Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Anacortes, Washington

Financial Statements

Years Ended December 31, 2017 and 2016

WIPFLi LLP
CPAs and Consultants

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

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Table of Contents

WIPFLI LLP

Independent Auditor's Report

Board of Commissioners
Skagit County Public Hospital District No. 2
d/b/a Island Hospital
Anacortes, Washington

Report on the Financial Statements

We have audited the accompanying financial statements of Skagit County Public Hospital District No. 2 d/b/a Island Hospital (the "Hospital") as of and for the years ended December 31, 2017 and 2016, and the related notes to the financial statements, which collectively comprise the Hospital's 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; 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 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 Skagit County Public Hospital District No. 2 d/b/a Island Hospital as of December 31, 2017 and 2016, and the changes in its net position and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States.

Other Matters

Change in Accounting Principle

As discussed in Note 1 to the financial Statements, in 2017 the Hospital adopted new accounting guidance, GASB Statement No. 75, *Accounting and Finanial Reporting for Post-Employment Benefits Other Than Pensions*. Our opinion is not modified with respect to this matter.

Required Supplementary Information

Accounting principles generally accepted in the United States require that the management's discussion and analysis on pages 3 through 10 and the Schedule of Changes in Total Other Post-Employment Benefit Liability and Related Ratios on page 53 be presented to supplement the basic financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, 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 financial statements, and other knowledge we obtained during our audit of the 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 October 23, 2018, on our consideration of the Hospital'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 soley 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 Hospital'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 Hospital's internal control over financial reporting and compliance.

Wipfli LLP

Wipfli LLP

October 23, 2018
Spokane, Washington

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Management's Discussion and Analysis

December 31, 2017 and 2016

Using This Annual Report

The Hospital's financial statements consist of three statements: statements of net position; statements of revenue, expenses, and changes in net position; and statements of cash flows. These financial statements and related notes provide information about the activities of Skagit County Public Hospital District No. 2 d/b/a Island Hospital (the "Hospital"), including resources held by the Hospital but restricted for specific purposes by contributors, grantors, or enabling legislation.

Statements of Net Position and Statements of Revenue, Expenses, and Changes in Net Position

Our analysis of the Hospital's finances begins on page 4. One of the most important questions asked about the Hospital's finances is, "Is the Hospital as a whole better or worse off as a result of the year's activities?" The statements of net position and the statements of revenue, expenses, and changes in net position report information about the Hospital's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

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

Statements of Cash Flows

The final required statements are the statements of cash flows. The statements report cash receipts, cash payments, and net changes in cash resulting from operating, investing, and financing activities. It also describes the sources and uses of cash during the reporting period.

Introduction

The discussion and analysis of the Hospital's financial performance provides an overview of the financial activities for the years ended December 31, 2017 and 2016. The financial statements and notes are to be read in conjunction with this section. The following narrative utilizes approximate amounts unless otherwise specified.

Financial Highlights

For the fiscal year ended December 31, 2017, the Hospital reported a net operating loss of $1,841,000, excess of revenue over expenses before capital contributions of $1,309,000, and a margin of 1.4%. This compares to amounts in 2016 of a net operating loss of $1,070,000, excess of revenue over expenses of $979,000, and a margin of 1.0%.

The following significant events had an impact on the operating results for the Hospital:

- In August 2011, the Hospital entered into a Lease and Services Agreement with Orcas Medical Foundation. The Hospital agreed to lease the 6,000 square foot facility, and Orcas Medical Foundation contracted with Island Hospital to operate and manage the primary care medical facility with federal rural health clinic status. In 2017 and 2016, Orcas Medical Foundation provided support in the amount of $70,000. In June 2016, the Hospital gave notice to the Orcas Medical Foundation that we would be terminating the agreement at the end of 2016. In December, the Hospital signed an agreement extending management of the clinic through June 2017 and in early 2017 signed another extension to September 2017 to allow the Orcas Medical Foundation to allow a smooth transition to the University of Washington.

- In October 2011, the Hospital entered into a refundable grant agreement in support of professional urology services in Skagit County with Skagit Valley Hospital. The grant calls for an initial grant of $107,000, which was paid in 2011, and an additional $227,000 for the first year of the agreement defined as November 1, 2011 to October 31, 2012. Additional grant funding is determined by a set formula in the agreement based upon the financial performance of the clinic. Additional grant funding was requested in 2017 and 2016 of $280,000. In August of 2017, the Hospital provided a 180-day notice of termination to Skagit County Public Hospital District No 1 that the Grant Agreement would terminate as of March 1, 2018.

- The Hospital submitted an application to the Office of Management and Budget (OMB) of the United States of America requesting a reclassification from the Mount Vernon-Anacortes MSA to the Seattle-Tacoma-Olympia CSA for purposes of increasing reimbursement from the Medicare program. The application was approved by OMB in December 2006 and approved by the Medicare Geographic Review Board in February 2007. The Hospital received extensions in subsequent periods that are effective through September 30, 2019.

Financial Highlights (Continued)

- The Hospital received $500,000 in 2010 and $100,000 from 2011 through 2017 from the Island Hospital Foundation for the purpose of funding the Medical Arts Pavilion with a commitment to receive $100,000 per year through 2020. The Hospital also received the following from the Foundation:

Year	Capital	Other program support
2010	$ 135,655	$ 90,900
2011	144,200	86,700
2012	148,910	241,851
2013	113,472	175,853
2014	115,000	202,028
2015	2,500	260,917
2016	292,300	306,937
2017	600,740	396,106

- In April 2014, the Hospital entered into an Accountable Care Network (ACN) with UW Medicine. The ACN is currently an option for some Boeing beneficiaries, and UW Medicine continues to offer their product on a broader scale. At this time, the Hospital only participates in the Boeing product.

- In June 2016, the Hospital gave notice to the Catherine Washburn Memorial Association that they would not be renewing the operating and lease agreement for the Lopez Medical Center at the end of the current agreement in June 2017. The Hospital agreed to extend the period to September 2017 to allow a smooth transition to the University of Washington.

- In April 2016, the Hospital gave Skagit Radiology notice that they would not be renewing the Professional services agreement under the same terms, which included the Hospital billing for all services and a fee paid to Skagit Radiology for those services. As of September 1, 2016, a new agreement was in place in which Skagit Radiology began billing directly for their professional fees.

- In November 2016, the Hospital signed a software and implementation agreement with Meditech to move to their 6.1 EMR. The estimated 7 year total cost of ownership is $12 million. Implementation will occur during 2017 with a scheduled go-live date of May 1, 2018. Ongoing maintenance costs are projected to be around $2 million annually.

- The Hospital recruited two Family Practice physicians to Fidalgo Medical Associates in 2016. Both started in the fall and plan to develop Family Care practices, as well as Obstetrics. In 2017, the Hospital recruited a pediatric physician to the practice to replace a retiring physician. Recruiting these physicians will improve access to primary care in the community.

Financial Highlights (Continued)

- In April 2017, the Hospital District Board made the decision to exit from the Home Health business and found an entity that has experience in providing Home Health services and was interested in retaining this service in our community. In August 2017, the sale to Glacier Peak Healthcare, Inc. was finalized.

- In May 2017, the Board approved requesting of the district taxpayers a levy lift of $0.31 cents from the current existing $0.19 cents. Proceeds from the levy lift will be used to fund facilities and equipment for the District. In August, the ballot measure passed with 51.77%.

- In August 2018, the balloon payments classified as current liabilities as of December 31, 2017, under the Community Development Entity Loans will come due. NDC CDE Loan B in the amount of $1,770,800 and Kitsap CDE Loan D in the amount of $729,000 are interest-only loans in the form of a Qualified Equity Investment on the District's New Markets Tax Credit Leveraged Loan and will be forgiven by the Tax Credit Investor upon termination of the seven-year compliance period ending in August 2018. NDC CDE Loan A in the amount of $5,373,200 and Kitsap CDE Loan C in the amount of $2,121,000 were refinanced as described in Note 20 in the accompanying notes to the financial statements.

- The Hospital participates in an agent multiple-employer other postemployment benefits plan (OPEB). In accordance with RCW 41.05.085 and RCW 41.05.022, eligible Hospital retirees and spouses are entitled to subsidies associated with postemployment health benefits provided through the Public Employee Benefits Board (PEBB). The PEBB was created within the Washington State Health Care Authority to administer medical, dental, and life insurance plans for public employees and retirees. The Hospital implemented GASB Statement 75 for the year ended December 31, 2017. This statement requires the Hospital to recognize total OPEB liabilities, and the related deferred inflows and outflows for its actuarially determined unfunded liabilities of postemployment plans available to retirees. Amounts that would have been reported as OPEB expense in prior periods are reported as a restatement as required. The prior period adjustment necessary to implement GASB Statement 75 was $8,989,231, adding a 2016 OPEB obligation of $9,077,550 and adding a deferred outflow amount of $88,319. If the District decided to leave the PEBB, the related deferred inflows, outflows and liabilities would be removed from the statements of net position.

Net Position

The summarized statements of net position as of December 31, 2017, 2016, and 2015, are as follows:

	2017	2016	2015
	(In Thousands)		
Current assets:			
Cash and cash equivalents	$ 28,119	$ 27,030	$ 26,194
Patient accounts recievable - Net	8,733	9,055	10,305
Other current assets	2,963	2,948	3,068
Total current assets	39,815	39,033	39,567
Capital assets - Net	65,697	63,613	63,779
Other assets	6,987	7,903	7,093
Deferred outflows of resources	1,615	1,647	1,775
Total assets and deferred outflows of resources	$ 114,114	$ 112,196	$112,214
Current liabilities	$ 22,708	$ 11,816	$ 11,105
Long-term debt - Net	33,891	46,089	48,192
Total OPEB liability	9,864	-	-
Other liabilities	904	854	851
Total liabilities	67,367	58,759	60,148
Deferred inflows of resources - OPEB	389	-	-
Net position	46,358	53,437	52,066
Total liabilities, deferred inflows of resources, and net position	$ 114,114	$ 112,196	$112,214

Total assets and deferred outflows of resources increased by $1,919,000 in 2017 and decreased by $18,000 in 2016. Current liabilities increased by $10,893,000 in 2017 and increased by $711,000 in 2016.

Long-term debt decreased by $12,197,000 in 2017 and decreased by $2,103,000 in 2016.

The total OPEB liability is reported in 2017 due to a change in accounting principal as described in Notes 1 and 12 of the accompanying financial statements.

Net Position (Continued)

The Hospital's net position is the difference between its assets and liabilities reported in the statements of net position. The Hospital's net position, before the accumulated effect of a change in accounting principal, increased by $1,910,000, or 3.6%, in 2017 and increased by $1,371,000, or 2.6%, in 2016.

Statements of Revenue, Expenses, and Changes in Net Position

The summarized statements of revenue, expenses, and changes in net position for the years ended December 31, 2017, 2016, and 2015 are as follows:

	2017	2016	2015
	(In Thousands)		
Operating revenue:			
Net patient service revenue	$ 93,787	$ 93,989	$ 92,439
Other operating revenue	914	1,206	981
Total operating revenue	94,701	95,195	93,420
Operating expenses:			
Salaries, wages, and benefits	54,061	51,431	49,160
Professional and physician fees	3,833	5,902	6,173
Supplies	23,206	23,566	21,218
Purchased services	8,436	8,492	8,693
Depreciation and amortization	4,101	3,958	3,916
Other	2,905	2,915	3,231
Total operating expenses	96,542	96,264	92,391
Operating income	(1,841)	(1,069)	1,029
Nonoperating revenue - Net	3,150	2,048	1,762
Excess of revenue over expenses	1,309	979	2,791
Capital contributions	601	392	104
Increase in net position	1,910	1,371	2,895
Net position at beginning of year as previously stated	53,437	52,066	49,171
Cumulative effect for change in accounting principle	(8,989)	-	-
Net position at beginning of year, restated	44,448	52,066	49,171
Net position at end of year	$ 46,358	$ 53,437	$ 52,066

Statements of Revenue, Expenses, and Changes in Net Position (Continued)

Sources of Revenue

Net patient service revenue decrease by $202,000, or 0.2%, in 2017. This was a result of relatively stable volumes, contractual adjustments, and bad debts during the year even with the discontinuance of the Orcas and Lopez clinics, as well as the sale of Home Health. Net patient service revenue increased by $1,550,000, or 1.7%, in 2016. Patient service revenue is reported net of contractual adjustments with Medicare, Medicaid, and other third-party payors. The collection percentage for the Hospital remained at 41% in 2017 and 2016.

The percentage of revenue by payor class based on total patient service revenue for the years ended December 31, 2017, 2016, and 2015, was as follows:

	2017	2016	2015	2016 to 2017 Change
Medicare and Medicare Managed Care	52.5 %	53.5 %	52.8 %	-1.0 %
Medicaid and Medicaid Managed Care	12.3 %	12.1 %	11.8 %	0.2 %
Other government	10.6 %	10.3 %	8.5 %	0.3 %
Commercial	23.1 %	22.8 %	25.7 %	0.3 %
Self-pay	1.5 %	1.3 %	1.2 %	0.2 %
Totals	100.0 %	100.0 %	100.0 %	

Bad debt expense decreased by $217,000, or 12%, in 2017 and decreased by $148,000, or 9%, in 2016.

Charity care/financial assistance write-offs increased by $232,000, or 59%, in 2017 and increased by $84,000, or 27%, in 2016.

Operating Expenses

Total operating expenses in 2017 increased by $277,000, or 0.03%, compared to an increase of $3,873,000, or 4.2%, in 2016. Primary factors in the change in total operating expenses were as follows:

- Salaries, wages, and benefits increased by 5.11% in 2017, primarily due a change in accounting principal as described in notes 1, 12, and 19 of the accompanying financial statements, and a 4% increase in FTEs. Total FTEs increased by 21 to a total of 568 in 2017.

- Professional and physician fees expense decreased by 35% in 2017 due to lower locum costs related to general surgery.

Statements of Revenue, Expenses, and Changes in Net Position (Continued)

Operating Expenses (Continued)

- Purchased services decreased by 0.7% in 2017 due to decreases in contracted labor costs.
- Supplies decreased by 2% in 2017 due to a concentrated effort in the Pharmacy to control drug costs.
- Depreciation increased by 3.6% percent in 2017 and increased by 1.1% percent in 2016.
- Other operating expenses decreased by 0.4% in 2017 due to a decrease in insurance cost.

Currently Known Facts, Decisions, or Conditions

The Washington State Auditor's Office performed a financial and compliance audit for the year ended December 31, 2015. The Hospital was issued a report with no findings.

In 2010, the Hospital contracted with DNV Healthcare, Inc. (DNV) to conduct the accreditation survey and was issued an accreditation certificate on March 19, 2013, which was renewed in 2016 and is now good through March 2019. In March 2014, the Hospital also received ISO certification through DNV which is also good through March 2019. The DNV accreditation process requires annual surveys, and DNV was at the Hospital January 16th – January 18th conducting their 2018 survey. The Hospital received its final report of findings and have responded with a corrective action plans to address those findings.

The Medicare cost report for 2016 has been filed and is awaiting final review. The Medicare cost report for 2017 was filed in May 2018.

Contacting the Hospital's Financial Management

This financial report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of the Hospital's finances and to show the Hospital's accountability for the money it receives. If you have questions about this report or need additional financial information, contact Administration, Skagit County Public Hospital District No. 2, 1211 24th Street, Anacortes, Washington 98221.

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Statements of Net Position

December 31, 2017 and 2016

	2017	2016
Current assets:		
Cash and cash equivalents	$ 28,119,490	$ 27,029,521
Receivables:		
Patient - Net	8,733,362	9,054,857
Other	241,840	407,348
Prepaid expenses	826,373	869,282
Inventories	1,649,418	1,541,028
Noncurrent cash, cash equivalents, and investments required for current liabilities	244,985	130,786
Total current assets	39,815,468	39,032,822
Noncurrent cash, cash equivalents, and investments, less current portion:		
Noncurrent cash and cash equivalents, less current portion	5,424,277	6,381,994
Noncurrent investments	451,556	427,934
Total noncurrent cash, cash equivalents, and investments, less current portion	5,875,833	6,809,928
Capital assets:		
Nondepreciable capital assets	10,891,781	6,176,901
Depreciable capital assets - Net	54,805,231	57,435,780
Capital assets - Net	65,697,012	63,612,681
Other assets:		
Intangible assets - Net	598,703	598,703
Purchase option	512,499	494,499
Total other assets	1,111,202	1,093,202
Deferred outflows of resources:		
Loss on refunding of long-term debt	1,518,647	1,646,903
Other post-employment benefits	96,189	-
Total deferred outflows of resources	1,614,836	1,646,903
TOTAL ASSETS AND DEFERRED OUTFLOWS OF RESOURCES	$ 114,114,351	$ 112,195,536

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Statements of Net Position (Continued)

December 31, 2017 and 2016

	2017	2016
Current liabilities:		
Current portion of long-term debt and capital lease obligations	$ 11,857,824	$ 1,750,768
Accounts payable	5,222,756	4,551,462
Accrued payroll and related liabilities	4,117,727	4,072,621
Accrued interest	125,661	130,786
Estimated third-party payer settlements	1,209,540	1,142,156
Other current liabilities	174,957	167,867
Total current liabilities	22,708,465	11,815,660
Long-term liabilities:		
Long-term debt and capital lease obligations, less current portion	33,891,376	46,088,623
Deferred compensation payable	458,104	437,604
Professional liability claims payable	445,927	416,333
Total OPEB liability	9,863,713	-
Total long-term liabilities	44,659,120	46,942,560
Total liabilities	67,367,585	58,758,220
Deferred inflows of resources - Other post-employment benefits	388,874	-
Net position:		
Net investment in capital assets	19,947,812	15,773,290
Restricted, expendable	4,455,094	6,133,577
Unrestricted	21,954,986	31,530,449
Total net position	46,357,892	53,437,316
TOTAL LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND NET POSITION	$ 114,114,351	$ 112,195,536

See accompanying notes to the financial statements.

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Statements of Revenue, Expenses, and Changes in Net Position

Years Ended December 31, 2017 and 2016

	2017	2016
Operating revenue:		
Net patient service revenue	$ 93,786,789	$ 93,989,196
Other operating income	913,620	1,205,877
Total operating revenue	94,700,409	95,195,073
Operating expenses:		
Salaries and wages	42,566,973	41,549,790
Employee benefits	11,493,994	9,881,301
Professional and physician fees	3,832,993	5,902,282
Supplies	23,206,232	23,565,521
Purchased services	8,435,926	8,491,975
Rents and leases	756,748	788,717
Depreciation and amortization	4,101,221	3,958,084
Other expenses	2,147,301	2,126,965
Total operating expenses	96,541,388	96,264,635
Operating loss	(1,840,979)	(1,069,562)
Nonoperating revenue (expense):		
Investment income	317,262	163,706
Interest expense	(1,823,910)	(1,872,963)
Tax levy	3,450,270	3,370,457
Loss from investment in joint venture	(83,938)	(368,383)
Other nonoperating revenue - Net	1,290,362	755,554
Total nonoperating revenue - Net	3,150,046	2,048,371
Income before capital contributions, excess of revenue over expenses	1,309,067	978,809
Capital contributions	600,740	392,300
Increase in net position	1,909,807	1,371,109
Net position at beginning, as previously stated	53,437,316	52,066,207
Cumulative effect for change in accouning principle	(8,989,231)	-
Net position, beginning of year, restated	44,448,085	52,066,207
Net position, end of year	$ 46,357,892	$ 53,437,316

See accompanying notes to the financial statements.

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Statements of Cash Flows

Years Ended December 31, 2017 and 2016

	2017	2016
Cash flows from operating activities:		
Receipts from and on behalf of patients	$ 94,175,668	$ 95,303,904
Payments to suppliers and contractors	(37,588,623)	(40,740,351)
Payments to and on behalf of employees	(52,851,816)	(50,969,064)
Receipts from other operating revenue	913,620	1,205,877
Net cash provided by operating activities	4,648,849	4,800,366
Cash flows from noncapital financing activities:		
Other nonoperating receipts, including contributions	772,406	804,789
Cash flows from capital and related financing activities:		
Purchase of capital assets	(6,206,316)	(3,939,205)
Proceeds from sale of capital assets	545,810	-
Principal payments on long-term debt and capital lease obligations	(1,750,868)	(1,641,874)
Interest payments on long-term debt and capital lease obligations	(2,040,102)	(2,100,180)
Receipts from tax levy - Debt service	3,250,163	3,173,067
Receipts from tax levy - Capital purchases	210,445	191,432
Contributions for capital assets	600,740	392,300
Net cash used in capital and related financing activities	(5,390,128)	(3,924,460)
Cash flows from investing activities:		
Proceeds from interest and dividends on investments	299,262	145,656
Capital contributions for investment in joint venture	(83,938)	(368,383)
Net cash provided by (used in) investing activities	215,324	(222,727)
Net increase in cash and cash equivalents	246,451	1,457,968
Cash and cash equivalents - Beginning of year	33,542,301	32,084,333
Cash and cash equivalents - End of year	$ 33,788,752	$ 33,542,301

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Statements of Cash Flows (Continued)

Years Ended December 31, 2017 and 2016

	2017	2016
Reconciliation of operating loss to net cash provided by operating activities:		
Operating loss	$ (1,840,979)	$ (1,069,562)
Adjustments to reconciled operating loss to net cash provided by operating activities:		
Depreciation and amortization	4,101,221	3,958,084
Provision for bad debts	1,621,023	1,837,670
Changes in assets and liabilities:		
Receivables:		
Patient - Net	(1,299,528)	(587,700)
Other	155,170	61,547
Prepaid expenses	42,909	59,457
Inventories	(108,390)	(52,303)
Accounts payable	671,294	180,562
Accrued payroll and related liabilities	45,106	457,073
Estimated third-party payor settlements	67,384	64,738
Deferred compensation payable	(3,122)	4,954
Professional liability claims payable	29,594	(114,154)
Other post-employment benefits and related deferred inflows and outflows of resources	1,167,167	-
Net cash provided by operating activities	$ 4,648,849	$ 4,800,366
Reconciliation of cash and cash equivalents to the statements of net position:		
Cash and cash equivalents in current assets	$ 28,119,490	$ 27,029,521
Noncurrent cash and cash equivalents	5,669,262	6,512,780
Total cash and cash equivalents	$ 33,788,752	$ 33,542,301
Noncash capital and financing activites:		
Loss on disposal of capital assets	$ -	$ 93,239
Supplemental cash flow information:		
Taxes receivable	$ 44,192	$ 54,530

See accompanying notes to the financial statements.

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Notes to Financial Statements

Note 1: Summary of Significant Accounting Policies

The Entity

The financial statements include the accounts of Skagit County Public Hospital District No. 2 d/b/a Island Hospital (the "Hospital"), located in Anacortes, Washington, and Island Hospital Medical Properties.

The Hospital is organized as a municipal corporation pursuant to the laws of the state of Washington. As organized, the Hospital is exempt from federal income tax. The Hospital's Board of Commissioners is comprised of five community members elected by local voters to six-year terms. The Hospital is not considered to be a component unit of the County. The Hospital is an acute-care community hospital with 43 licensed beds that provides services for Anacortes and surrounding communities. As of September 22, 2017, the Hospital operates two primary care clinics: Anacortes Family Medicine and Fidalgo Medical Associates at Island Hospital. Prior to that, the Hospital also operated two primary care clinics out in the San Juan Islands, Lopez Island Medical Center and Orcas Medical Clinic.

Island Hospital Medical Properties is a Washington nonprofit corporation organized and operated for the exclusive purpose within the meaning of Internal Revenue Code 501 (c)(2) of holding title to property in support of its sole member, Skagit County Public Hospital District No. 2. The application for acquiring the 501 (c)(2) status was accepted by the Internal Revenue Service (IRS) in June 2012. Island Hospital Medical Properties is a blended component unit of the Hospital, and activity related to Island Hospital Medical Properties is reflected in the financial statements.

Financial Statement Presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB).

The accounting records of the Hospital are maintained in accordance with methods prescribed by the State Auditor under the authority of Chapter 43.09 RCW and the *Washington State Department of Health Accounting and Reporting Manual for Hospitals*.

The Hospital's statements are reported using the economic resources measurement focus and full accrual basis of accounting. Revenue is recorded when earned, and expenses are recorded when the liability is incurred, regardless of the timing of the cash flows. Property taxes are recognized as revenue in the year in which they are levied. Grants and similar items are recognized as revenue as soon as eligibility requirements imposed by the provider have been met.

Note 1: Summary of Significant Accounting Policies (Continued)

Use of Estimates

The preparation of the accompanying financial statements in conformity with GAAP requires management to make certain estimates and assumptions that directly 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 revenue and expenses during the reporting period. Actual results may differ from these estimates.

Cash and Cash Equivalents

The Hospital considers all highly liquid debt instruments, including noncurrent cash and cash equivalents, with an original maturity of three months or less to be cash equivalents.

Patient Accounts Receivable and Credit Policy

Patient accounts receivable are uncollateralized patient obligations that are stated at the amount management expects to collect from outstanding balances. These obligations are primarily from local residents, most of whom are insured under third-party payor agreements. The Hospital bills the third-party payors on the patient's behalf, or, if a patient is uninsured, the patient is billed directly. Once claims are settled with the primary payor, any secondary insurance is billed, and patients are billed for copay and deductible amounts that are the patients' responsibility. Payments on patient accounts receivable are applied to the specific claim identified on the remittance advice or statement. The Hospital does not have a policy to charge interest on past due accounts.

Patient accounts receivable are recorded in the accompanying statements of net position net of contractual adjustments and an allowance for uncollectable accounts, which reflect management's estimate of the amounts that will not be collected. The carrying amounts of patient accounts receivable are reduced by allowances that reflect management's best estimate of the amounts that will not be collected. Management provides for contractual adjustments under terms of third-party reimbursement agreements through a reduction of gross revenue and a credit to patient accounts receivable. In addition, management provides for probable uncollectable amounts, primarily for uninsured patients and amounts patients are personally responsible for, through a reduction of gross revenue and a credit to the allowance for uncollectable accounts.

In evaluating the collectability of patient accounts receivable, the Hospital analyzes past results and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for uncollectable accounts and provision for bad debts. Management regularly reviews data from the major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectable accounts and a provision for bad debts for expected uncollectable 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.

Note 1: Summary of Significant Accounting Policies (Continued)

Patient Accounts Receivable and Credit Policy (Continued)

For receivables associated with self-pay patients (which includes patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Hospital 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 undiscounted 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.

Inventories

Inventories consist of medical, surgical, and pharmaceutical supplies and are stated at the lower of cost, determined by the last-in, first-out method, or market.

Investments

Investments in debt and equity securities are reported at fair value except for short-term highly liquid investments that have a remaining maturity of one year or less at the time they are purchased. These investments are carried at amortized cost. Interest, dividends, and gains and losses, both realized and unrealized, on investments in debt and equity securities are included in nonoperating revenues when earned.

Note 1: Summary of Significant Accounting Policies (Continued)

Fair Value Measurements

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

Assets or liabilities measured and reported at fair value are classified and disclosed in one of the three following categories:

Level 1 - Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Hospital has the ability to access.

Level 2 - Inputs to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets in inactive markets.
- Inputs, other than quoted prices, that are observable for the asset or liability.
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified contractual term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset’s or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Noncurrent Cash, Cash Equivalents, and Investments

Noncurrent cash, cash equivalents, and investments include assets set aside for future capital improvements or other designated uses over which the Board of Commissioners retains control and assets restricted by donors or by bond agreements for capital improvements or debt service.

Note 1: Summary of Significant Accounting Policies (Continued)

Capital Assets

Capital assets are stated at historical cost. Equipment under capital leases is stated at the present value of minimum lease payments. Maintenance, repairs, and minor replacements are charged to expense as incurred. The Hospital's policy is to capitalize all capital asset expenditures exceeding $1,000. Depreciation is computed on a straight-line basis over the estimated useful lives of the assets. Equipment held under capital leases and leasehold improvements is amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Such amortization is included in depreciation and amortization expense in the accompanying financial statements. The Hospital estimates the useful lives of assets to be as follows:

Land improvements	15 to 20 years
Buildings and leasehold improvements	13 to 60 years
Equipment	3 to 20 years

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

Asset Impairment

The Hospital reviews its capital assets periodically to determine potential impairment by comparing the carrying value with the estimated future net discounted cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future net cash flows be less than the carrying value, the Hospital would recognize an impairment loss at that time. No impairment loss was recognized for the years ended December 31, 2017 and 2016.

Intangible Assets

Intangible assets include goodwill and restrictive covenants related to the purchase of the Island Radiology practice in January 2004, the purchase of Fidalgo Medical Associates in 2008, and the purchase of Island Surgeons in 2009. Goodwill is reviewed annually for impairment. The value of the restrictive covenants was fully amortized in prior fiscal years.

Note 1: Summary of Significant Accounting Policies (Continued)

Deferred Outflows/Inflows of Resources

In addition to assets, the statements of net position will sometimes report a separate section of deferred outflows of resources. This separate financial statement element, deferred outflows of resources, represents a consumption of net position that applies to a future period and so will not be recognized as an outflow of resources (expense) until then. The Hospital reports deferred outflows of resources for contributions to other post-employement benefit plans subsquent to the measurement date of the other post-employment benefits liability. In addition, The Hospital has recognized losses on refunding of long-term debt, resulting from a difference in the carrying value of refunded debt and its reacquisition price. The loss on refunding of long-term debt is recognized as a deferred outflow of resources and amortized over the life of the new debt, using the effective interest method.

In addition to liabilities, the statements of net position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, deferred inflows of resources, represents the acquisition of net position that applies to a future period and so will not be recognized as an inflow of resources (revenue) until that time. The Hospital reports deferred inflows of resources related to its other post-employment benefits liability.

Compensated Absences

The Hospital's employees earn paid time off for vacation, holidays, and short-term illnesses at varying rates, depending on years of service. The related liability is accrued during the period in which it is earned.

Net Position

Net position of the Hospital is classified into three components. Net investment in capital assets consists of capital assets net of accumulated depreciation and reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. Restricted net position is noncapital net position that must be used for a particular purpose as specified by creditors, grantors, contributors external to the Hospital, or laws or regulations of other governments or imposed by law through constitutional provisions or enabling legislation and includes amounts deposited with trustees as required by revenue bond indenture and note payable escrow agreements. Unrestricted net position is remaining net position that does not meet the definition of net investment in capital assets or restricted net position.

When both restricted and unrestricted resources are available for use, it is the Hospital’s policy to use externally restricted resources first.

Note 1: Summary of Significant Accounting Policies (Continued)

Operating Revenue and Expenses

The Hospital's statements of revenue, expenses, and changes in net position distinguish between operating and nonoperating revenue and expenses. Operating revenue results from exchange transactions associated with providing health care services, the Hospital's principal activity. Operating expenses are all expenses incurred to provide health care services, other than financing costs. All other revenue and expenses not meeting these definitions, including property tax revenue, investment income, interest income, and interest expense, are reported as nonoperating revenue and expenses.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Estimated uncollectable revenue is reported as provision for bad debts in the financial statements. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Some health care is provided with the knowledge that it will not be reimbursed. This is reported under charity care/financial assistance.

For uninsured patients who do not qualify for charity care/financial assistance, the Hospital recognizes revenue on the basis of its standard rates for services provided (or on the basis of discounted rates, if negotiated or provided by policy). On the basis of historical experience, a significant portion of the Hospital's uninsured patients will be unable or unwilling to pay for services provided. Thus, the Hospital records a provision for bad debts related to uninsured patients in the period the services are provided.

Charity Care/Financial Assistance

The Hospital provides care to patients who meet certain criteria under its charity care/financial assistance policy without charge or at amounts less than established rates. The Hospital maintains records to identify the amount of charges foregone for services and supplies furnished under its charity care/financial assistance policy. Because the Hospital does not pursue collection of amounts determined to qualify as charity care/financial assistance, they are not reported as net patient service revenue in the accompanying statements of revenue, expenses, and changes in net position.

Advertising Costs

Advertising costs are expensed as incurred.

Note 1: Summary of Significant Accounting Policies (Continued)

Electronic Health Record Incentive Payments

The American Recovery and Reinvestment Act of 2009 (ARRA) provides for incentive payments under the Medicare and Medicaid programs for certain hospitals and physician practices that demonstrate meaningful use of certified EHR technology. These provisions of ARRA, collectively referred to as the Health Information Technology for Economic and Clinical Health Act (the "HITECH Act"), are intended to promote the adoption and meaningful use of health information technology and qualified EHR technology.

The Hospital recognizes revenue for EHR incentive payments when there is reasonable assurance that the Hospital will meet the conditions of the program, primarily demonstrating meaningful use of certified EHR technology for the applicable period. The demonstration of meaningful use is based on meeting a series of objectives. Meeting the series of objectives in order to demonstrate meaningful use becomes progressively more stringent as its implementation is phased in through stages as outlined by the Centers for Medicare & Medicaid Services (CMS).

Amounts recognized under the Medicare and Medicaid EHR incentive programs are based on management's estimates, which are based in part on cost report data that is subject to audit by fiscal intermediaries; accordingly, amounts recognized are subject to change. In addition, the Hospital's attestation of its compliance with the meaningful use criteria is subject to audit by the federal government or its designee. The Hospital incurs both capital expenditures and operating expenses in connection with the implementation of its EHR initiative. The amount and timing of these expenditures does not directly correlate with the timing of the Hospital's receipt or recognition of the EHR incentive payments.

Grants and Contributions

From time to time, the Hospital receives grants from Skagit County and the state of Washington, as well as contributions from individuals and private organizations. Revenue from grants and contributions may be restricted for either specific operating purposes or capital purposes. Amounts that are unrestricted or that are restricted for a specific operating purpose are reported as nonoperating revenue. Amounts restricted for capital acquisitions are reported after nonoperating revenue and expenses.

New Accounting Pronouncements

The Hospital early adopted the provisions of Governmental Accounting Standards Board Statement No. 75, *Accounting and Financial Reporting for Post-Employment Benefits Other Than Pensions*. The objective of this statement is to improve the usefulness of information about other post-employment benefits included in the financial reports of state and local governments for making decisions and assessing accountability. The implementation of this statement required a restatement of beginning net position as described more fully in Note 19.

Note 1: Summary of Significant Accounting Policies (Continued)

Subsequent Events

Subsequent events have been evaluated through October 23, 2018, which is the date the financial statements were available to be issued. Subsequent events are discussed in Note 20.

Note 2: Deposits and Investments

The *Revised Code of Washington* (RCW), Chapter 39, authorizes municipal governments to invest their funds in a variety of investments, including federal, state, and local government certificates, notes, or bonds; the State of Washington Local Government Investment Pool; savings accounts in qualified public depositories; and certain other investments. State law requires collateralization of all deposits with federal depository insurance or other acceptable collateral. The Hospital's cash on deposit with banks is insured through the Federal Deposit Insurance Corporation up to $250,000 per financial institution. Cash on deposit with the Washington State Local Government Investment Pool and with qualified public depositaries is protected against loss by the State of Washington Public Deposit Protection Commission, as provided for by RCW 39.58, subject to certain limitations.

The Skagit County Treasurer acts as the treasurer for certain deposits and investments of the Hospital. Deposits that are not covered by depository insurance are collateralized in the name of the County, and uninsured investments are registered in the name of the County.

Cash and cash equivalents consisted of the following at December 31:

	2017	2016
Cash on hand	$ 3,250	$ 3,750
Washington Federal Bank, depository accounts	890,389	531,540
Skagit County Treasurer's Office	1,348,483	559,877
Washington State Local Government Investment Pool	25,877,368	25,934,354
Total cash and cash equivalents	$ 28,119,490	$ 27,029,521

Note 2: Deposits and Investments (Continued)

Noncurrent cash, cash equivalents, and investments consisted of the following at December 31:

	2017	2016
Internally designated by Board:		
Cash and cash equivalents - Capital improvements	$ 131,952	$ 44,059
Accrued interest - Capital improvements	33,131	12,909
Washington State Local Government Investment Pool - Capital improvements	1,049,085	322,235
Investments - Deferred compensation arrangements	451,556	427,934
Total internally designated by the Board	1,665,724	807,137
Restricted:		
Proceeds of 2004/2012 Unlimited Tax General Obligation bonds to be used for capital improvements		
Cash and cash equivalents	165,454	213,059
Washington State Local Government Investment Pool	210,385	148,418
Totals	375,839	361,477
Restricted for the repayment of 2005/2014 Refunding Limited Tax General Obligation Bonds:		
Cash and cash equivalents	75,789	94,648
Washington State Local Government Investment Pool	1,046,641	805,047
Totals	1,122,430	899,695
Restricted proceeds of 2014 Limited Tax General Obligation issues to be used for capital improvements - Washington State Local Government Investment Pool	223,957	2,469,199
Restricted for the repayment of new market tax credit loans - Cash and cash equivalents	2,732,868	2,403,206
Total restricted	4,455,094	6,133,577
Total noncurrent cash, cash equivalents, and investments	6,120,818	6,940,714
Less - Current portion	244,985	130,786
Noncurrent cash, cash equivalents, and investments - Less current portion	$ 5,875,833	$ 6,809,928

Note 2: Deposits and Investments (Continued)

Funds held with the Washington State Local Government Investment Pool are considered cash for purposes of presenting cash flows.

Note 3: Fair Value Measurements

The following is a description of the valuation methodologies used for assets measured at fair value.

Money market funds: Valued using a net asset value (NAV) of $1.

Mutual funds: Valued at the daily closing price as reported by the fund. Mutual funds held by the Hospital are open-end mutual funds that are registered with the U.S. Securities and Exchange Commission. These funds are required to publish their daily NAV and to transact at that price. The mutual funds held by the Hospital are deemed to be actively traded.

Equities: The fair value for equities is determined based on quoted market prices and other observable market data.

The Hospital's investments by level within the fair value hierarchy were as follows at December 31, 2017:

	Level 1	Level 2	Level 3	Total Assets at Fair Value
Money market funds	$ 243,865	$ -	$ -	$ 243,865
Mutual funds	146,573	-	-	146,573
Equities	61,118	-	-	61,118
Total investments at fair value	$ 451,556	$ -	$ -	$ 451,556

The Hospital's investments by level within the fair value hierarchy were as follows at December 31, 2016:

	Level 1	Level 2	Level 3	Total Assets at Fair Value
Money market funds	$ 207,163	$ -	$ -	$ 207,163
Mutual funds	163,390	-	-	163,390
Equities	57,381	-	-	57,381
Total investments at fair value	$ 427,934	$ -	$ -	$ 427,934

Note 4: Patient Accounts Receivable

The Hospital has a concentration of credit risk with respect to unsecured patient accounts receivable. The majority of the Hospital's patients are local residents and are insured under third-party payor agreements.

Patient accounts receivable consisted of the following at December 31:

	2017	2016
Patients and their insurance carriers	$ 5,240,661	$ 4,749,226
Medicare	3,253,133	3,884,632
Medicaid	1,018,314	1,261,042
Total patient accounts receivable, net of contractual allowances	9,512,108	9,894,900
Less - Allowance for doubtful accounts	778,746	840,043
Patient receivables - Net	$ 8,733,362	$ 9,054,857

The Hospital has not changed its charity care/financial assistance or uninsured discount policies during fiscal years 2016 or 2017. The Hospital does not maintain a material allowance for doubtful accounts from third-party payors, nor did it have significant write-offs from third-party payors.

Note 5: Reimbursement Arrangements With Third-Party Payors

The Hospital has agreements with third-party payors that provide for reimbursement at amounts that vary from the Hospital's established rates. A summary of the basis of reimbursement with major third-party payors follows:

Medicare

Inpatient acute care services provided by the Hospital rendered to Medicare program beneficiaries are paid primarily at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Outpatient services provided to Medicare program beneficiaries are reimbursed on a prospective payment methodology, also based on a patient classification system, and fee schedules.

Medicaid

Medicaid reimbursement for most outpatient hospital and clinic services is prospectively set based on the ratio of estimated aggregate costs to aggregate charges. Certain outpatient services and physician services are reimbursed based on predetermined fee schedules.

Note 5: Reimbursement Arrangements With Third-Party Payors (Continued)

Other

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

Physician and Professional Services in Rural Health Clinics

Certain physician and professional services rendered to Medicare and Medicaid beneficiaries qualify for reimbursement as Medicare-approved rural health clinic services. Qualifying services are reimbursed based on a cost-reimbursement methodology. Under federal law, rural health clinics also are entitled to receive an additional payment for the difference between cost and the amount paid by Medicaid managed-care health plans. All other physician and professional services rendered to Medicare and Medicaid beneficiaries are paid based on prospectively determined fee schedules.

Accounting for Contractual Arrangements

The Hospital is reimbursed for certain cost-reimbursable items at an interim rate, and final settlements are determined after an audit of the Hospital's related annual cost reports by the respective Medicare and Medicaid fiscal intermediaries. Estimated provisions to approximate the final expected settlements after review by the intermediaries are included in the accompanying financial statements. Differences between the Hospital's estimates and subsequent final settlements by the Medicare and Medicaid fiscal intermediary will be included in future statements of revenue, expenses, and changes in net position. The cost reports for the Hospital have been audited by Medicare intermediaries through December 31, 2014.

Medicare and Medicaid EHR Incentive Funding

The Hospital has applied for and received funding from the Medicare and Medicaid EHR incentive program. The funding period for the EHR incentive program is based on eligible hospitals submitting applications to the program prior to each federal fiscal year ending September 30.

Under the program, the Hospital recognized $140,369 and $388,558 in incentive revenue for the years ended December 31, 2017 and 2016, respectively. The revenue has been recognized as other operating revenue in the statements of revenue, expenses, and changes in net position.

Note 5: Reimbursement Arrangements With Third-Party Payors (Continued)

Compliance

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services, and billing regulations. Government activity with respect to investigations and allegations concerning possible violations of such regulations by health care providers has increased. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of fines and penalties, as well as repayments for patient services previously billed. 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.

The Centers for Medicare and Medicaid Services (CMS) uses recovery audit contractors (RAC) as part of its efforts to ensure accurate payments. RACs search for potentially inaccurate Medicare payments that might have been made to health care providers and that were not detected through existing CMS program integrity efforts. Once the RAC identifies a claim it believes is inaccurate, it makes a deduction from or addition to the provider's Medicare reimbursement in an amount estimated to equal the overpayment or underpayment. Certain states also have hired Medicaid Integrity Contractors (MIC) to perform audits similar to RACs. The Hospital will have the ability to appeal adjustments before final settlement of the claim is made. As of December 31, 2017, the Hospital has not been notified by any RAC or MIC of any potential significant reimbursement adjustments.

Note 6: Capital Assets

Capital assets activity for the year ended December 31, 2017, was as follows:

	Beginning Balance	Additions	Transfers	Retirements	Ending Balance
Depreciable capital assets:					
Land improvements	$ 2,130,330	$ -	$ -	$ -	$ 2,130,330
Buildings and leasehold improvements	69,647,251	41,662	348,919	-	70,037,832
Fixed equipment	8,707,357	-	101,561	-	8,808,918
Major moveable equipment	28,658,057	762,409	236,886	(661,818)	28,995,534
Total depreciable capital assets	109,142,995	804,071	687,366	(661,818)	109,972,614
Less accumulated depreciation for :					
Land improvements	1,501,355	82,177	-	-	1,583,532
Buildings and leasehold improvements	21,985,527	1,555,524	-	-	23,541,051
Fixed equipment	6,356,192	412,895	-	-	6,769,087
Major movable equipment	21,864,141	2,050,625	-	(641,053)	23,273,713
Total accumulated depreciation	51,707,215	4,101,221	-	(641,053)	55,167,383
Depreciable capital assets - Net	57,435,780	(3,297,150)	687,366	(20,765)	54,805,231
Nondepreciable capital assets:					
Artwork	311,906	2,633	-	-	314,539
Land	4,708,577	-	-	-	4,708,577
Construction in progress	1,156,418	5,399,613	(687,366)	-	5,868,665
Total nondepreciable capital assets	6,176,901	5,402,246	(687,366)	-	10,891,781
Capital assets - Net	$ 63,612,681	$ 2,105,096	$ -	$ (20,765)	$ 65,697,012

Construction in progress at December 31, 2017, consisted of facilities improvement projects, electronic health records upgrades, and various small improvement projects within the Hospital.

Note 6: Capital Assets (Continued)

Capital assets activity for the year ended December 31, 2016, was as follows:

	Beginning Balance	Additions	Transfers	Retirements	Ending Balance
Depreciable capital assets:					
Land improvements	$ 2,132,886	$ -	$ -	$ (2,556)	$ 2,130,330
Buildings and leasehold improvements	69,610,903	36,348	-	-	69,647,251
Fixed equipment	8,733,411	16,681	-	(42,735)	8,707,357
Major movable equipment	28,142,765	2,956,628	133,303	(2,574,639)	28,658,057
Total depreciable capital assets	108,619,965	3,009,657	133,303	(2,619,930)	109,142,995
Less accumulated depreciation for :					
Land improvements	1,404,159	98,452	-	(1,256)	1,501,355
Buildings and leasehold improvements	20,434,207	1,530,481	20,839	-	21,985,527
Fixed equipment	5,988,941	425,497	(20,839)	(37,407)	6,356,192
Major movable equipment	22,448,515	1,903,654	-	(2,488,028)	21,864,141
Total accumulated depreciation	50,275,822	3,958,084	-	(2,526,691)	51,707,215
Depreciable capital assets - Net	58,344,143	(948,427)	133,303	(93,239)	57,435,780
Nondepreciable capital assets:					
Artwork	306,204	5,702	-	-	311,906
Land	4,708,577	-	-	-	4,708,577
Construction in progress	419,743	869,978	(133,303)	-	1,156,418
Total nondepreciable capital assets	5,434,524	875,680	(133,303)	-	6,176,901
Capital assets - Net	$ 63,778,667	$ (72,747)	$ -	$ (93,239)	$ 63,612,681

Note 6: Capital Assets (Continued)

The Hospital's net investment in capital assets included the following at December 31:

	2017	2016
Capital assets - Net	$ 65,697,012	$ 63,612,681
Less:		
Long-term debt and capital lease obligations	45,749,200	47,839,391
Totals	$ 19,947,812	$ 15,773,290

Note 7: Purchase Option

The Hospital entered into an option agreement to purchase real property in March 2006. As part of the purchase option agreement, the Hospital made an initial payment to the seller of $300,000 as additional consideration for the rights granted to the Hospital under the agreement. If the Hospital exercises the purchase option, the Hospital will have a credit against the purchase price of $300,000 plus accrued interest earned at an annual rate of 6%. The Hospital has not exercised the purchase option as of December 31, 2017.

Note 8: Long-Term Liabilities

Long-term liabilities activity for the year ended December 31, 2017, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Long-term debt:					
2012 Refunding UTGO Bonds	$ 23,670,000	$ -	$ (1,280,000)	$ 22,390,000	$ 1,375,000
2014 Refunding LTGO Bonds	10,995,000	-	(420,000)	10,575,000	435,000
NDC CDE Loan A	5,373,200	-	-	5,373,200	5,373,200
NDC CDE Loan B	1,770,800	-	-	1,770,800	1,770,800
Kitsap CDE Loan C	2,121,000	-	-	2,121,000	2,121,000
Kitsap CDE Loan D	729,000	-	-	729,000	729,000
Long-term debt before unamortized premiums	44,659,000	-	(1,700,000)	42,959,000	11,804,000
Unamortized premiums on long-term debt	2,963,620	-	(339,323)	2,624,297	-
Total long-term debt	47,622,620	-	(2,039,323)	45,583,297	11,804,000
Capital lease obligations - Medical equipment	216,771	-	(50,868)	165,903	53,824
Total long-term debt and capital lease obligations	47,839,391	-	(2,090,191)	45,749,200	11,857,824
Other long-term liabilities:					
Deferred compensation payable	437,604	244,915	(224,415)	458,104	-
Professional liability claims payable	416,333	29,594	-	445,927	-
Total other long-term liabilities	853,937	274,509	(224,415)	904,031	-
Total long-term liabilities	$ 48,693,328	$ 274,509	$ (2,314,606)	$ 46,653,231	$11,857,824

Note 8: Long-Term Liabilities (Continued)

Long-term liabilities activity for the year ended December 31, 2016, was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
Long-term debt:					
2012 Refunding UTGO Bonds	$ 24,850,000	$ -	$ (1,180,000)	$ 23,670,000	$ 1,280,000
2014 Refunding LTGO Bonds	11,395,000	-	(400,000)	10,995,000	420,000
NDC CDE Loan A	5,373,200	-	-	5,373,200	-
NDC CDE Loan B	1,770,800	-	-	1,770,800	-
Kitsap CDE Loan C	2,121,000	-	-	2,121,000	-
Kitsap CDE Loan D	729,000	-	-	729,000	-
Long-term debt before unamortized premiums	46,239,000	-	(1,580,000)	44,659,000	1,700,000
Unamortized premiums on long-term debt	3,315,923	-	(352,303)	2,963,620	-
Total long-term debt	49,554,923	-	(1,932,303)	47,622,620	1,700,000
Capital lease obligations - Medical equipment	278,645	-	(61,874)	216,771	50,768
Total long-term debt and capital lease obligations	49,833,568	-	(1,994,177)	47,839,391	1,750,768
Other long-term liabilities:					
Deferred compensation payable	319,873	130,620	(12,889)	437,604	-
Professional liability claims payable	530,487	-	(114,154)	416,333	-
Total other long-term liabilities	850,360	130,620	(127,043)	853,937	-
Total long-term liabilities	$ 50,683,928	$ 130,620	$ (2,121,220)	$ 48,693,328	$ 1,750,768

Note 8: Long-Term Liabilities (Continued)

The terms and due dates of the Hospital's long-term debt and capital lease obligations are as follows:

2012 Refunding UTGO Bonds

Unlimited tax general obligation (UTGO) bonds of $26,550,000, dated September 26, 2012, were issued to advance refund and in substance defease the principal amounts totaling $26,730,000 of the 2004 unlimited tax general obligation bonds. The 2004 bonds were used to finance capital improvements for the Hospital.

Interest is payable semiannually on June 1 and December 1, beginning December 1, 2012, at rates that range from 2% to 5%. The bonds mature in principal installments ranging from $440,000 in 2012 to $2,850,000 in 2028. Scheduled maturities on and after December 1, 2023, will be subject to redemption at the option of the Hospital on and after December 1, 2023, in whole or in part, at par plus accrued interest to the date of redemption.

The Hospital irrevocably pledged to levy and collect taxes annually in sufficient amounts to pay the bond principal and interest payments when due. Such collections are reported as noncurrent cash and investments.

The recorded balance at the time of issuance included a bond premium of $3,585,459, which is being amortized using the effective interest method over the term of the bonds. The unamortized bond premium balance was $1,987,607 and $2,289,293 at December 31, 2017 and 2016, respectively.

As part of the advance refunding, a loss on refunding was incurred, considering the refunding of the 2004 bonds, actual cash received as part of the issuance, and unamortized premiums and issuance costs related to the 2004 and 2012 bonds. The loss on refunding in the original amount of $2,070,898 is being amortized using the effective interest rate method through 2028. The unamortized loss on refunding balance was $1,184,490 and $1,292,993 at December 31, 2017 and 2016, respectively.

2014 Refunding LTGO Bonds

Limited tax general obligation (LTGO) bonds of $12,090,000, dated November 12, 2014, were issued to advance refund and in substance defease the principal amounts totaling $9,190,000 of the 2005 limited tax general obligation bonds plus additional funds. The 2005 bonds were used to finance capital improvements for the Hospital and advance refund 1996 limited tax general obligation bonds.

Interest is payable semiannually on June 1 and December 1, beginning December 1, 2014, at rates that range from 2% to 5%. The bonds mature in principal installments ranging from $320,000 in 2014 to $960,000 in 2033. Scheduled maturities on and after December 1, 2023, will be subject to redemption at the option of the Hospital on and after December 1, 2023, in whole or in part, at par plus accrued interest to the date of redemption.

The Hospital irrevocably pledged to levy and collect taxes annually in sufficient amounts to pay the bond principal and interest payments when due. Such collections are reported as noncurrent cash and investments.

Note 8: Long-Term Liabilities (Continued)

2014 Refunding LTGO Bonds (Continued)

The recorded balance at the time of issuance included a bond premium of $752,738, which is being amortized using the effective interest method over the term of the bonds. The unamortized bond premium balance was $636,690 and $674,327 at December 31, 2017 and 2016, respectively.

As part of the advance refunding, a loss on refunding was incurred, considering the refunding of the 2005 bonds, actual cash received as part of the issuance, and unamortized premiums and issuance costs related to the 2005 and 2014 bonds. The loss on refunding in the original amount of $393,417 is being amortized using the effective interest rate method through 2033. The unamortized loss on refunding balance was $334,157 and $353,910 at December 31, 2017 and 2016, respectively.

Community Development Entity (CDE) Loans

In August 2011, IHMP secured financing utilizing the New Market Tax Credit program. Washington Federal is the tax credit investor with NDC New Markets Investment LXIII, LLC and Kitsap County NMTC Subsidiary Allocatee Three, LLC. The terms of the CDE loans are as follows:

NDC CDE Loan A: Original amount of $5,373,200; interest-only payments at 4.829% through August 2018; balloon principal payment due August 2018.

NDC CDE Loan B: Original amount of $1,770,800; interest-only payments at 4.829% through August 2041; balloon principal payment due August 2041. For purposes of the aggregate future annual principal and interest payments schedule, the Hospital reports this loan as maturing in 2018 to correspond with the anticipated repayment in August 2018.

Kitsap CDE Loan C: Original amount of $2,121,000; interest-only payments at 4.829% through August 2018; balloon principal payment due August 2018.

Kitsap CDE Loan D: Original amount of $729,000; interest-only payments at 4.829% through August 2041; balloon principal payment due August 2041. For purposes of the aggregate future annual principal and interest payments schedule, the Hospital reports this loan as maturing in 2018 to correspond with the anticipated repayment in August 2018.

Note 8: Long-Term Liabilities (Continued)

Capital Lease Obligations

The Hospital has entered into several agreements for the lease of various pieces of medical equipment. The agreements expire on various dates through 2020. The interest rates vary from 4.25% to 6.9%. Depreciation of the assets recorded under capital leases is included in depreciation in the accompanying statements of revenue, expenses, and changes in net position.

Equipment under capital lease obligations as of December 31 is as follows:

	2017	2016
Historical cost	$ 257,258	$ 257,258
Less: Accumulated amortization	107,087	55,685
Equipment acquired under capital lease obligations - Net	$ 150,171	$ 201,573

Aggregate future annual principal and interest payments related to long-term debt and capital lease obligations are as follows:

	Long-Term Debt		Capital Lease Obligations	
	Principal	Interest	Principal	Interest
2018	$ 11,804,000	$ 1,843,308	$ 53,824	$ 8,009
2019	1,940,000	1,403,625	56,951	4,882
2020	2,085,000	1,326,025	55,128	1,573
2021	2,225,000	1,242,625	-	-
2022	2,380,000	1,153,625	-	-
2023-2027	14,720,000	3,905,794	-	-
2028-2032	6,845,000	926,594	-	-
2033-2037	960,000	48,000	-	-
Total long-term debt and capital lease obligations	$ 42,959,000	$ 11,849,596	$ 165,903	$ 14,464

Note 9: Net Patient Service Revenue

Net patient service revenue consisted of the following for the years ended December 31:

	2017	2016
Gross patient service revenue	$ 230,567,903	$ 230,346,311
Less: Charity care/financial assistance	628,278	395,653
Totals	229,939,625	229,950,658
Contractual adjustments:		
Medicare	77,926,456	78,306,215
Medicaid	17,405,942	17,562,869
Other	39,199,415	38,254,708
Total contractual adjustments	134,531,813	134,123,792
Provision for bad debts	1,621,023	1,837,670
Net patient service revenue	$ 93,786,789	$ 93,989,196

Gross patient service revenue by payor was as follows for the years ended December 31:

	2017	2016
Medicare	53 %	54 %
Medicaid	12 %	12 %
Other government	11 %	10 %
Other third-party payors	23 %	23 %
Self-pay	1 %	1 %
Totals	100 %	100 %

Note 10: Charity Care/Financial Assistance

The Hospital provides health care services and other financial support through various programs that are designed, among other matters, to enhance the health of the community, including the health of low-income patients. Consistent with the mission of the Hospital, health care is provided to patients regardless of their ability to pay, including providing services to those persons who cannot afford health insurance because of inadequate resources.

Patients who meet certain criteria for charity care/financial assistance, generally based on federal poverty guidelines, are provided care based on criteria defined in the Hospital's charity care/financial assistance policy. The Hospital maintains records to identify and monitor the level of charity care/financial assistance it provides. The amount of charges foregone for services and supplies furnished under the Hospital's charity care/financial assistance policy aggregated $628,278 and $395,653 for the years ended December 31, 2017 and 2016, respectively.

The estimated cost of providing care to patients under the Hospital's charity care/financial assistance policy aggregated $268,000 and $169,000 for the years ended December 31, 2017 and 2016, respectively. The cost was calculated by multiplying the ratio of cost to gross charges for the Hospital times the gross uncompensated charges associated with providing charity care/financial assistance.

Note 11: Pension Plan and Deferred Compensation

Pension Plan

The Hospital has a defined contribution 401(a) and 403(b) plan that covers all of its eligible full-time benefited employees, called the Island Hospital Employees' Pension Plan (the "Plan"). The plan also includes a 457 plan for casual/part-time employees. The Plan is administered by VALIC Retirement Services Company. Plan terms are established and amended under the authority of the Hospital.

For the 401(a) plan, employees who have completed 18 months of employment, attained the age of 21, and are participating in the 403(b) plan are generally eligible to receive a 401(a) contribution under the Plan. The Plan provides for employer contributions based on a percentage of employee length of service. For eligible employees who defer at least 5% of their compensation, the Hospital makes contributions ranging from 6.1% to 6.5%. Employee contributions to the Plan were $2,580,970 and $2,801,946 for the years ended December 31, 2017 and 2016, respectively. The Hospital recognized pension plan expenses of $1,627,009 and $1,513,218 for the years ended December 31, 2017 and 2016, respectively.

All participating employees are 100% vested upon participation.

The Hospital has accrued a liability for pension contributions of $66,292 and $62,332 as of December 31, 2017 and 2016, respectively.

Note 11: Pension Plan and Deferred Compensation (Continued)

Deferred Compensation

The Hospital provides the Skagit County Public Hospital District No. 2 Supplemental Executive Retirement Plan (SERP), a 457(f) deferred compensation plan, to key employees under Section 457 of the Internal Revenue Code. Key employees are those specifically designated by the Hospital who qualify as a member of the "select group of management or highly compensated employees" for purposes of the Employee Retirement Income Security Act of 1974 and enter into a salary reduction agreement. This plan is administered by a compensation committee formed by the Hospital. The deferred compensation plan is funded by Hospital contributions of 7.64% of participating employees' compensation.

Participating employees are vested in the SERP upon the earlier of (a) completion of five full calendar years of service under the SERP, (b) reaching normal retirement age, (c) death, or (d) permanent disability. Any participant not vested who ceases to be an employee and ceases to earn benefit service shall forfeit the participant's right to benefits under the SERP. Forfeited amounts, if any, are used first to pay the SERP's administrative expenses, then to reduce the current-period contribution of the employer.

Hospital contributions to the plan were $86,395 for 2017 and $94,619 for 2016.

Note 12: Other Postemployment Benefits

The Hospital participates in an agent multiple-employer other postemployment benefits plan. In accordance with RCW 41.05.085 and RCW 41.05.022, eligible Hospital retirees and spouses are entitled to subsidies associated with postemployment health benefits provided through the Public Employee Benefits Board (PEBB). The PEBB was created within the Washington State Health Care Authority to administer medical, dental, and life insurance plans for public employees and retirees.

The subsidies provided by PEBB include the following:

- Explicit medical subsidy for post-65 retirees and spouses
- Implicit medical subsidy
- Implicit dental subsidy

The explicit subsidies are monthly amounts paid per post-65 retiree and spouse. As of the valuation date, the explicit subsidy for post-65 retirees and spouses is the lesser of $150 or 50% of the monthly premiums. As of January 1, 2019, the subsidy will be increased to $168 per month. The retirees and spouses currently pay the premium minus $150 when the premium is over $300 per month and pay half the premium when the premium is lower than $300 per month.

The implicit medical subsidy is the difference between the total cost of medical benefits and the premiums. For pre-65 retirees and spouses, the retiree pays the full premium amount, but that amount is based on a pool that includes active employees, who can be expected to have lower average health costs than retirees. For post-65 retirees and spouses, the retiree does not pay the full premium due to the subsidy discussed above.

Note 12: Other Postemployment Benefits (Continued)

As of the valuation date, the membership includes 585 active participants, 33 retirees and surviving spouses, and 15 spouses of current retirees.

Total Other Postemployment Benefits (OPEB) Liability

	2017
Total OPEB liability	$ 9,863,713
Covered employee payroll	$ 41,380,603
Total OPEB liability as a % of covered employee payroll	23.84%

The total OPEB liability was determined by an actuarial valuation as of the valuation date, calculated based on the discount rates below, and then projected to the measurement dates. There have been no significant changes between the valuation date and fiscal year-ends.

Valuation date	January 1, 2017
Measurement date	December 31, 2016

Discount Rate

Discount rate	3.78%
20-year tax exempt municipal bond yield	3.78%

The discount rate was based on the Bond Buyer General Obligation 20-bond municipal bond index for bonds that mature in 20 years.

Other Key Actuarial Assumptions

Census date	January 1, 2017
Price inflation	3.00%
Salary increase	3.75%
Actuarial cost method	Entry Age

Note 12: Other Postemployment Benefits (Continued)

Changes in Total OPEB Liability

	2017
Beginning of year balance	$ 9,077,550
Changes for the year:	
Service cost	949,231
Interest on total OPEB liability	356,394
Effect of assumptions changes or inputs	(431,143)
Expected benefit payments	(88,319)
End of year balance	$ 9,863,713

Sensitivity Analysis

The following presents the total OPEB liability of the Hospital, as of the measurement date, calculated using the discount rate of 3.78%, as well as what the Hospital's total OPEB liability would be if it were calculated using a discount rate that is 1 percentage point lower or 1 percentage point higher than the current rate.

	1% Decrease 2.78%	Discount Rate 3.78%	1% Increase 4.78%
Total OPEB liability	$ 12,148,056	$ 9,863,713	$ 8,101,961

The following presents the total OPEB liability of the Hospital, as of the measurement date, calculated using the current healthcare cost trend rates, as well as what the Hospital's total OPEB liability would be if it were calculated using trend rates that are 1 percentage point lower or 1 percentage point higher than the current trend rates. Health care trend rates are disclosed on page 46.

	1% Decrease	Current Trend Rate	1% Increase
Total OPEB liability	$ 7,881,721	$ 9,863,713	$ 12,545,330

OPEB Expense

OPEB expense recognized for the year ended December 31, 2017 was $1,167,167.

Note 12: Other Postemployment Benefits (Continued)

Schedule of Deferred Inflows and Deferred Outflows of Resources

Deferred inflows and outflows of resources are as follows:

	Deferred Outflows of Resources	Deferred Inflows of Resources
Economic or demographic (gains) or losses	$ -	$ -
Assumption changes or inputs	-	388,874
Benefit payments subsequent to the measurement date	96,189	-
Total	$ 96,189	$ 388,874

Economic/demographic (gains)/losses and assumption changes or inputs are recognized over the average remaining service life for all active and inactive members.

$96,189 reported as deferred outflows related to other postemployment benefits resulting from the Hospital's benefit payments subsequent to the measurement date will be recognized as a reduction of the total OPEB liability in the year ending December 31, 2018.

Other amounts currently reported as deferred outflows of resources and deferred inflows of resources related to other postemployment benefits will be recognized in OPEB expense as follows:

Years ending December 31:	
2018	$ (42,269)
2019	(42,269)
2020	(42,269)
2021	(42,269)
2022	(42,269)
Thereafter	$ (177,529)

Note that additional future deferred inflows and outflows of resources may impact these numbers.

Note 12: Other Postemployment Benefits (Continued)

Demographic Assumptions

Demographic assumptions regarding retirement, mortality, turnover, and marriage are based on assumptions used in the 2017 actuarial valuation of Washington State Public Employee Retirement System (PERS), and modified for the Hospital.

The assumed disability rates under PERS tier 2 and 3 from the 2017 actuarial valuation are less than 0.1% for ages 50 and below and continue to be low after that. The disability rate was assumed to be 0% for all ages.

For service retirement, post-2013, plans 2 and 3 were used, with less than 30 years of service assumptions from the 2017 actuarial valuation for PERS.

For mortality, the assumptions from the 2017 actuarial valuation for PERS (RP-2000 base mortality table, adjusted by -1 year for both males and females, with generational mortality adjustments using projection scale BB) were used.

For other termination of employment, the assumptions from the 2017 actuarial valuation for PERS were used, but no less than 2% per year.

Retirement eligibility: Members are eligible for service retirement at age 55 with 20 years of service or age 65 with 5 years of service.

Election assumption: 40% of members are assumed to elect medical benefits upon retirement. 40% of members are assumed to elect dental benefits upon retirement.

Election assumption (Spouses): 45% of members are assumed to enroll eligible spouses as of the retirement date.

Medicare coverage: 100% of members are assumed to enroll in Medicare, once eligible, after initial participation.

Spouse age: A male member is assumed to be three years older than his spouse, and female member is assumed to be one-year younger than her spouse.

Selection of carrier: All current and future retirees who elect medical and dental coverage are assumed to elect carriers based on the weighted average of selection of carriers by PEBB retirees.

Note 12: Other Postemployment Benefits (Continued)

Health Cost Trend

The health cost trend assumptions used in this valuation, assumed for both current and future retirees, are as follows:

Year	Pre-65	Post-65
2017	6.70%	6.80%
2018	6.70%	7.40%
2019	7.00%	7.40%
2020	5.50%	5.40%
2025	5.90%	5.60%
2035	6.60%	5.80%
2045	6.20%	5.70%
2055	5.90%	6.00%
2065	5.60%	5.60%
2075	4.80%	5.00%
2085	4.80%	4.90%
2095+	4.80%	4.90%

2017 Premium Levels

The 2017 assumed annual medical retiree contributions used in the valuation are displayed below. These represent a weighted average of 2017 PEBB retiree contributions by medical plan, based on overall PEBB current retiree medical plan election. These contributions are assumed for both current retirees and future retirees. Contributions are the same for retirees and spouses of retirees. The contributions exclude the administration charge, the state surcharge reduction, the Limeade administration charge, the Consumer Directed Health Plan employer contribution, the Health Savings Account (HSA) administration fee, and the HSA wellness fee, as these are direct pass-through expenses that are 100% paid by retirees.

	Subscriber or Spouse	
Medical plan:	Non-Medicare	Medicare
Weighted average based on current PEBB retirees	$ 7,414.96	$ 2,631.95

Note 12: Other Postemployment Benefits (Continued)

2017 Premium Levels (Continued)

The 2017 assumed annual dental retiree contributions are displayed below. These represent a weighted average of 2017 PEBB retiree contributions by dental plan, based on overall PEBB current retiree dental plan election. These contributions are assumed for both current retirees and future retirees.

Dental plan:	Subscriber	Spouse
Weighted average based on current PEBB retirees	$ 535.90	$ 542.79

Participant Data

The following participant data as of the valuation date was used:

	Attained Age At		
	Hire	Valuation	Count
Actives	39.5	46.6	585
Retirees	n/a	68.6	33

Note 13: Commitments Under Noncancelable Operating Leases

The Hospital is committed under various noncancelable operating leases, all of which are for buildings and equipment. These expire in various years through 2026. Future minimum operating lease payments are as follows:

	Amount
2018	$ 612,104
2019	555,023
2020	555,024
2021	555,024
2022	555,024
Total	$ 2,832,199

Note 14: Contingencies

Malpractice

The Hospital has professional liability insurance coverage with Washington Casualty Company. The policy provides protection on a "claims made" basis whereby only malpractice claims reported to the insurance carriers in the current year are covered by the current policies.

If there are unreported incidents that result in a malpractice claim in the current year, such claims will be covered in the year the claim is reported to the insurance carriers only if the Hospital purchases claims-made insurance in that year or the Hospital purchases "tail" insurance to cover claims incurred before but reported to the insurance carrier after cancellation or expiration of a claims-made policy.

The current malpractice insurance provides $1,000,000 per claim of primary coverage with a $5,000,000 annual aggregate limit plus $10,000,000 annual excess coverage per claim with a $10,000,000 annual aggregate. There are no significant deductibles or coinsurance clauses.

A liability of $445,927 has been accrued at December 31, 2017 for future coverage for acts occurring in this or prior years. Also, it is possible that claims may exceed coverage available in any given year.

Risk Management

The Hospital is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this coverage in any of the three preceding years.

Health Care Reform

As a result of recently enacted federal health care reform legislation, substantial changes are anticipated in the United States' health care system. Such legislation includes numerous provisions affecting the delivery of health care services, the financing of health care costs, reimbursement of health care providers, and the legal obligations of health insurers, providers, and employers. These provisions are currently slated to take effect at specified times over approximately the next decade. The federal health care reform legislation does not affect the financial statements for the years ended December 31, 2017 and 2016.

Note 15: Functional Expenses

The Hospital provides general health care services to residents within its geographic location. Expenses related to providing these services, including interest expense, consisted of the following for the year ended December 31:

	2017	2016
Health care services	$ 90,963,471	$ 91,036,977
Management and administrative	7,401,827	7,100,621
Total expenses	$ 98,365,298	$ 98,137,598

Note 16: Tax Levy

The Hospital is permitted to levy an annual expense fund levy on the taxable property within the district without a vote of the taxpayers. In addition, taxes are levied annually on the taxable property within the district to service bond principal and interest payments on the 2012 UTGO Bonds and 2014 LTGO Bonds. Taxes to finance debt service on the UTGO bonds may be levied without limit as to rate and amount. The Hospital records property taxes on the accrual method.

Property taxes are levied by the County on the Hospital's behalf on January 1 and are intended to finance the Hospital's activities of the same calendar year. Amounts levied are based on assessed property values as of the preceding May 31. The state assessed a value base for the taxing district of approximately $5.4 billion with a maximum levy rate of 0.6394 and 0.6628 per $1,000 assessed value for the years ended December 31, 2017 and 2016, respectively.

The property tax calendar includes these dates:

Levy date	January 1
Lien date	January 1
Tax bill mailed	February 14
First installment payment due	April 30
Second installment payment due	October 31

Property taxes are considered delinquent on the day following each payment due date, and interest must be paid on delinquent taxes. No allowance for uncollectable taxes receivable was considered necessary at the statements of net position dates.

Note 16: Tax Levy (Continued)

The Hospital received approximately 3.4% of its financial support from property taxes in 2017 and 2016. These funds were available for the following:

	2017	2016
Capital purchases	$ 210,445	$ 191,432
Debt service	3,239,825	3,179,025
Total tax levy	$ 3,450,270	$ 3,370,457

Note 17: Investment in Joint Venture

Investment in Medical Information Network-North Sound

The Hospital has an investment in Medical Information Network-North Sound (MIN-NS) to develop, implement, and maintain an electronic health record system for health care providers in Skagit County. The Hospital has a 50% interest in the joint venture. The interest is accounted for using the equity method of accounting.

The operations of MIN-NS have resulted in a loss on investment in joint venture of $83,938 and $368,383 for the years ended December 31, 2017 and 2016, respectively, and a residual investment of $0. Upon withdrawal, members are required to fund their respective portion of current year losses, if any, incurred by the joint venture.

Copies of the MIN-NS financial statements are available upon request.

Note 18: Foundation

The Island Hospital Foundation (the "Foundation") is a nonprofit entity that was organized to solicit and accept charitable contributions in order to provide support for the Hospital. The Foundation provided contributions to the Hospital for various capital and other projects in the amounts of $996,846 and $599,237 during the years ended December 31, 2017 and 2016, respectively.

The Foundation's financial position was as follows at December 31:

	2017	2016
Assets	$ 2,909,989	$ 2,607,139
Liabilities	$ 2,545	$ 855
Net assets	2,907,444	2,606,284
Liabilities and net assets	$ 2,909,989	$ 2,607,139

Note 19: Prior Period Adjustment

The Hospital implemented GASB Statement 75 for the year ended December 31, 2017. This statement requires the Hospital to recognize total OPEB liabilities, and the related deferred inflows and outflows for its actuarially determined unfunded liabilities of postemployment plans available to retirees. Amounts that would have been reported as OPEB expense in prior periods are reported as a restatement as required. The prior period adjustment necessary to implement GASB Statement 75 was $8,989,231, adding a 2016 OPEB obligation of $9,077,550 and adding a deferred outflow amount of $88,319.

Note 20: Subsequent Events

Line of Credit

The Hospital entered into a revolving line of credit agreement dated February 1, 2018 with a maximum principal amount of up to $4,000,000 and an interest rate equal to the three month London Inter-bank Offer Rate plus 2.00%, resetting every three months on January 1, April 1, July 1, and October 1 of each year. Interest-only payments are due quarterly, with principal due at maturity on February 1, 2020. The lender has the option to extend the maturity an additional 12 months on each anniversary of the closing date.

Long-Term Debt

Subsequent to year-end, the Hospital entered into the following long-term debt agreement:

Bond payable in the amount of $15,000,000, with principal due annually on December 1 from 2020 through 2038 in amounts ranging from $545,000 to $1,100,000, and interest at 3.70% due semiannually each June 1 and December 1, beginning December 1, 2018, collateralized by tax proceeds. Proceeds were used to refinance the NDC CDE Loan A and Kitsap CDE Loan C, with the remainder to be used for capital projects. The outstanding balances of NDC CDE Loan B and Kitsap CDE Loan D were forgiven.

Dissolution of IHMP

In August 2018, the board of directors of IHMP adopted a resolution to dissolve IHMP. All assets, liabilities, and net assets held with IHMP were transferred to the Hospital upon IHMP's dissolution.

Required Supplementary Information

Skagit County Public Hospital District No. 2 d/b/a Island Hospital

Required Supplementary Information

Schedule of Changes in Total OPEB Liability and Related Ratios - Other Postemployment Benefits

Total OPEB Liability

	2017
Service cost	$ 949,231
Interest on total OPEB liability	356,394
Effect of assumption changes or inputs	(431,143)
Expected benefit payments	(88,319)
Net change in total OPEB liability	786,163
Total OPEB liability, beginning	9,077,550
Total OPEB liability, ending	$ 9,863,713

GASB Statement 75 requires this information to be provided for 10 years. Because this is the first year of implementation, 10 years is not available.

Notes to Schedule

There are no changes of benefit terms.

Changes of assumptions and other inputs reflect the effects of changes in the discount rate each period.

WIPFLI LLP

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

Board of Commissioners
Skagit County Public Hospital District No. 2
d/b/a Island Hospital
Anacortes, Washington

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States, the financial statements of Skagit County Public Hospital District No. 2 d/b/a Island Hospital (the "Hospital"), which comprise the statements of net position as of December 31, 2017 and 2016, and the related statements of revenue, expenses, and changes in net position and cash flows for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated October 23, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Hospital's internal control over financial reporting ("internal control") to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control. Accordingly, we do not express an opinion on the effectiveness of the Hospital'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 Hospital'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 Hospital'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 Hospital's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Wipfli LLP

Wipfli LLP

October 23, 2018
Spokane, Washington