,850	3,692,026
	133,224,815	142,755,981
Less amounts required for current liabilities	(6,936,466)	(6,590,128)
	126,288,349	136,165,853
CAPITAL ASSETS		
Land	10,066,771	10,066,771
Construction in progress	108,520	11,790,900
Depreciable capital assets, net of accumulated depreciation	143,567,166	112,459,692
	153,742,457	134,317,363
INVESTMENTS IN JOINT VENTURES	12,706,638	13,304,598
Total assets	385,437,651	386,650,412
DEFERRED OUTFLOWS OF RESOURCES		
Deferred losses on refundings	4,433,839	4,850,514
Total assets and deferred outflows of resources	\$ 389,871,490	\$ 391,500,926

Public Hospital District No. 1 of Skagit County, Washington
Statements of Net Position

LIABILITIES AND NET POSITION

	December 31,	
	2017	2016
CURRENT LIABILITIES		
Accounts payable	\$ 17,827,715	\$ 21,151,371
Accrued salaries, wages, and employee benefits	20,923,534	17,414,678
Estimated third-party payor settlements	5,798,762	6,769,288
Accrued interest payable	686,466	705,128
Current portion of long-term debt	9,956,836	6,544,116
	<hr/>	<hr/>
Total current liabilities	55,193,313	52,584,581
LONG-TERM DEBT, net of current portion	175,727,612	179,580,745
ESTIMATED PROFESSIONAL LIABILITY	4,036,788	4,003,245
	<hr/>	<hr/>
Total liabilities	234,957,713	236,168,571
	<hr/>	<hr/>
NET POSITION		
Net investment in capital assets	5,388,222	2,450,799
Restricted for debt service	12,838,113	13,192,533
Unrestricted	136,687,442	139,689,023
	<hr/>	<hr/>
Total net position	154,913,777	155,332,355
	<hr/>	<hr/>
Total liabilities and net position	<u>\$ 389,871,490</u>	<u>\$ 391,500,926</u>

Public Hospital District No. 1 of Skagit County, Washington
Statements of Revenues, Expenses, and Changes in Net Position

	Years Ended December 31,	
	2017	2016
OPERATING REVENUES		
Net patient service revenue (net of provision for bad debts of \$21,720,708 and \$11,182,017)	\$ 349,023,832	\$ 329,786,426
Other operating revenues	24,447,464	20,804,656
Total operating revenues	373,471,296	350,591,082
OPERATING EXPENSES		
Salaries and wages	170,653,757	149,268,822
Employee benefits	38,219,792	33,191,350
Professional fees	22,416,239	21,001,133
Supplies	51,202,622	51,062,743
Purchased services	57,401,198	53,655,642
Other	25,719,542	24,636,344
Depreciation and amortization	14,288,610	15,034,234
Interest and amortization	5,434,898	6,800,891
Total operating expenses	385,336,658	354,651,159
Operating loss	(11,865,362)	(4,060,077)
NONOPERATING INCOME, net		
Investment income	1,413,277	844,222
Revenues from tax levies for general obligation bonds	4,174,538	3,965,343
Interest and amortization expense	(2,198,698)	(2,301,539)
Other income (expense)	(56,083)	284,721
Nonoperating income, net	3,333,034	2,792,747
Deficiency of revenues over expenses before capital contributions and transfers	(8,532,328)	(1,267,330)
CAPITAL CONTRIBUTIONS	287,196	758,087
GAIN ON TRANSFER OF ASSETS	7,826,554	15,530,954
INCREASE (DECREASE) IN NET POSITION	(418,578)	15,021,711
NET POSITION, beginning of year	155,332,355	140,310,644
NET POSITION, end of year	\$ 154,913,777	\$ 155,332,355

Public Hospital District No. 1 of Skagit County, Washington

Statements of Cash Flows

Increase (Decrease) in Cash and Cash Equivalents

	Years Ended December 31,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from and on behalf of patients	\$ 355,547,195	\$ 319,955,898
Cash paid to suppliers	(159,204,529)	(141,937,883)
Cash paid to employees	(205,364,693)	(178,852,211)
Other cash receipts	19,753,503	17,192,062
Net cash from operating activities	10,731,476	16,357,866
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of capital assets	(25,754,878)	(25,552,703)
Principal payments on long-term debt	(7,572,474)	(4,635,660)
Interest paid on long-term debt	(8,062,348)	(10,275,232)
Escrow payment for refunding of general obligation bonds	-	(46,240,000)
Proceeds from issuance of long-term debt	-	62,730,000
Proceeds from bond premium	-	6,629,015
Cash paid for financing costs	-	(813,605)
Cash received from tax revenues for general obligation bonds	4,191,233	3,970,960
Cash received from transfer of assets	7,826,554	13,780,895
Other	231,113	1,042,808
Net cash from capital and related financing activities	(29,140,800)	636,478
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash distributions from joint ventures	2,851,893	2,669,965
Net change in investments and assets limited as to use	23,226,552	(21,470,399)
Investment income	1,653,457	987,825
Net cash from investing activities	27,731,902	(17,812,609)
NET CHANGE IN CASH AND CASH EQUIVALENTS	9,322,578	(818,265)
CASH AND CASH EQUIVALENTS, beginning of year	2,874,653	3,692,918
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 12,197,231</u>	<u>\$ 2,874,653</u>
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE STATEMENTS OF NET POSITION		
Cash	\$ 1,142,196	\$ 715,306
Cash and cash equivalents in assets limited as to use	11,055,035	2,159,347
	<u>\$ 12,197,231</u>	<u>\$ 2,874,653</u>

Public Hospital District No. 1 of Skagit County, Washington

Statements of Cash Flows (continued)

Increase (Decrease) in Cash and Cash Equivalents

	Years Ended December 31,	
	2017	2016
RECONCILIATION OF OPERATING INCOME TO		
NET CASH FROM OPERATING ACTIVITIES		
Operating loss	\$ (11,865,362)	\$ (4,060,077)
Adjustments to reconcile operating income to net cash		
from operating activities		
Investment income considered an investing activity	(160,291)	(72,356)
Interest expense considered a capital financing activity	5,434,898	6,800,891
Depreciation and amortization	14,288,610	15,034,234
Income recognized from joint ventures	(2,253,933)	(2,205,002)
Changes in operating assets and liabilities		
Accounts receivable, net	7,493,889	(12,237,940)
Other receivables	(2,279,737)	(1,335,236)
Supplies inventory	(27,208)	(25,567)
Prepaid expenses	852,393	317,669
Accounts payable	(3,323,656)	7,500,579
Accrued salaries, wages, and employee benefits	3,508,856	3,607,961
Estimated third-party payor settlements	(970,526)	2,407,412
Reserve for professional liability costs	33,543	625,298
Net cash from operating activities	<u>\$ 10,731,476</u>	<u>\$ 16,357,866</u>
DISCLOSURE OF NONCASH INVESTING ACTIVITIES		
Capital assets financed with capital lease obligation	<u>\$ 6,154,087</u>	
Capital assets financed through vendor	<u>\$ 1,804,739</u>	

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 1 – Organization

Organization – Public Hospital District No. 1 of Skagit County, Washington (the District), is organized as a municipal corporation pursuant to the laws of the state of Washington. The District is governed by an elected five-member board. The District, doing business as Skagit Valley Hospital (SVH), added the clinic division on July 1, 2010. The clinic division is known as Skagit Regional Clinics (SRC). On January 1, 2011, the District created the system name Skagit Regional Health (SRH). This name encompasses both SVH's and SRC's operations. SVH is a licensed 137-bed acute care hospital in Mount Vernon, Washington. The District also operates Camano Rural Health Clinic on Camano Island, Washington.

UW Medicine and Public Hospital District No. 3 of Snohomish County (PHD No. 3), which operated Cascade Valley Hospital and Clinics (CVH) in Arlington, Washington, entered into a long-term alliance with UW Medicine with respect to clinical and other ventures and a lease by the District of PHD No. 3's health care facilities (UW Affiliation Agreement).

Pursuant to the UW Affiliation Agreement, UW Medicine serves as SVH's and CVH's complex tertiary and quaternary health system for specialty care services not available in mutually designated communities and provided by UW Medicine. UW Medicine is 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. 3 also entered into an Affiliation Agreement Regarding the Lease and Operation of CVH, (the Affiliation Agreement). CVH is a 48-bed facility that is approximately 20 miles southeast of SVH's main campus. In accordance with Affiliation Agreement, the District began operating CVH on June 1, 2016. The Affiliation Agreement is structured as a long-term lease (the Lease) between PHD No. 3 and the District. PHD No. 3 leased substantially all of its assets, certain other clinic facilities, PHD No. 3's interest as lessor in certain leases, and intangible assets to the district for a term of 30 years. The District will pay PHD No. 3 an annual base rent of \$10 and is responsible for all costs and expenses associated with the leased assets, including maintenance and capital improvements.

Pursuant to the Affiliation Agreement, PHD No. 3 transferred all of its cash and cash equivalents of a retained amount to the District in 2017. The retained amount is equal to PHD No. 3's known and contingent liabilities and debts plus a minimum cash balance of \$1,000,000. Thereafter, PHD No. 3 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. 3. The proceeds from PHD No. 3's regular property tax levy and the Smokey Point LLC lease will be used to pay PHD No. 3'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 PHD No. 3 from its regular property tax levy and the Smokey Point LLC lease exceeds PHD No. 3's existing obligations in any year, and the PHD No. 3 cash balance is equal to \$1,000,000, the excess funds will be transferred to the District. Cash transferred by PHD No. 3 to the District was \$7,826,554 and \$13,780,985 in 2017 and 2016. Prepaid assets of \$474,637 and inventory of \$1,275,422 were transferred in 2016. This resulted in a gain on transfer of assets of \$7,826,554 and \$15,530,954 in 2017 and 2016, respectively.

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

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

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).

Basis of presentation – 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 receipt or disbursement of cash.

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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents – Cash and cash equivalents include demand and interest-bearing deposits with an original maturity of three months or less.

Patient accounts receivable – Accounts receivable are reduced by an allowance for doubtful 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 doubtful 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 doubtful 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 doubtful 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' balances (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 doubtful accounts.

Supplies inventory – Supplies inventory, consisting of medicine and medical supplies, is valued at the lower of cost (computed on the first-in, first-out basis), or net realizable value.

Capital assets – Land, buildings, and equipment acquisitions are recorded at cost. Improvements and replacements of land, buildings, and equipment are capitalized. The District's capitalization threshold is \$1,000 per item and a useful life of at least three years. Maintenance and repairs are expensed. The cost of land, buildings, and equipment sold or retired and the related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recorded.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 2 – Summary of Significant Accounting Policies (continued)

Depreciation is recorded over the estimated useful life of each class of depreciable asset using the American Hospital Association's guidelines and is computed using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. The estimated useful lives used by the District are as follows:

Land improvements	3 – 40 years
Buildings	26 – 40 years
Fixed equipment	3 – 25 years
Major movable and minor equipment	3 – 20 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 estimated useful life of the related asset.

Federal income taxes – The District, as a political subdivision of the state of Washington, is not subject to federal income taxes under Section 115 of the Internal Revenue Code.

Assets limited as to use and short-term investments – Periodically, the Board of Commissioners sets aside cash resources for the funding of future capital improvements and self-insurance reserves. In addition, certain funds are restricted by bond indentures to be used solely for debt service or for the funding of future capital projects. Pool A and Pool B funds are restricted for capital improvements and operations of CVH as defined in the Affiliation Agreement. These funds are invested in bankers' acceptances, obligations of the United States Government, the State Treasurer's Investment Pool, and certificates of deposit with financial institutions in accordance with state guidelines.

All District investments are carried at market value. Investment income earned on self-insurance funds and the revenue bond indenture agreements are reported as other operating revenue. Realized and unrealized investment income or losses on other investments are reported as nonoperating gains and losses.

Investments in joint ventures – The District has investments in several different joint ventures providing health care services and accounts for these investments using the equity method, under which the District's share of net income is reported in other operating revenues.

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 illness; natural disasters; medical malpractice; and employee accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The District pays certain workers' compensation claims on a self-insured basis. The District has purchased stop-loss insurance to cover workers' compensation claims that exceed stated limits and has recorded an estimated reserve for incurred but not reported claims based on an actuarial estimate, which was \$3,093,000 and \$2,624,000 at December 31, 2017 and 2016, respectively. These amounts are recorded in accrued salaries, wages, and employee benefits on the statements of net position. The District also pays certain professional liability claims on a self-insured basis (Note 10).

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 2 – Summary of Significant Accounting Policies (continued)

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 the outstanding balances of 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 specific purpose. The unrestricted component of net position is the remaining net amount of the assets and liabilities that are not included in the determination of net investment in capital assets or the restricted components 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, such as patient service revenue, result from exchange transactions associated with providing health care services—the District's primary business. Nonexchange revenues, such as revenues for tax levies and contributions for 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 related to general obligation bonds. Tax levy income and debt service related to general obligation bonds and peripheral or incidental transactions are reported as nonoperating gains and losses.

Net patient service revenue – Patient service revenue is recorded at established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Preliminary settlements under reimbursement agreements with Medicare and Medicaid are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

Reimbursements received from certain third-party payors are subject to audit and retroactive adjustment. Provision for possible adjustment as a result of audits is recorded in the financial statements. When reimbursement settlements are received, or when information becomes available with respect to reimbursement changes, any variations from amounts previously accrued are accounted for in the period in which the settlements are received or the change in information becomes available.

Charity care – The District provides care to patients who meet certain criteria under its charity care policies. Because the District does not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient service revenue. Forgone revenue for charity care provided during 2017 and 2016 measured by the District's standard charges was \$4,141,519 and \$5,192,608, respectively.

Public Hospital District No. 1 of Skagit 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 statements of net position date but before financial statements are 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 statements 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 statements of net position but arose after the statements of net position date and before the financial statements are available to be issued.

The District has evaluated subsequent events through April 20, 2018, which is the date the financial statements are available to be issued.

Note 3 – 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. 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 Medicare severity diagnosis-related groups (MS-DRGs). Each MS-DRG has a payment weight assigned to it, based on the average resources used to treat Medicare patients in that MS-DRG. The District's classification of MS-DRGs and the appropriateness of their admission are subject to an independent review by a peer review organization. Most 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 2015. Net revenue billed under Medicare totaled approximately \$138,613,000 and \$125,779,000 for 2017 and 2016, respectively. Unsecured net patient accounts receivable due from Medicare at December 31, 2017 and 2016, were approximately \$17,074,000 and \$16,991,000, respectively.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 3 – Net Patient Service Revenue (continued)

Medicaid – Beginning July 1, 2005, a new inpatient Medicaid reimbursement methodology for all noncritical access Washington State governmental hospitals was implemented called “Certified Public Expenditures.” Under this program, the District is paid for inpatient Medicaid services based on certain costs as determined by Medicaid. 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 this program, the District will be reimbursed the higher of the cost of service or “baseline” reimbursement that would have been received based on the pre-July 1 inpatient payment system. Outpatient services are paid on a fee schedule or a percentage of allowed charges based on a ratio of the District’s allowable operating expenses to total allowable revenue. The District has finalized the Medicaid CPE cost reports through June 30, 2009. Net revenue billed under the Medicaid program totaled approximately \$58,028,000 and \$55,504,000 for 2017 and 2016, respectively. Unsecured net patient accounts receivable due from Medicaid at December 31, 2017 and 2016, were approximately \$7,116,000 and \$7,637,000, respectively.

The District’s estimates of final settlements to or from Medicare and Medicaid through 2017 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 also entered into various payment arrangements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations, which provide for payment or reimbursement at amounts different from published rates. Contractual adjustments represent the difference between published rates for services and amounts paid or reimbursed by these third-party payors.

The following are the components of net patient service revenue for the District for the years ended December 31, 2017 and 2016:

	2017	2016
Gross patient service revenue	\$ 1,221,719,792	\$ 1,086,763,826
Less adjustments to gross patient service revenue		
Contractual adjustments	846,833,733	740,602,775
Provision for bad debts	21,720,708	11,182,017
Charity care	4,141,519	5,192,608
Total adjustments to gross patient service charges	872,695,960	756,977,400
Net patient service revenue	\$ 349,023,832	\$ 329,786,426

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

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

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 (LGIP), eligible bankers' acceptances, and repurchase agreements.

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, 2017 and 2016, all deposits and investments of the District are categorized as Category 1 and consist of the following:

	2017	2016
Unrestricted cash	\$ 1,142,196	\$ 715,306
Short-term investments		
Investment in State Treasurer's Investment Pool	17,970,128	22,907,058
Assets limited as to use		
Cash and cash equivalents	11,055,035	2,159,347
Certificates of deposit	677,886	1,748,124
Government agency securities	44,848,373	104,836,681
Investment in State Treasurer's Investment Pool	76,643,521	34,011,829
	133,224,815	142,755,981
Total deposits and investments	<u>\$ 152,337,139</u>	<u>\$ 166,378,345</u>

The composition of investments, reported at fair value by investment type at December 31, 2017, and excluding unrestricted cash, short-term investments, and other assets limited as to use balances of \$107,488,766, is as follows:

Investment Type	Quoted Prices in Active Markets for Identical Assets (Level 1)	Percentage of Totals
Government agency securities	\$ 44,848,373	100%
Total	<u>\$ 44,848,373</u>	<u>100%</u>

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

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

The composition of investments, reported at fair value by investment type at December 31, 2016, and excluding unrestricted cash, short-term investments, and other assets limited as to use balances of \$61,541,664, is as follows:

Investment Type	Quoted Prices in Active Markets for Identical Assets (Level 1)	Percentage of Totals
Government agency securities	\$ 104,836,681	100%
Total	\$ 104,836,681	100%

The District's deposits and investments had the following maturities as of December 31, 2017:

Deposit/Investment Type	Fair Value	Investment Maturities (in Years)	
		Less Than 1	1–5
Demand deposit	\$ 10,144,805	\$ 10,144,805	\$ -
Money market	2,052,426	2,052,426	-
Certificates of deposit	677,886	677,886	-
Government agency securities	44,848,373	44,848,373	-
Investment in State Treasurer's Investment Pool	94,613,649	94,613,649	-
	<u>\$ 152,337,139</u>	<u>\$ 152,337,139</u>	<u>\$ -</u>

The District participates in the 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.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

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

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.

Deposits – All of the District's deposits are either insured or collateralized. The District's insured deposits are covered by the Federal Deposit Insurance Corporation (FDIC). Collateral protection is provided by the Washington Public Deposit Protection Commission (WPDPC).

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.

In addition to interest and investment income included in nonoperating income, interest income included in other operating revenues totaled \$160,291 and \$72,356 for the years ended December 31, 2017 and 2016, respectively.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 5 – Capital Assets

Capital asset additions, retirements, and balances for the years ended December 31, 2017 and 2016, were as follows:

	Beginning Balance January 1, 2017	Additions	Retirements	Account Transfers	Ending Balance December 31, 2017
NONDEPRECIABLE CAPITAL ASSETS					
Land	\$ 10,066,771	\$ -	\$ -	\$ -	\$ 10,066,771
Construction in progress	11,790,900	210,426	-	(11,892,806)	108,520
Total nondepreciable capital assets	21,857,671	210,426	-	(11,892,806)	10,175,291
DEPRECIABLE CAPITAL ASSETS					
Land improvements	7,340,456	-	-	-	7,340,456
Buildings and leasehold improvements	138,510,996	816,225	-	-	139,327,221
Fixed equipment	22,749,345	105,162	(7,883)	110,425	22,957,049
Movable equipment	92,376,908	32,581,891	(1,057,504)	11,782,381	135,683,676
LESS ACCUMULATED DEPRECIATION AND AMORTIZATION					
Land improvements	(3,142,150)	(308,972)	-	-	(3,451,122)
Buildings and leasehold improvements	(56,207,642)	(5,332,245)	-	-	(61,539,887)
Fixed equipment	(17,966,962)	(598,236)	7,883	-	(18,557,315)
Movable equipment	(71,201,259)	(8,049,157)	1,057,504	-	(78,192,912)
Depreciable capital assets, net	112,459,692	19,214,668	-	11,892,806	143,567,166
	<u>\$ 134,317,363</u>	<u>\$ 19,425,094</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 153,742,457</u>
	Beginning Balance January 1, 2016	Additions	Retirements	Account Transfers	Ending Balance December 31, 2016
NONDEPRECIABLE CAPITAL ASSETS					
Land	\$ 10,066,771	\$ -	\$ -	\$ -	\$ 10,066,771
Construction in progress	240,542	11,902,158	-	(351,800)	11,790,900
Total nondepreciable capital assets	10,307,313	11,902,158	-	(351,800)	21,857,671
DEPRECIABLE CAPITAL ASSETS					
Land improvements	7,320,272	20,184	-	-	7,340,456
Buildings and leasehold improvements	135,288,504	2,998,780	(128,088)	351,800	138,510,996
Fixed equipment	22,474,409	274,936	-	-	22,749,345
Movable equipment	83,213,166	10,356,645	(1,192,903)	-	92,376,908
LESS ACCUMULATED DEPRECIATION AND AMORTIZATION					
Land improvements	(2,790,287)	(351,863)	-	-	(3,142,150)
Buildings and leasehold improvements	(50,966,140)	(5,369,590)	128,088	-	(56,207,642)
Fixed equipment	(17,389,000)	(577,962)	-	-	(17,966,962)
Movable equipment	(63,659,343)	(8,734,819)	1,192,903	-	(71,201,259)
Depreciable capital assets, net	113,491,581	(1,383,689)	-	351,800	112,459,692
	<u>\$ 123,798,894</u>	<u>\$ 10,518,469</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 134,317,363</u>

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 5 – Capital Assets (continued)

The District has included equipment under capital lease obligations with a cost of \$6,848,819 and \$865,267 in capital assets at December 31, 2017 and 2016. Amortization expense of \$495,619 and \$173,053 related to this equipment was recorded in depreciation and amortization expense for 2017 and 2016, respectively. Accumulated amortization for equipment under capital lease was \$726,357 and \$230,737 at December 31, 2017 and 2016, respectively.

Depreciation and amortization expense of operating assets for the years ended December 31, 2017 and 2016, was \$14,288,610 and \$15,034,234, respectively.

Note 6 – Investments in Joint Ventures

Cascade Imaging Associates, LLC – Together with a local radiology group, the District formed Cascade Imaging Associates, LLC (CIA), a limited liability company, to provide magnetic resonance imaging and computer-assisted tomography services to the residents of the community. The District has a 50% interest in CIA at December 31, 2017. During the years ended December 31, 2017 and 2016, the District recognized operating income of \$1,889,141 and \$1,792,761, respectively, for its share of the net income realized by CIA. The District's recorded investment in CIA was \$532,899 and \$393,758 at December 31, 2017 and 2016, respectively.

Medical Information Network – North Sound, Inc. – Together with area hospitals, the District joined Medical Information Network – North Sound, Inc. (MIN – NS), a Washington nonprofit corporation, to electronically connect patients, providers, and others to a regional electronic health record to improve quality and efficiency of health care services in North Sound communities. The District has a 50% interest in MIN – NS at December 31, 2017. During the years ended December 31, 2017 and 2016, the District recognized operating loss of \$154,405 and \$121,984, respectively, for its share of net loss realized by MIN – NS. The District's recorded investment in MIN – NS was \$78,012 and \$232,417 at December 31, 2017 and 2016, respectively.

Skagit Digital Imaging, LLC – Together with a local radiology group, the District formed Skagit Digital Imaging, LLC (SDI), a limited liability company, to provide mammography and stereotactic biopsy services to the residents of the community. The District has a 50% interest in SDI at December 31, 2017. During the years ended December 31, 2017 and 2016, the District recognized an operating loss of \$92,483 and \$27,965, respectively, for its share of the net loss realized by SDI. The District's recorded investment in SDI was \$164,819 and \$207,302 at December 31, 2017 and 2016, respectively.

Skagit Hospice Services, LLC – Together with Public Hospital District No. 304 of Skagit County, Washington, the District formed Skagit Hospice Services, LLC, dba Hospice of the Northwest (Hospice), a limited liability company, to provide hospice services to the residents of the community. The District has a 50% interest in Hospice at December 31, 2017. During the years ended December 31, 2017 and 2016, the District recognized an operating loss of \$48,749 and operating income of \$104,848, respectively, for its share of the net income or loss realized by Hospice. The District's recorded investment in Hospice was \$1,359,231 and \$1,407,980 at December 31, 2017 and 2016, respectively.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 6 – Investments in Joint Ventures (continued)

Skagit Valley Real Estate Partnership – As part of the closing of the integration with SRC in 2013, the District purchased a membership interest in Skagit Valley Real Estate Partnership (SVREP), a partnership that invests in and develops real property located mainly in Skagit and Snohomish Counties, Washington. The District has a 30% interest in SVREP at December 31, 2017. During the years ended December 31, 2017 and 2016, the District recognized operating income of \$347,100 and \$246,386, respectively, for its share of the net income realized by SVREP. The District's recorded investment in SVREP was \$5,009,979 and \$5,067,879 at December 31, 2017 and 2016, respectively.

Smokey Point Medical Center, LLC – Together with PHD No. 3, the District formed Smokey Point Medical Center, LLC (SPMC), a limited liability company, which owns the building, land, and equipment leased to the District and PHD no. 3 to operate the Smokey Point clinics. The District has a 50% interest in SPMC at December 31, 2017. During the years ended December 31, 2017 and 2016, the District recognized operating income of \$341,436 and \$223,491, respectively, for its share of the net income realized by SPMC. The District's recorded investment in SPMC was \$5,561,698 and \$5,995,262 at December 31, 2017 and 2016, respectively.

Aggregated financial information for all of the District's joint ventures is summarized below:

	2017	2016
Current assets	\$ 7,403,206	\$ 7,370,543
Noncurrent assets, net	26,257,925	28,020,438
	<u>\$ 33,661,131</u>	<u>\$ 35,390,981</u>
Current liabilities	\$ 1,974,916	\$ 2,114,309
Long-term liabilities	11,770,231	12,424,071
Equity	19,915,984	20,852,601
	<u>\$ 33,661,131</u>	<u>\$ 35,390,981</u>
Revenue	\$ 27,156,951	\$ 26,587,270
Expenses	21,764,051	21,355,673
Net income	<u>\$ 5,392,900</u>	<u>\$ 5,231,597</u>

For more information on these joint ventures, including financial statements for the individual joint ventures, please contact the Business Services office of the District.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 7 – Long-Term Debt and Other Noncurrent Liabilities

Interest rates and maturities of long-term debt at December 31, 2017 and 2016, for the District consisted of the following:

	2017	2016
Revenue and refunding bonds, 2016 series, 4.00% to 5.00%, due serially on December 1, in amounts from \$1,575,000 in 2018 to \$5,875,000 in 2032, maturing in 2037, net of unamortized premium of \$6,260,736 and \$6,576,403 in 2017 and 2016, respectively.	\$ 67,425,736	\$ 69,276,403
Revenue bonds, 2010 series, 4.00% to 6.00%, due serially on December 1, in amounts from \$500,000 in 2018 to \$7,425,000 in 2035, net of unamortized discount of \$296,137 and \$312,742 in 2017 and 2016, respectively.	31,733,863	32,197,258
General obligation and refunding bonds, 2012 series, 3.13% to 5.00%, due serially on December 1, in amounts from \$2,590,000 in 2018 to \$6,225,000 in 2028, net of unamortized premium of \$4,625,857 and \$5,049,600 in 2017 and 2016, respectively.	51,240,857	54,009,600
Revenue and refunding bonds, 2013A series, 4.00% to 5.00%, due serially on December 1, in amounts from \$1,585,000 in 2018 to \$7,895,000 in 2036, maturing in 2037, net of unamortized premium of \$1,957,920 and \$2,061,880 in 2017 and 2016, respectively.	26,157,920	27,786,880
Notes payable to individuals, due in monthly installments from \$15,700 to \$23,200, including interest from 4.50% to 5.00% with various maturities through July 2024.	1,362,926	1,754,859
Note payable to bank, due in monthly installments of \$9,900, including interest at 4.25% through January 2021.	330,399	433,212
Note payable to Epic, due in monthly installments of \$224,409, including interest at 1 month LIBOR + 2.00% (3.24% at December 31) through June 2018	1,136,739	-
Capital lease obligations, stated at present value of future minimum lease payments.	6,296,008	666,649
	185,684,448	186,124,861
Less current portion	(9,956,836)	(6,544,116)
	<u>\$ 175,727,612</u>	<u>\$ 179,580,745</u>

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 7 – Long-Term Debt and Other Noncurrent Liabilities (continued)

Under the terms of the revenue and refunding bonds, the District has agreed to maintain certain financial ratios and meet certain covenants. Management is not aware of any violations with its debt covenants.

During 2016, the District issued the 2016 revenue bonds to carry out a tax-exempt refunding of the 2005 and 2007 revenue and refunding bonds. The refunding resulted in the recognition of an accounting loss of \$703,391, which will be deferred and amortized over the life of the 2007 bond, which was set to mature in 2032 and 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 \$8,527,000 over the next 16 years and resulted in an economic gain (difference between the present values of the old and new debt service payments) of \$6,663,000.

To refund and defease the series 2005 bonds and the series 2007 bonds, the District irrevocably deposited a portion of the series 2016 bond proceeds, along with District funds, into an escrow fund held by an escrow agent. Upon such deposit, the series 2005 bonds and the series 2007 bonds were deemed defeased and are no longer outstanding.

Changes in the District's noncurrent liabilities during the years ended December 31, 2017 and 2016, are summarized below:

	Beginning Balance January 1, 2017	Additions	Reductions	Ending Balance December 31, 2017	Amounts Due Within One Year
LONG-TERM DEBT					
2010 Revenue bonds	\$ 32,197,258	\$ -	\$ 463,395	\$ 31,733,863	\$ 500,000
2012 GO and refunding bonds	54,009,600	-	2,768,743	51,240,857	2,590,000
2013 Revenue and refunding bonds	27,786,880	-	1,628,960	26,157,920	1,585,000
2016 Revenue and refunding bonds	69,276,403	-	1,850,667	67,425,736	1,575,000
Notes payable to individuals	1,754,859	-	391,933	1,362,926	413,010
Note payable to bank	433,212	-	102,813	330,399	90,115
Note payable to Epic	-	1,804,739	668,000	1,136,739	1,136,739
Capital lease obligations	666,649	6,154,087	524,728	6,296,008	2,066,972
Total long-term debt	186,124,861	7,958,826	8,399,239	185,684,448	9,956,836
ESTIMATED PROFESSIONAL LIABILITY	4,003,245	33,543	-	4,036,788	-
Total noncurrent liabilities	\$ 190,128,106	\$ 7,992,369	\$ 8,399,239	\$ 189,721,236	\$ 9,956,836

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 7 – Long-Term Debt and Other Noncurrent Liabilities (continued)

	Beginning Balance January 1, 2016	Additions	Reductions	Ending Balance December 31, 2016	Amounts Due Within One Year
LONG-TERM DEBT					
2004 GO bonds	\$ 2,020,000	\$ -	\$ 2,020,000	\$ -	\$ -
2005 Revenue bonds	16,280,212	-	16,280,212	-	-
2007 Revenue bonds	31,050,205	-	31,050,205	-	-
2010 Revenue bonds	32,640,652	-	443,394	32,197,258	480,000
2012 GO and refunding bonds	54,433,343	-	423,743	54,009,600	2,345,000
2013 Revenue and refunding bonds	29,360,840	-	1,573,960	27,786,880	1,525,000
2016 Revenue and refunding bonds	-	69,359,015	82,612	69,276,403	-
Notes payable to individuals	2,130,624	-	375,765	1,754,859	1,535,000
Note payable to bank	530,971	-	97,759	433,212	393,574
Capital lease obligations	848,785	-	182,136	666,649	95,827
					169,715
Total long-term debt	169,295,632	69,359,015	52,529,786	186,124,861	6,544,116
ESTIMATED PROFESSIONAL LIABILITY	3,377,947	625,298	-	4,003,245	-
Total noncurrent liabilities	\$ 172,673,579	\$ 69,984,313	\$ 52,529,786	\$ 190,128,106	\$ 6,544,116

Annual debt service requirements to maturity for long-term debt are as follows:

Year Ending December 31,	Bonds and Notes Payable			Capital Leases Payable		
	Principal	Interest	Total	Principal	Interest	Total
2018	\$ 7,889,864	\$ 8,142,011	\$ 16,031,875	\$ 2,066,972	\$ 34,304	\$ 2,101,276
2019	6,953,588	7,849,807	14,803,395	2,066,010	22,529	2,088,539
2020	7,403,991	7,524,910	14,928,901	2,006,344	10,669	2,017,013
2021	7,798,430	7,175,025	14,973,455	156,682	2,677	159,359
2022	8,352,303	6,802,078	15,154,381	-	-	-
2023-2027	49,796,888	27,890,194	77,687,082	-	-	-
2028-2032	37,760,000	16,330,046	54,090,046	-	-	-
2033-2037	40,885,000	6,674,769	47,559,769	-	-	-
Total	166,840,064	\$ 88,388,840	\$ 255,228,904	\$ 6,296,008	\$ 70,179	\$ 6,366,187
Net unamortized premiums	12,548,376					
	<u>\$ 179,388,440</u>					

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 8 – Deferred Compensation and Pension Plans

The District has a deferred compensation plan and pension plans created in accordance with Internal Revenue Code §457(b), §401(a), and §414(h). The plans are available to eligible employees and collectively provide for District matching contributions of a maximum of 9% 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 makes contributions on behalf of eligible employees based upon funding levels ranging from 4% to 9% of an employee's gross earnings plus an additional 1/10 of 1% for each year of the first 10 years of credited service. The District contributes up to 9% 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 has limited administrative involvement and does not perform the investing function for the plans. The District does not hold the assets of the plans in a trustee capacity and does not perform fiduciary accountability for the plans. Therefore, the District employees' deferred compensation plans are not reported on the financial statements of the District.

The District's contributions to the employee benefit plans totaled approximately \$7,259,000 and \$6,532,000 in 2017 and 2016, respectively. Contributions made by employees to the benefit plans totaled approximately \$8,351,000 and \$7,261,000 in 2017 and 2016, respectively. For more information on the retirement plans, contact the District's director of human resources.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 9 – Property Taxes

The 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. 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. Further amounts of tax need to be authorized by the vote of the people.

For 2017 and 2016, the District did not have a regular tax levy. There is a voter-approved tax levy for service of the unlimited tax general obligation bonds. For 2017 and 2016, the tax levy for bond service was \$0.88 and \$0.90 per \$1,000 on a total assessed valuation of \$4,291,075,086 and \$4,082,372,115, for a total levy of \$3,771,898 and \$3,693,514, respectively. The District also receives revenue from timber taxes. Timber tax revenue in 2017 and 2016 was \$402,640 and \$271,829, 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.

Note 10 – Professional Liability Insurance

The District has purchased professional liability insurance from Washington Casualty Company (WCC) on a claims-made basis in the amount of \$1 million per occurrence, with a \$5 million annual aggregate limit. The District has a retention of \$100,000 per claim with an aggregate retention of \$300,000. WCC, together with Ironshore, also provides excess coverage on a claims-made basis in the amount of \$45 million per occurrence, with a \$49 million annual aggregate limit. The District accrues an actuarial estimate of the expected value of losses and related expenses for unreported incidents and claims on an occurrence basis, discounted at 4%, which was \$4,037,000 and \$4,003,000 at December 31, 2017 and 2016, respectively.

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 11 – Joint Venture Transactions

The District provides services, including accounting, management, and ancillary services, to the joint ventures (Note 6). The District was reimbursed approximately \$11,964,000 and \$11,285,000 in expenses related to these services for the years ended December 31, 2017 and 2016, respectively.

As of December 31, 2017 and 2016, the District had a total of approximately \$694,000 and \$983,000, respectively, in accounts receivable from joint ventures.

The joint ventures provide various services to the District (Note 6). The District paid approximately \$15,930,000 and \$13,204,000 to the joint ventures for providing these services for the years ended December 31, 2017 and 2016, respectively.

As of December 31, 2017 and 2016, the District had a total of approximately \$982,000 and \$867,000, respectively, in accounts payable to joint ventures.

Note 12 – Concentrations 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 net receivables from patients and third-party payors at December 31, 2017 and 2016, was as follows:

	2017	2016
Medicare	35%	30%
Medicaid	15%	14%
Group Health	8%	11%
Patient and self-pay	1%	2%
Commercial	30%	33%
Other third-party payors	11%	10%
	<u>100%</u>	<u>100%</u>

Public Hospital District No. 1 of Skagit County, Washington

Notes to Financial Statements

Note 13 – Commitments and Contingencies

Operating leases – The District leases certain facilities and equipment under operating lease arrangements. The following is a schedule by year of future minimum lease payments as of December 31, 2017:

2018	\$ 7,464,212
2019	6,608,743
2020	6,464,211
2021	6,346,759
2022	5,097,895
2023-2027	15,289,751
2028-2031	7,324,483
	<hr/>
	<u>\$ 54,596,054</u>

Rent expense on operating leases for 2017 and 2016 was \$9,784,000 and \$9,027,000, 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.

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, accreditation, 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. 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.

Note 14 – Collective Bargaining Agreements

At December 31, 2017, the District had a total of approximately 3,084 employees. Of this total, 2,195 employees are covered by collective bargaining agreements. There are 602 employees under agreements that expire during 2018.

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

To the Board of Commissioners
Public Hospital District No. 1 of Skagit County, 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 the District as of and for the year ended December 31, 2017, and the related notes to the financial statements, which collectively comprise the District's basic financial statements, and have issued our report thereon dated April 20, 2018.

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 opinions 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.

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.

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

Everett, Washington
April 20, 2018

