KPMG

SALEM HEALTH HOSPITALS AND CLINICS

Consolidated Financial Statements

June 30, 2017 and 2016

(With Independent Auditors' Report Thereon)

SALEM HEALTH HOSPITALS AND CLINICS

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KPMG LLP
Suite 3800
1300 South West Fifth Avenue
Portland, OR 97201

Independent Auditors' Report

The Board of Trustees
Salem Health Hospitals and Clinics:

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Salem Health Hospitals and Clinics, which comprise the consolidated balance sheets as of June 30, 2017 and 2016, and the related consolidated statements of operations, changes in net assets, and cash flows for the year ended June 30, 2017 and the nine month period ended June 30, 2016, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Salem Health Hospitals and Clinics as of June 30, 2017 and 2016, and the results of their operations and their cash flows for the year ended June 30, 2017 and the nine-month period ended June 30, 2016, in accordance with U.S. generally accepted accounting principles.

Other Matter

Our audits were conducted for the purpose of forming an opinion on the basic financial statements as whole. The lean initiatives footnote included in note 15 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

KPMG LLP

Portland, Oregon
October 6, 2017

SALEM HEALTH HOSPITALS AND CLINICS

Consolidated Balance Sheets

June 30, 2017 and 2016

(In thousands)

Assets		**June 30, 2017**	**June 30, 2016**
Current assets:			
Cash and cash equivalents	$	7,174	5,413
Patient accounts receivable, less allowance for doubtful accounts of $19,581 in 2017 and $15,199 in 2016		90,452	79,325
Other receivables		15,765	20,919
Supplies inventory		6,809	6,861
Prepaid expenses and other		7,126	6,329
Total current assets		127,326	118,847
Assets limited as to use		613,452	537,699
Property and equipment, net		466,383	475,541
Rental and other property held for future development, net of accumulated depreciation of $3,020 in 2017 and $4,046 in 2016		23,801	13,480
Other noncurrent assets		11,371	10,182
Total assets	$	1,242,333	1,155,749
Liabilities and Net Assets			
Current liabilities:			
Accounts payable	$	37,838	44,295
Accrued liabilities:			
Payroll, payroll taxes, and withholdings		11,930	14,689
Paid time off		19,319	18,989
Other		10,980	10,259
Estimated third-party payor settlements, net		2,496	2,107
Current portion of long-term debt		5,922	5,660
Current portion of estimated professional liability		1,604	1,834
Total current liabilities		90,089	97,833
Long-term debt, net of current portion		279,114	291,050
Accrued postretirement healthcare benefits		4,953	6,453
Fair value of interest rate swap agreement		12,874	18,828
Other long-term liabilities		131	12
Estimated professional liability, net of current portion		7,121	7,482
Total liabilities		394,282	421,658
Net assets:			
Unrestricted		842,293	727,907
Temporarily restricted		3,481	3,907
Permanently restricted		2,277	2,277
Total net assets		848,051	734,091
Total liabilities and net assets	$	1,242,333	1,155,749

See accompanying notes to consolidated financial statements.

SALEM HEALTH HOSPITALS AND CLINICS

Consolidated Statements of Operations

Year ended June 30, 2017 and 9-month period ended June 30, 2016

(In thousands)

		Year ended June 30, 2017	9 months ended June 30, 2016
Operating revenue:			
Patient service revenue, net of contractual allowances and discounts	$	756,559	541,503
Provision for bad debts		(39,107)	(19,389)
Net patient service revenue, less provision for bad debts		717,452	522,114
Other revenue		39,346	33,347
Net assets released from restriction used for operations		659	301
Total operating revenue		757,457	555,762
Operating expenses:			
Labor and benefits		404,903	290,436
Medical and other supplies		105,544	78,764
Purchased services and other		109,849	88,702
Depreciation		44,943	31,185
Professional fees		28,208	23,173
Interest and amortization		11,419	9,362
Total operating expenses		704,866	521,622
Excess of revenue over expenses from operations		52,591	34,140
Other income:			
Investment income, net		63,748	18,207
Loss on disposal of property and equipment		(1,644)	(18)
Other, net		(4,856)	(521)
Total other income, net		57,248	17,668
Excess of revenue over expenses		109,839	51,808
Change in net unrealized gain or loss on non fair value option investments		(3,317)	3,211
Change in fair value of interest rate swap agreement		5,954	(2,836)
Change in postretirement benefit obligation		1,291	(325)
Net assets released from restriction used for property and equipment		619	459
Change in unrestricted net assets	$	114,386	52,317

See accompanying notes to consolidated financial statements.

SALEM HEALTH HOSPITALS AND CLINICS

Consolidated Statements of Changes in Net Assets

Year ended June 30, 2017 and 9-month period ended June 30, 2016

(In thousands)

		Unrestricted	Temporarily restricted	Permanently restricted	Total
Net assets at September 30, 2015	$	675,590	3,479	2,275	681,344
Excess of revenue over expenses		51,808	—	—	51,808
Change in net unrealized gain (loss) on other-than-trading securities		3,211	1	—	3,212
Change in fair value of interest rate swap agreement		(2,836)	—	—	(2,836)
Change in postretirement benefit obligation		(325)	—	—	(325)
Net assets released from restriction used for property and equipment		459	(459)	—	—
Restricted contributions		—	892	2	894
Temporarily restricted investment and other income, net		—	295	—	295
Net assets released from restrictions for operations		—	(301)	—	(301)
Change in net assets		52,317	428	2	52,747
Net assets at June 30, 2016		727,907	3,907	2,277	734,091
Excess of revenue over expenses		109,839	—	—	109,839
Change in net unrealized gain (loss) on other-than-trading securities		(3,317)	—	—	(3,317)
Change in fair value of interest rate swap agreement		5,954	—	—	5,954
Change in postretirement benefit obligation		1,291	—	—	1,291
Net assets released from restriction used for property and equipment		619	(619)	—	—
Restricted contributions		—	576	—	576
Temporarily restricted investment and other income, net		—	276	—	276
Net assets released from restrictions for operations		—	(659)	—	(659)
Change in net assets		114,386	(426)	—	113,960
Net assets at June 30, 2017	$	842,293	3,481	2,277	848,051

See accompanying notes to consolidated financial statements.

SALEM HEALTH HOSPITALS AND CLINICS

Consolidated Statements of Cash Flows

Year ended June 30, 2017 and 9-month period ended June 30, 2016

(In thousands)

	Year ended June 30, 2017	9 months ended June 30, 2016
Cash flows from operating activities:		
Change in net assets	$ 113,960	52,747
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	44,756	31,482
Change in net unrealized (gains) losses on non fair value option investments	3,317	(3,212)
Change in net unrealized gains on fair value option investments and realized gains on sales of investments	(53,137)	(9,929)
Change in fair value of interest rate swap agreement	(5,954)	2,836
Cash collections on contributions for long-term purposes	(96)	(486)
Loss on refunding	4,387	—
Loss on disposal of property and equipment	1,644	18
Changes in operating assets and liabilities:		
Patient accounts receivable	(11,127)	(5,315)
Other receivables	5,154	(5,545)
Supplies inventory	52	(339)
Prepaid expenses	(797)	1,399
Other noncurrent assets	(1,444)	(3,062)
Accounts payable	(2,467)	6,493
Accrued liabilities	(1,708)	7,872
Estimated third-party payor settlements, net	389	(1,043)
Accrued postretirement healthcare benefits	(1,500)	(82)
Other long-term liabilities	119	(24)
Estimated professional liability	(591)	2,325
Net cash provided by operating activities	94,957	76,135
Cash flows from investing activities:		
Purchases of investments	(62,946)	(43,896)
Proceeds from sales of investments	37,013	16,187
Proceeds from sales of property, rental and other	1,867	—
Purchases of property and equipment and rental and other property	(53,971)	(51,327)
Net cash used in investing activities	(78,037)	(79,036)
Cash flows from financing activities:		
Proceeds from bond refunding	214,722	—
Repayment of long-term debt	(229,256)	(45)
Payment of deferred financing costs	(721)	—
Restricted contributions for long-term purposes	96	486
Net cash (used in) provided by financing activities	(15,159)	441
Net increase (decrease) in cash and cash equivalents	1,761	(2,460)
Cash and cash equivalents at beginning of year	5,413	7,873
Cash and cash equivalents at end of year	$ 7,174	5,413
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 15,863	7,212
Change in construction related payables	(3,989)	504

See accompanying notes to consolidated financial statements.

(1) Organization and Principles of Consolidation

Salem Health Hospitals and Clinics and subsidiaries (collectively, the Corporation) are Oregon nonprofit corporations providing a comprehensive system of healthcare services to the communities of Salem and Dallas, Oregon, and the surrounding Marion and Polk Counties.

The accompanying consolidated financial statements include the accounts and transactions of the Corporation and its subsidiaries, of which the Corporation is the parent holding company and sole member. The subsidiaries consist of Salem Health (Salem) and Salem Health West Valley (West Valley) (collectively, the Hospitals); Salem Health Foundation (SHF) and West Valley Hospital Foundation (WVHF) (collectively, the Foundations); Willamette Valley Insurance Corporation (WVIC), a captive insurance company domiciled in Hawaii; and Salem Health Professional Services (SHPS), whose principal purpose is to provide professional billing services to the Hospitals. All significant intercompany accounts and transactions have been eliminated in consolidation. The Corporation has formed an Obligated Group which is responsible for paying hospital revenue bond debt. Currently Salem is the only member of the Obligated Group.

The Hospitals provide healthcare and healthcare-related services to patients in their service areas. The Hospitals' mission is to improve the health and well-being of the people and the communities they serve. The Foundations are dedicated to raising, managing, and distributing funds to help the Hospitals achieve their mission.

For the 9-month period ended June 30, 2016, the Corporation affiliated with OHSU clinical enterprises (note 2). As a result of this affiliation, the Corporation changed its fiscal year to end on June 30. Therefore the 2016 consolidated financial statements reflect the results of the Corporation as of June 30, 2016 and for the 9-month period from October 1, 2015 through June 30, 2016. The corporation terminated the affiliation agreement in 2017.

(2) OHSU Affiliation

In November 2015, the Corporation affiliated with Oregon Health & Science University (OHSU) through the execution of a Joint Management Agreement (the JMA) between the two organizations, forming OHSU Partners, LLC (OHSU Partners) a limited liability company. Under the JMA, OHSU Partners was obligated to manage the combined clinical enterprises of the Corporation and OHSU as a single economic entity and united health system.

The JMA provided that the total operating results of the integrated health system were apportioned to the Corporation and OHSU consistent with an allocation method based on each party's historical operating income. The JMA provided that 19% of the operating results were apportioned to the Corporation and 81% were apportioned to OHSU. Each month, these "allocation percentages" were required to be applied to net operating results of the integrated health system to determine each party's "allocation amount". If a party's "allocation amount" was less than that party's clinical enterprise operating results, such party has a "due to" amount payable to the other party. If a party's "allocation amount" was more than such party's clinical enterprise operating results, that party has a "due from" receivable from the other party.

Changes in priorities and processes requiring course corrections are common in the first years of an affiliation and the conclusion was reached by both the Corporation and OHSU that the JMA was not working in the way originally intended. The parties recognized the need for a transition. As a result, the Corporation and OHSU entered in to a transition agreement that terminated the JMA effective May 4, 2017, with each party reassuming oversight and full management of their own clinical enterprises and the Corporation transferring its interest in OHSU Partners to OHSU. For the fiscal year ended June 30, 2017 and 9 month period ending June 30, 2016, the Corporation paid OHSU $0 and $8,260, respectively, pursuant to the JMA and transition agreement.

The Corporation and OHSU shared the expenses of OHSU Partners equally as a management fee. The management fees were $4,929 and $2,026 during the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016, respectively.

(3) Summary of Significant Accounting Policies

(a) Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates include allowance for doubtful accounts and contractual reserves on patient accounts receivable, valuation of investments, assignment of useful lives to property and equipment, third-party payor cost report settlements, self-insured liabilities, interest rate swap valuation, and postretirement liabilities.

(b) Cash and Cash Equivalents

Cash equivalents include investments in highly liquid instruments with original maturities of three months or less, excluding assets limited as to use. Cash equivalents totaled $405 and $874 at June 30, 2017 and 2016, respectively.

The Corporation maintains bank accounts at several financial institutions. The Corporation’s bank balances at each financial institution are insured by the Federal Deposit Insurance Corporation (FDIC) up to $250. At June 30, 2017 and 2016, the Corporation’s bank balances at certain financial institutions exceeded FDIC coverage.

(c) Patient Accounts Receivable and Allowance for Doubtful Accounts

Patient accounts receivable are recorded at an estimated contractual arrangement and do not bear interest. Amounts collected on patient accounts receivable are included in net cash provided by operating activities in the consolidated statements of cash flows. The primary risk of noncollection of patient accounts receivable relates to uninsured patient accounts and patient accounts for which the primary insurance payor has paid, but patient responsibility amounts (generally, deductibles and copayments) remain outstanding.

(Continued)

(In thousands)

The allowances for doubtful accounts are primarily estimated based upon the Hospitals' historical collection experience, the age of the patient's account, the patient's economic ability to pay, and the effectiveness of collection efforts. Patient accounts receivable balances are routinely reviewed in conjunction with historical collection rates and other economic conditions that might ultimately affect the collectability of patient accounts when considering the adequacy of the amounts recorded in the allowance for doubtful accounts. Actual write-offs historically have approximated management's expectations.

The mix of gross receivables from significant third-party payors as of June 30, 2017 and 2016 was as follows:

	2017	2016
Medicare	42 %	41 %
Medicaid	16	18
Private pay	5	5
Commercial and other payors	37	36

The mix of gross patient service revenue from significant third-party payors for the year ended June 30, 2017 and the 9-month period ended June 30, 2016 was as follows:

	12 months ended June 30, 2017	9 months ended June 30, 2016
Medicare	48 %	47 %
Medicaid	22	23
Private pay	2	2
Commercial and other payors	28	28

Significant changes in payor mix, business office operations, economic conditions, or trends in federal and state governmental healthcare coverage could affect the Hospitals' collection of accounts receivable, cash flows, and results of operations. The Hospitals' patient responsibility write-offs were $34,726 and $19,433 during the year ended June 30, 2017 and the 9-month period ended June 30, 2016. The Hospitals also maintain an allowance for doubtful accounts for third-party payors, which has been determined based on historical bad debt expense on those account types.

(d) Supplies Inventory

Supplies inventory is stated at the lower of cost (as determined by the first-in, first-out method) or market.

(e) Assets Limited as to Use

Assets limited as to use consist of investments designated by the Corporation's Board of Trustees (the Board) for future capital acquisitions and other purposes, investments held by the Foundations whose use has been restricted by donors, and assets held by a trustee under a bond indenture agreement (notes 5 and 13). Funds held by trustee are set aside in separate trust accounts for future capital projects and debt service reserve funds.

Investments in equity and debt securities are reported at fair value in the accompanying consolidated balance sheets. The fair values are based on quoted market prices at the reporting date for those or similar investments. Investment income or loss (including realized gains and losses on investments, unrealized gains and losses on investments for which the Corporation has designated the fair value option, interest, and dividends) is included in the excess of revenue over expenses unless the income or loss is restricted by the donor or law. All of the Corporation's investments are classified as other-than-trading securities at June 30, 2017 and 2016 except those for which the fair value option was elected. The Corporation has elected the fair value option under FASB ASC 825-10 *Financial Instruments* for certain of its investment securities. Unrestricted unrealized gains and losses on other-than-trading investments for which the fair value option has not been elected are excluded from excess of revenue over expenses unless they are considered other-than-temporarily impaired.

For each of the investment categories for which the fair value option has not been elected, the Corporation continually monitors investment performance and the potential need for recording an impairment on investments. A number of criteria are considered during this process including, but not limited to whether the Corporation intends to sell the security; the current fair value as compared to cost of the security; the length of time the security's fair value has been below cost; the likelihood that the Corporation will be required to sell the security before recovery of its cost basis; objective information supporting recovery in a reasonable period of time; specific credit issues related to the issuer; and current economic conditions.

For debt securities that the Corporation does not intend to sell and more likely than not would not be required to sell prior to recovery of the cost basis, the Corporation recognizes other-than-temporary losses in accordance with the provisions of the ASC 320 *Investments – Debt and Equity Securities*. The amount of the other-than-temporary loss is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between a security's cost basis and the present value of expected future cash flows discounted at the security's effective interest rate. The amount due to all other factors is recognized in other changes in net assets. For the year ended June 30, 2017 and the 9-month period ended June 30, 2016, the Corporation recognized no other-than-temporary losses.

(Continued)

The Corporation holds investments in corporate bonds, fixed income mutual funds, U.S. Treasury and government agency securities, money market funds and equity mutual funds. Management believes that the Corporation's credit risk with respect to these investments is minimized due to the diversity of the individual investments and the financial strength of the entities, which have issued the securities or instruments. However, due to changes in economic conditions, interest rates, and common stock prices, the market value of the Corporation's investments can be volatile. Consequently, the fair value of the Corporation's investments could change significantly in the near term as a result of such volatility.

(f) Property and Equipment

Property and equipment (including rental and other property held for future development) are stated at cost. Donated property and equipment are recorded at estimated fair value on the date of donation. Improvements and replacements of property and equipment are capitalized. Routine maintenance and repairs are charged to expense as incurred.

Depreciation is computed using the straight-line method over the shorter of the lease term or estimated useful life of each class of depreciable asset. The estimated useful life of buildings and improvements is 5 to 50 years while the estimated useful life of equipment is 2 to 20 years. Net interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

(g) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose. Permanently restricted net assets are those whose use has been restricted by donors to be maintained in perpetuity.

(h) Consolidated Statements of Operations

Excess of revenue over expenses from operations includes amounts generated from direct patient care, other revenue related to the operation of the Hospitals' facilities, unrestricted contributions received by the Foundations, and gains (losses) on disposals of property and equipment. Other activities that result in income or expenses unrelated to the Hospitals' and the Foundations' primary missions are excluded from excess of revenue over expenses from operations. Other income (loss) includes net investment income; change in unrealized gains and losses on investment securities for which the fair value option is elected; any other-than-temporary impairment losses on investment securities; rental income and expenses related to nonoperating real estate properties; gain (loss) on disposals of rental and other property held for future development; loss on extinguishment of debt; and other incidental transactions.

Changes in unrestricted net assets that are excluded from the excess of revenue over expenses, consistent with industry practice, include the change in net unrealized gains (losses) on securities for which the fair value option is not elected; change in net benefit obligation related to postretirement benefits; change in fair value of interest rate swap agreement for an effective hedging relationship; contributions of long-lived assets (including assets acquired using contributions, which, by donor restriction, are to be used for the purpose of acquiring such assets).

(i) Net Patient Service Revenue

Services are rendered to patients under contractual arrangements with Medicaid and Medicare programs and various other payors including preferred provider organizations (PPOs) and health maintenance organizations (HMOs), which provide for payment or reimbursement at amounts different from established rates. Contractual adjustments represent the difference between established rates for services and amounts reimbursed by these third-party payors.

The Medicare program reimburses Salem at prospectively determined rates for the majority of inpatient and outpatient services rendered to patients, primarily on the basis of Medicare severity diagnosis-related groups (MS-DRGs) and Ambulatory Payment Classification Groups (APCs), respectively. West Valley is a “critical access hospital” (CAH) for Medicare and Medicaid program purposes. As a CAH, West Valley may not operate more than 25 beds and the average length of stay for acute care patients may not exceed 96 hours. The Medicare and Medicaid program reimburses West Valley on the basis of its current allowable costs. When paid under cost reimbursement, the Hospitals are reimbursed at an interim rate with final settlement determined after submission of annual cost reports and audits thereof by the fiscal intermediaries, subjecting the Hospitals to retroactive settlements for prior year cost reports. Actual settlements historically approximated management’s expectations.

Salem’s cost reports have both been audited and final settled by the Medicare fiscal intermediaries through September 30, 2014 and the Medicaid administrators through September 30, 2014. West Valley’s cost reports have both been audited and final settled by the Medicare fiscal intermediaries through September 30, 2015 and the Medicaid administrators through September 30, 2015. Prior period adjustments were $2,304 and $1,081 for the year ended June 30, 2017 and the 9-month period ending June 30, 2016, respectively.

The Hospitals have also entered into payment agreements with certain commercial insurance carriers, HMOs, and PPOs to provide medical services to subscribing participants. The basis for payment to the Hospitals under these agreements includes prospectively determined rates per discharge, actual charges, and fee schedules.

(j) Contributions Received

Unconditional promises to give cash and other assets to the Corporation are recorded as other revenue and other receivables at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received or at which point the conditions have been substantially met. Gifts are reported as either temporarily or permanently restricted contributions if they are received with donor stipulations that limit the use of the donated assets. When the terms of a donor restriction are met, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and consolidated statements of changes in net assets as net assets released from restrictions.

Contributions of long-lived assets such as property and equipment are reported as unrestricted, and are excluded from the excess of revenue over expenses. Contributions of long-lived assets with explicit restrictions that specify how the assets are to be used and contributions 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 Corporation reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

SHF is a beneficiary under various wills and trust agreements, the total realizable amounts of which are not presently estimable. SHF's share of such bequests is recorded when the probate court has declared the testamentary instrument valid and the proceeds are measurable.

(k) Income Taxes

The Corporation, Salem, West Valley, SHF, WVHF, SHPS, and WVIC are tax-exempt organizations pursuant to Internal Revenue Code (IRC) Section 501(c)(3). As such, only unrelated business income is subject to federal or state income taxes. Management has not recorded a provision as unrelated business income, if any, is immaterial to the consolidated financial statements.

Accounting principles generally accepted in the United States of America require the Corporation to evaluate tax positions taken by the Corporation and recognize a tax liability (or asset) if the Corporation has taken an uncertain position that more likely than not would not be sustained upon examination by the IRS. Management has analyzed tax positions taken by the Corporation and has concluded that as of June 30, 2017 there are no uncertain positions taken or expected to be taken that would require recognition of a liability (or asset) or disclosure in the consolidated financial statements. The Corporation is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The Corporation management believes it is no longer subject to income tax examinations for years prior to fiscal year 2011.

(l) Reclassifications

Certain prior period amounts in the accompanying consolidated financial statements and notes thereto have been reclassified to conform to current period presentation. These reclassifications had no material effect on the results of operations or financial position for any period presented.

(m) New Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which amends the guidance for revenue recognition to replace numerous industry specific requirements and converges certain areas under this topic with those of the International Financial Reporting Standards. The ASU implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. The ASU also requires enhanced disclosures regarding the nature, amount, timing, and uncertainty of revenue and cash flows from contracts with customers. The Corporation has established a transition team to analyze the impact of the standard on their revenue contracts by reviewing current accounting policies and practices and identifying potential differences that would result from applying the requirements of the new standard. The Corporation is assessing the impact of ASU 2014-09 and the most appropriate transition method.

(Continued)

They expect to finalize their assessment and determine their adoption method by December 31, 2017. The new standard becomes effective beginning July 1, 2018, as they do not plan to early adopt.

In January 2016, the FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities.* The ASU will require that changes in the value of equity investments with readily determinable market values be recognized through revenue in excess of expenses. The new standard becomes effective for the Corporation beginning July 1, 2018.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, which supersedes Topic 840, *Leases*. ASU No. 2016-02 increases the transparency and comparability of organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This guidance requires that entities recognize a right-of-use asset and a lease liability measured at the present value of the lease payments in the statement of financial position, recognize a single lease cost allocated over the lease term on a generally straight-line basis, and classify all cash payments within operating activities in the statement of cash flows. The amendments in this update are effective for the Corporation beginning July 1, 2019. Early adoption is permitted. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which includes a number of optional practical expedients that entities may elect to apply. While the Corporation is currently assessing the potential future impact of adopting this standard, the Corporation expects the primary impact will be the recognition, on a discounted basis, of their minimum commitments under noncancelable operating leases on their consolidated balance sheets, resulting in the recording of right-of-use assets and lease obligations. The Corporation’s minimum undiscounted commitments under noncancelable operating leases are disclosed in note 14.

In August 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This ASU contains the following key aspects: (A) reduces the number of net asset classes presented from three to two: with donor restrictions and without donor restrictions; (B) requires all not-for-profits to present expenses by their functional and their natural classifications in one location in the financial statements; (C) requires not-for-profits to provide quantitative and qualitative information about management of liquid resources and availability of financial assets to meet cash needs within one year of the balance sheet date; and (D) retains the option to present the statement of cash flows using either the direct or indirect method. The new standard becomes effective for the Corporation on July 1, 2018.

(In thousands)

(4) Benefits to the Community

The Corporation provides services to the community both for people in need and to enhance the health status of the broader community as part of its charitable mission.

(a) Services for People in Need

The following represents the estimated cost of providing certain services to the community, along with a description of selected activities sponsored by the Hospitals during 2017 and 2016. The costs in the second table below represent the estimated cost of providing certain services to the community for the 9-month period ended June 30, 2016. Had the amounts been projected over twelve months, the amount of services provided to people in need would have been comparable to those provided for the year ended June 30, 2017.

	Year ended June 30, 2017		
	Estimated costs to provide care	**Offsetting revenue**	**Estimated net cost**
Services for people in need:			
Charity care	$ 8,763	—	8,763
Medicaid	174,984	133,855	41,129
Medicare	310,428	268,698	41,730
	$ 494,175	402,553	91,622
Percentage of total operating expenses			13.4 %

	9-month period ended June 30, 2016		
	Estimated costs to provide care	**Offsetting revenue**	**Estimated net cost**
Services for people in need:			
Charity care	$ 7,583	—	7,583
Medicaid	131,509	101,130	30,379
Medicare	220,056	188,930	31,126
	$ 359,148	290,060	69,088
Percentage of total operating expenses			13.2 %

In support of its mission, the Hospitals voluntarily provide medically necessary patient care services that are discounted or free of charge to persons who have insufficient resources and/or who are uninsured. The criteria for charity care are determined based on eligibility for insurance coverage, household income, qualified assets, catastrophic medical events, or other information supporting a patient's inability to pay for services provided. Specifically, the Hospitals provide an uninsured discount of 15% to all uninsured patients. Further discounts are available for patients, on a sliding scale, whose household income is less than 400% of the federal poverty level or roughly $97 for a family of four in Salem, Oregon. For patients whose household income is at or below 200% of the federal poverty level, a full subsidy is available. In addition to the household income criteria, the patients' qualified assets (e.g., assets and investments excluding patient's primary residence), and other catastrophic or economic circumstances are considered in determining eligibility for charity care.

In addition to charity care, the Hospitals provide services under various states' Medicaid programs for financially needy patients and to Medicare beneficiaries. The aggregate cost of providing services to Medicaid and Medicare beneficiaries exceeds the aggregate reimbursements from these programs.

The cost of services provided to beneficiaries of the Medicaid and Medicare programs and cost of charity care is estimated based on the relationship of costs (excluding the costs associated with medical education, research, community health services, and other contributions) to billed charges for Medicaid and Medicare patient accounts and for patient charges written off as charity deductions.

The Hospitals employ financial counselors and social workers, who assist patients in obtaining coverage for their healthcare needs. This includes assistance with workers compensation, motor vehicle accident policies, COBRA, veterans' assistance, and public assistance programs, such as Medicaid.

(b) Benefits to Community

Community health services include classes provided to the community at minimal or no cost, health education for children and parents with young families, resource centers, support groups, health screenings, senior wellness, volunteer programs, caregivers respite, and support for parish nursing programs.

Community benefit activities include activities that develop community health programs and partnerships.

Donations to charitable organizations include direct support provided to community organizations through cash or in-kind donations that support organizations' missions of supporting health and human services, civic and community causes, and business development efforts.

In-kind contributions provided by the Corporation include the following: facility space, staff availability for training and education opportunities, supplies, and professional services in collaboration with charitable, educational, and government organizations throughout the community.

(In thousands)

(c) Other Benefits

In furtherance of its mission, the Corporation also commits significant time and resources to endeavors and critical services that meet unfilled community needs. Many of these activities are sponsored with the knowledge that they will not be self-supporting or financially viable. Such programs include hospice, mental and behavioral health, primary care clinics in underserved neighborhoods, free patient transportation, lodging, meals, and medications for transient patients when needed, participation in blood drives, and the provision of educational opportunities for students interested in pursuing medical-related careers.

The Corporation also provides additional benefits to the community through the advocacy of community service by employees. Employees of the Corporation serve numerous organizations through board representation, membership in associations, and other related activities.

(5) Assets Limited as to Use

Assets limited as to use consisted of the following at June 30, 2017 and 2016:

		2017	2016
Board designated for capital acquisitions and other purposes:			
Cash and cash equivalents	$	30,660	32,623
Low duration fixed income		127,498	120,347
Core fixed income mutual funds		145,831	136,081
Domestic equity mutual funds		238,079	185,106
International equity mutual funds		64,183	50,376
Accrued interest receivable		350	347
Total internally designated for capital acquisitions and other purposes		606,601	524,880
Held by the Foundations:			
Cash and cash equivalents		257	135
Low duration fixed income		631	—
Core fixed income mutual funds		1,907	2,433
Domestic equity mutual funds		3,345	3,733
International equity mutual funds		663	320
Accrued interest receivable		6	6
Total held by the Foundations		6,809	6,627

(In thousands)

		2017	2016
Held by trustee:			
Cash and cash equivalents	$	42	181
Low duration fixed income		—	5,994
Accrued interest receivable		—	17
Total held by trustee		42	6,192
Total assets limited as to use	$	613,452	537,699

Cash and cash equivalents investments consist primarily of separately held U.S. Treasury and agency securities, corporate bonds, and money market funds with an average duration of one year or less.

Low duration fixed income investments consist of fixed income mutual funds with investment strategies of holding securities with an average duration of one to three years.

Core fixed income investments consist primarily of separately held U.S. Treasury and agency securities, and corporate bonds, with an investment strategy to hold securities with an average duration of three to five years.

Investment income (losses), net, consisted of the following for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016:

		12 months ended June 30, 2017	9 months ended June 30, 2016
Investment income:			
Interest and dividend income	$	10,086	7,652
Realized gains on sales of investments, net		6,594	19,925
Net unrealized gains (losses) on fair value investments		47,235	(9,250)
Investment expenses		(167)	(120)
Investment income, net	$	63,748	18,207
Changes in net assets:			
Change in net unrealized gain (loss) on other-than-trading securities	$	(3,317)	3,212

(In thousands)

The following tables summarize the Corporation's investments that are not accounted for under the fair value option and had unrealized losses as of June 30, 2017:

For less than 12 months		Fair value	Cost basis	Gross unrealized loss
Corporate bonds	$	2,681	2,696	15
Fixed income mutual funds		124,285	125,102	817
U.S. government agency securities		1,400	1,411	11
U.S. Treasury securities		3,770	3,797	27
Total	$	132,136	133,006	870

For 12 months or longer		Fair value	Cost basis	Gross unrealized loss
Corporate bonds	$	61	63	2
Fixed income mutual funds		58,537	61,437	2,900
U.S. government agency securities		171	173	2
Total	$	58,769	61,673	2,904

Total		Fair value	Cost basis	Gross unrealized loss
Corporate bonds	$	2,742	2,759	17
Fixed income mutual funds		182,822	186,539	3,717
U.S. government agency securities		1,571	1,584	13
U.S. treasury securities		3,770	3,797	27
	$	190,905	194,679	3,774

(Continued)

(In thousands)

The following tables summarize the Corporation's investments that are not accounted for under the fair value option and had unrealized losses as of June 30, 2016:

For less than 12 months		Fair value	Cost basis	Gross unrealized loss
Fixed income mutual funds	$	792	793	1
Total	$	792	793	1

For 12 months or longer		Fair value	Cost basis	Gross unrealized loss
Corporate bonds	$	322	327	5
Fixed income mutual funds		55,086	57,471	2,385
U.S. government agency securities		2,898	2,900	2
Total	$	58,306	60,698	2,392

Total		Fair value	Cost basis	Gross unrealized loss
Corporate bonds	$	322	327	5
Fixed income mutual funds		55,878	58,264	2,386
U.S. government agency securities		2,898	2,900	2
	$	59,098	61,491	2,393

The individual securities included in the above tables have been assessed by management and do not require an adjustment for other-than-temporary impairment because the Corporation does not intend to sell and do not believe they would be required to sell the securities prior to maturity or market recovery. The unrealized losses are primarily driven by changes in interest rates and overall market conditions.

(6) Property and Equipment, Net

Property and equipment consisted of the following at June 30, 2017 and 2016:

		June 30, 2017	June 30, 2016
Land and improvements	$	43,122	43,004
Buildings and improvements		590,199	554,832
Equipment		280,558	338,642
		913,879	936,478

(In thousands)

		June 30, 2017	June 30, 2016
Less accumulated depreciation	$	(456,497)	(494,335)
		457,382	442,143
Construction in progress		9,001	33,398
Property and equipment, net	$	466,383	475,541

(7) Investments in Health Related Activities

The following is a summary of the Corporation's related-party investments which are included in other noncurrent assets in the accompanying consolidated balance sheets at June 30, 2017 and 2016:

Entity	Basis of accounting	Ownership percentage	Investment balance included in the accompanying consolidated balance sheets as of June 30, 2017 and 2016		The Corporation's share of income (losses) included in the accompanying consolidated statements of operations for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016	
			2017	2016	2017	2016
PPP	Equity method	0.25 %	$ 3,955	3,262	1,498	1,284
WVCH	Cost method	18.20	545	545	1,100	1,726
Propel	Equity method	21.96	1,455	1,858	(2,105)	(46)

(a) Premier Purchasing Partners, L.P. (PPP)

PPP is a California limited partnership formed to allow its partners to obtain discounts by pooling certain purchases. Salem purchased 9,518 shares of PPP for $75. Premier is a public company and a portion of the Corporation's shares vest into Class B stock each year. The Corporation's investment in PPP is accounted for under the equity method of accounting as the original shares purchased become vested and converted into Class B stock. Salem also receives periodic distributions of its share of PPP's profits.

(b) Willamette Valley Community Health (WVCH)

The Corporation, on behalf of the Hospitals, cofounded WVCH with nine other providers of healthcare in Marion and Polk Counties. WVCH is an Oregon limited liability company and is certified by the Oregon Health Authority as a coordinated care organization (CCO). Section 26 of H.B. 3650 provides that CCOs will be responsible for providing fully integrated physical health services, chemical dependency, mental health services, and beginning dental health services. CCOs will initially provide the foregoing health services to Medicaid beneficiaries. The Corporation's investment in WVCH is accounted for under the cost method.

(In thousands)

(c) Population Health Alliance of Oregon, LLC (Propel)

The Corporation cofounded Propel with eight other organizations. Propel was established with the intent to be a third party provider of services to effectively manage the population health risks of its members. The Corporation's investment in Propel is accounted for under the equity method due to the significant influence the Corporation has with the organization.

(8) Long-Term Debt

Long-term debt consisted of the following at June 30, 2017 and 2016:

		2017	2016
Hospital Revenue Bonds, Series 2016A; payable in installments from $1,915 to $15,490 beginning in 2017 through 2046; interest at rates ranging from 2% to 5%	$	209,804	—
Hospital Revenue Bonds, Series 2008B; payable in installments from $3,575 to $6,000 beginning in 2019 through 2034; interest at rates resetting every 7 days; the rates were 0.89% and 0.42% as of June 30, 2017 and June 30, 2016, respectively		75,000	75,000
Hospital Revenue Bonds, Series 2006A; payable in installments from $1,780 to $17,040 beginning in 2014 through 2036; interest at rates ranging from 4.50% to 5.00%		—	113,724
Hospital Revenue Bonds, Series 2008A; payable in installments from $760 to $7,900 beginning in 2015 through 2023; interest rates ranging from 5.25% to 5.75%		—	39,376
Hospital Revenue Bonds, Series 2013A; payable in installments from $420 to $2,935 beginning in 2014 through 2036; interest rate is 2.30% through June 1, 2020		—	34,155
Hospital Revenue Bonds, Series 2013B; payable in installments from $415 to $2,935 beginning in 2014 through 2036; interest rate is 2.57% through June 1, 2020		—	34,160
Other		232	295
		285,036	296,710
Less current portion		(5,922)	(5,660)
	$	279,114	291,050

(Continued)

(In thousands)

In November 2008, Salem entered into a loan agreement (the November 2008 Agreement) with the Authority, whereby the Authority issued $75,000 of par amount variable-rate tax-exempt Revenue Bonds (the 2008B Bonds) with a final maturity of 2034. The 2008B Bonds bear interest at rates that change weekly. The Series 2008B Bonds are subject to purchase from time to time at the option of the owners thereof and are required to be purchased in certain events. In order to assure the availability of funds for the payment of the purchase price, Salem has provided for the purchase of such 2008B Bonds under a direct-pay letter-of-credit agreement (the Letter of Credit). The maximum commitment under this Letter of Credit is $76,048 for the 2008B Bonds. The 2008B Bonds are subject to annual mandatory sinking fund redemptions beginning in 2019 ranging from $3,575 to $6,000. The 2008B Bonds are subject to optional and special redemption prior to maturity at the direction of Salem under certain circumstances as described in the November 2008 Agreement. The 2008B Letter of Credit expires in November 2021.

Additionally, in 2008 Salem entered into a cash flow hedge of the 2008B Variable Rate Bonds. The swap agreement maintains the total notional amount of $75,000 and converts the variable interest rate to a fixed rate of approximately 3.541%. See note 9 for further information related to Salem's interest rate management transactions.

In November 2016, Salem entered into a Loan Agreement (The November 2016 Agreement) with the Authority, whereby the authority issued $197,685 of par amount fixed-rate tax-exempt Revenue Refunding Bonds (Series 2016A Bonds). The proceeds from Series 2016A were used to (i) refund and redeem the Series 2006A Bonds; (ii) refund, defease, and redeem the Series 2008A Bonds; (iii) refund and redeem the Series 2013 Bonds; and (iv) pay fees and expenses related to the Series 2016A Bonds. As a result, the amounts related to those issues have been removed from the notes. The 2016A Bonds were issued at a premium in the amount of $17,037, of which $558 has been cumulatively amortized and recorded as a reduction of interest expense in the accompanying consolidated statements of operations for the fiscal year ended June 30, 2017. The remaining amount of unamortized premium included in long-term debt was $16,479 at June 30, 2017.

Scheduled principal repayments of long-term debt are as follows:

	Revenue bonds	Other	Total
2018	$ 5,035	68	5,103
2019	5,185	72	5,257
2020	5,490	78	5,568
2021	5,710	14	5,724
2022	5,920	—	5,920
Thereafter	240,985	—	240,985
	$ 268,325	232	268,557

Interest costs, including amortization of bond premium, in the amounts of $11,419 and $9,362 were charged to operations during the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016, respectively.

(In thousands)

(9) Derivative Instruments and Hedging Activities

Salem has an interest-rate-related derivative instrument to manage its exposure on its debt instruments. The Corporation does not enter into derivative instruments for any purpose other than cash flow hedging purposes. The Corporation follows FASB ASC 815-10, *Derivatives and Hedging*. ASC 815-10 provides accounting and reporting standards for derivative instruments and hedging activities and requires that Salem recognize these as either assets or liabilities in the consolidated balance sheets and measure them at fair value.

In 2008, Salem entered into an interest rate swap transaction to effectively convert the 2008B variable rate debt to a fixed rate of 3.541% through August 15, 2034. The interest rate swap has a notional amount of $75,000. Salem evaluated the interest rate swap transaction and determined that it met the criteria to be classified as a cash flow hedge and the changes in fair value have been recorded as a change in unrestricted net assets in the accompanying consolidated financial statements.

The interest rate swap transaction allows Salem to terminate the financial instrument by requiring full settlement of any interest or termination value, upon five days' written notice given to Salem's bond insurer and counterparty. The fair value of the interest rate swap agreement is determined by or based on the spread in interest rates with consideration of credit risk to both Salem and its counterparty. The estimated fair value of the interest rate swap at June 30, 2017 and 2016 was a liability of $12,874 and $18,828, respectively. Salem was not required to post collateral against the liability of its interest rate swap during the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016 and has not been required to post any collateral to date for the life of the swap.

(10) Temporarily Restricted Net Assets

Temporarily restricted net assets were restricted for the following purposes at June 30, 2017 and 2016:

		2017	2016
Acquisition or construction of property and equipment for the Hospitals	$	354	630
Specific programs of the Hospitals		2,274	2,351
Scholarships		628	713
Other		225	213
	$	3,481	3,907

(11) Retirement and Postretirement Plans

(a) Defined Contribution Retirement Plan

The Hospitals have a contributory, defined contribution retirement plan (the Retirement Plan) covering substantially all full-time employees. All eligible employees are allowed to contribute to the Retirement Plan on the first day of the month following their date of hire. The Hospitals contribute 5.5% to 8.5% of participating employees' annual compensation to the Retirement Plan. To receive the benefit of the Hospitals' contributions, employees must have one year or more of service at one of the Hospitals and contribute at least 1.0% of their annual compensation to the Retirement Plan. Retirement Plan costs were $16,579 and $12,056 for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016, respectively, and are included in labor and benefits in the accompanying consolidated statements of operations.

(b) Postretirement Healthcare Plan

The Hospitals also sponsor a postretirement healthcare plan (the Postretirement Plan) that provides healthcare benefits to certain retirees and their dependents until the retirees reach the age of Medicare eligibility. Generally, retirees are eligible to participate in the Postretirement Plan if they retire from one of the Hospitals at age 55 years or older with 10 years of service. Retirees can convert 25% of their unused extended illness bank (EIB) balance to an equivalent dollar amount, which may then be used to purchase medical, dental, or vision coverage for the retiree and/or dependents. Any unused balance will be forfeited when the retiree reaches the age of Medicare eligibility.

The Corporation accounts for the Postretirement Plan in accordance with FASB ASC 715, *Compensation – Retirement Benefits*, which requires the employer to recognize the overfunded or underfunded status of a plan as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. Under ASC 715 *Compensation – Retirement Benefits*, the measurement of the funded status is the difference between the fair value of the plan assets compared to the benefit obligation of the plan. ASC 715 also required the Corporation to recognize in unrestricted net assets any unrecognized net actuarial gains or losses and any unrecognized prior service costs or credits as they arise and disclose in the notes to the consolidated financial statements additional information about the effect on net periodic benefit cost on the next fiscal year that arises from the delayed recognition of these items. The Corporation's measurement date for plan assets and benefit obligation is as of June 30, 2017 and 2016. For the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016 the Corporation utilized the RP-2014 mortality tables, for estimating the actuarial values.

(In thousands)

The accrued liability for postretirement benefits at June 30, 2017 and 2016 was as follows:

		2017	2016
Change in benefit obligation:			
Benefit obligation at beginning of year	$	6,897	6,992
Service cost		192	169
Interest cost		150	152
Participants' contributions		480	316
Actuarial (gain)		(1,472)	(76)
Benefits paid		(940)	(656)
Benefit obligation at end of year	$	5,307	6,897
Change in plan assets:			
Fair value of plan assets at beginning of year	$	—	—
The Hospitals' contributions		460	340
Participants' contributions		480	316
Benefits paid		(940)	(656)
Fair value of plan assets at end of year	$	—	—

A reconciliation of the Postretirement Plan's funded status at June 30, 2017 and 2016 and to the Hospitals' accrued postretirement healthcare benefits at June 30, 2017 and 2016 was as follows:

		2017	2016
Funded status	$	(5,307)	(6,897)
Current portion of accrued postretirement healthcare benefits		354	444
Long-term portion of accrued postretirement healthcare benefits	$	(4,953)	(6,453)

The current portion of accrued postretirement healthcare benefits is included in accrued liabilities in the accompanying consolidated balance sheets.

(In thousands)

The components of the Hospitals' net periodic postretirement benefit cost (benefit) included in labor and benefits in the accompanying consolidated statements of operations for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016 were as follows:

		12 months ended June 30, 2017	9 months ended June 30, 2016
Service cost	$	192	169
Interest cost		150	152
Amortization of prior service credit		(141)	(382)
Amortization of net gain		(40)	(18)
Net periodic postretirement benefit cost (benefit)	$	161	(79)

Gains accumulated in unrestricted net assets in the accompanying consolidated statements of changes of net assets through the fiscal year ended June 30, 2017 and the 9-month period as of June 30, 2016 were $2,309 and $1,018, respectively. The components of the Hospitals' other changes in plan assets and benefit obligations recognized in unrestricted net assets in the accompanying consolidated statements of changes of net assets for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016 were as follows:

		12 months ended June 30, 2017	9 months ended June 30, 2016
Net gain (loss)	$	1,472	76
Amortization of net loss		(40)	(19)
Amortization of prior service cost		(141)	(382)
Total recognized in unrestricted net assets	$	1,291	(325)

Weighted average assumptions used to determine benefit obligations for June 30, 2017 and 2016 were as follows:

	2017	2016
Discount rate	2.75 %	2.25 %
Rate of compensation increase	3.75	3.75

For actuarial measurement purposes, an 8.0% annual rate of increase in the per capita cost of covered healthcare benefits was assumed for 2017 through 2018. Thereafter, the rate was assumed to decrease by approximately 0.5% percentage point on an annual basis to 5.45% in 2025 and then decrease gradually to 4.2%.

(Continued)

(In thousands)

Assumed healthcare cost trend rates have a significant effect on the amounts reported for postretirement healthcare plans. A one-percentage-point change in assumed healthcare cost trend rates would have the following effects for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016:

		12 months ended June 30, 2017	9 months ended June 30, 2016
One-percentage-point increase:			
Increase in total of service and interest cost components	$	24	23
Increase in postretirement benefit obligation		268	380
One-percentage-point decrease:			
Decrease in total of service and interest cost components	$	(22)	(21)
Decrease in postretirement benefit obligation		(253)	(357)

Benefit payments funded by Salem Health, which reflect future service, as appropriate, are expected to be paid as follows for the future fiscal years ending June 30:

2018	$	354
2019		414
2020		481
2021		531
2022		563
2023–2027		3,207

These estimates are based on assumptions about future events. Actual benefit payments may vary significantly from these estimates.

(12) Functional Classification of Expenses

Expenses on a functional basis for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016 were as follows:

		12 months ended June 30, 2017	9 months ended June 30, 2016
Healthcare services	$	620,342	457,580
General and administrative		84,524	64,042
	$	704,866	521,622

(13) Fair Value Measurements and the Fair Value Option

(a) Fair Value of Financial Instruments

The carrying amounts for each class of financial instrument noted below are included in the consolidated balance sheets under the indicated captions.

The fair values of the financial instruments as discussed below at June 30, 2017 and 2016 represent management's best estimates of the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at the measurement date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Corporation's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Corporation based on the best information available in the circumstances.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and cash equivalents; patient accounts receivable; estimated third-party payor settlements; other receivables; accounts payable; construction accounts payable; and accrued liabilities: The carrying value of these financial instruments is equal to the carrying amounts, at face value or cost plus accrued interest, and approximates fair value because of the short maturity of these instruments.

Assets limited as to use: All equity securities are classified as available-for-sale and measured using quoted market prices at the reporting date multiplied by the quantity held. Debt securities classified as available-for-sale are measured using quoted market prices multiplied by the quantity held when quoted market prices are available. If quoted market prices for those debt securities are not available, the fair value is determined using matrix pricing, which is based on quoted prices for securities with similar coupons, ratings, and maturities, rather than on specific bids and offers for the designated security.

Interest rate swap agreement: The carrying value of the interest rate swap agreement is equal to the estimated fair value of the agreement. The fair value of interest rate swap is determined using pricing models developed based on the LIBOR swap rate and other observable market data. The value was determined after considering the potential impact of collateralization and netting agreements, adjusted to reflect nonperformance risk of both the counterparty and Salem.

(In thousands)

(b) Fair Value Hierarchy

FASB ASC 820-10, *Fair Value Measurement*, establishes a fair value 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) and the lowest priority to measurements involving significant unobservable inputs (Level 3). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest-level input that is significant to the fair value measurement in its entirety. There were no reclassification of securities between Level 1 and Level 2 during the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016. There were no Level 3 securities at June 30, 2017 or 2016.

The following table presents assets and liabilities that are measured at fair value on a recurring basis (including items that are required to be measured at fair value and items for which the fair value option has been elected) at June 30, 2017:

		Fair value measurements at reporting date using	
	June 30, 2017	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)
Assets:			
Cash and cash equivalents	$ 31,315	31,315	—
Corporate bonds	5,120	—	5,120
Fixed income mutual funds	263,421	263,421	—
U.S. Treasury securities	4,800	—	4,800
Equity mutual funds	306,270	306,270	—
U.S. government agency securities	2,526	—	2,526
Total	$ 613,452	601,006	12,446

(In thousands)

		Fair value measurements at reporting date using	
	June 30, 2017	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)
Liabilities:			
Interest rate swap	$ 12,874	—	12,874
Total	$ 12,874	—	12,874

The following table presents assets and liabilities that are measured at fair value on a recurring basis (including items that are required to be measured at fair value and items for which the fair value option has been elected) at June 30, 2016:

		Fair value measurements at reporting date using	
	June 30, 2016	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)
Assets:			
Cash and cash equivalents	$ 33,309	33,309	—
Corporate bonds	4,365	—	4,365
Fixed income mutual funds	248,108	248,108	—
U.S. Treasury securities	4,111	—	4,111
Equity mutual funds	239,536	239,536	—
U.S. government agency securities	8,270	—	8,270
Total	$ 537,699	520,953	16,746
Liabilities:			
Interest rate swap	$ 18,828	—	18,828
Total	$ 18,828	—	18,828

(14) Commitments and Contingencies

(a) General and Professional Liability Insurance

On a claims-made basis, WVIC provides excess insurance coverage up to a $1,000 self-insured retention limit per occurrence and $6,000 annual aggregate limit for healthcare professional liability ($1,000/$6,000 limits) for Salem effective November 1, 2004. WVIC provided insurance coverage for West Valley between May 1, 2005 and September 30, 2007 and for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016. In excess of the $1,000/$6,000 limits, the Hospitals annually purchase reinsurance coverage for claims up to $34,000 in aggregate on a claims-made basis. Reinsurance contracts do not relieve the Corporation from its obligations to claimants. Failure of reinsurers to honor their obligations could result in losses to the Corporation. The Corporation evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurer to manage its exposure to significant losses from reinsurer insolvencies.

General and professional liability costs are accrued based upon an actuarial determination with estimated future professional liability losses recorded at the expected, undiscounted level. The Corporation has recorded estimated liabilities for incurred but not reported professional liability claims and for deductibles on reported claims aggregating $6,739 and $7,703 as of June 30, 2017 and 2016, respectively. The estimated liabilities for incurred but not reported medical claims are recorded on the Hospitals' books. WVIC carries the estimated liabilities for deductibles on reported claims. Management believes that these estimated liabilities are adequate; however, the establishment of estimated liabilities for incurred but not reported medical malpractice claims and for deductibles on reported claims is an inherently uncertain process, and there can be no assurance that currently established reserves will prove adequate to cover actual ultimate expenses. Subsequent actual experience could result in reserves being too high or too low, which could positively or negatively impact operations in future periods.

The Corporation records claim liabilities without consideration of insurance recoveries and receivables for insurance recoveries to be reported separately subject to a valuation allowance as appropriate. The Corporation recorded an asset for insurance recoveries receivable and estimated liabilities, which are not net of any estimated recoveries in amount of $1,986 and $1,612 as of June 30, 2017 and 2016, respectively. The insurance recovery receivable and insured claims liability are included in other noncurrent assets and estimated medical malpractice claims liability in the accompanying consolidated balance sheets. No valuation allowance was recorded related to reinsurance receivables as of June 30, 2017 and 2016.

(b) Self-Insured Employee Benefits

The Corporation is self-insured for employee medical and dental claims. Claims are accrued as the incidents become known. The Corporation has recorded an accrual for the estimated claims including estimates of the ultimate costs for both reported claims and claims incurred but not reported of $3,483 and $2,920 as of June 30, 2017 and 2016, respectively. Management believes that these amounts, which have been included within other accrued liabilities in the accompanying consolidated balance sheets, are adequate to cover estimated employee medical and dental claims.

(In thousands)

(c) Risk Management

In the ordinary course of business, the Corporation is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; and natural disasters. Management believes that adequate commercial insurance coverage has been purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016. The Corporation is self-insured for workers' compensation claims. The Corporation has recorded estimated liabilities for claims in the amount of $2,657 and $2,622 as of June 30, 2017 and 2016, respectively.

(d) Regulation and Litigation

The healthcare industry is governed by various laws and regulations of federal, state, and local governments. These laws and regulations are subject to ongoing government review and interpretation, and include matters such as licensure, accreditation, reimbursement for patient services, and referrals for Medicare and Medicaid beneficiaries. Compliance with these laws and regulations is required for participation in government healthcare programs and have become more complicated in recent years due to changes resulting from the Health Reform Law and the introduction of health benefit exchanges and coordinated care organizations into the local marketplace. Certain governmental agencies routinely investigate and pursue allegations concerning possible overpayments resulting from violation of fraud and abuse statutes by healthcare providers. These types of investigations may result in settlements involving fines and penalties as well as repayment of improper reimbursement. The Corporation has implemented procedures for monitoring and enforcing compliance with laws and regulations and is not aware of significant instances of noncompliance.

(e) Operating Leases

The Corporation has certain noncancelable operating leases for office space and equipment. The Corporation recorded lease expense of $3,155 and $1,865, which is included in purchased services and other in the consolidated statements of operations for the fiscal year ended June 30, 2017 and the 9-month period ended June 30, 2016, respectively.

The following is a schedule of future minimum payments required under the Corporation's operating leases at June 30, 2017:

2018	$	1,676
2019		1,609
2020		1,609
2021		1,393
2022		930
Thereafter		703
	$	7,920

(15) Lean initiatives (unaudited)

The Lean Management system was initially introduced to the Corporation in 2010 to improve the quality of care and transform their culture. The purpose of Lean is to create value for the patient through its three main components: continuous improvement, elimination of waste and variation, and respect for people. Using Lean, the Corporation aligns their strategies to their daily work: engaging their providers and employees to become problem solvers and continually ask the question “why”, ensuring all employees work together toward the same outcomes, and keeping the Corporation strong and effective.

In fiscal year 2017 the Corporation had a strategic goal to engage frontline staff in leading and completing a Lean activity to remove waste from the system, creating improved value for their patients.

	12 months ending June 30, 2017	9 months ending June 30, 2016
	(not in thousands)	
% of front line staff leading and completing a lean activity	53 %	8 %
Total lean activities completed	3,788	1,340

The Corporation continues to invest increasing efforts in the Lean system to create value for their patients by increasing access to care, improving patient experience, and delivering quality care at a lower cost.

(16) Subsequent Events

The Corporation evaluated subsequent events after the consolidated balance sheet date of June 30, 2017 through October 6, 2017, which was the date the consolidated financial statements were issued.