Taos Health Systems, Inc.

Independent Auditor's Report and
Consolidated Financial Statements

May 31, 2018 and 2017

Taos Health Systems, Inc.
May 31, 2018 and 2017

Contents

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Independent Auditor's Report

Board of Directors
Taos Health Systems, Inc.
Taos, New Mexico

We have audited the accompanying consolidated financial statements of Taos Health Systems, Inc. (the Organization), which comprise the consolidated balance sheets as of May 31, 2018 and 2017, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated 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 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 auditor's 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.

Board of Directors
Taos Health Systems, Inc.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Taos Health Systems, Inc. as of May 31, 2018 and 2017, and the results of its operations, changes in net assets and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BKD, LLP

Denver, Colorado
December 5, 2018

Taos Health Systems, Inc.
Consolidated Balance Sheets
May 31, 2018 and 2017

Assets

	2018	2017
Current Assets		
Cash and cash equivalents	$ 1,477,014	$ 3,013,589
Short-term investments	23,728	325,771
Patient accounts receivable, net of allowance; 2018 - $2,465,650 and 2017 - $1,674,791	10,469,815	5,943,515
Estimated amounts due from third-party payers	1,965,042	399,595
Supplies	1,413,333	1,734,140
Other receivables	134,324	114,742
Estimated insurance recovery receivable *	800,000	3,970,000
Prepaid expenses and other	597,790	830,608
Total current assets	16,881,046	16,331,960
Assets Limited as to Use		
Internally designated	90,837	2,179,356
Investments		
Investment in equity investee	114,601	75,257
Property and Equipment, at Cost		
Land and land improvements	2,466,483	2,527,249
Buildings and leasehold improvements	17,063,290	17,498,921
Equipment	25,216,173	26,230,953
Construction in progress	315,249	627,218
	45,061,195	46,884,341
Less accumulated depreciation	(28,387,552)	(31,384,188)
	16,673,643	15,500,153
Other Assets		
Other	195,676	276,373
Total assets	$ 33,955,803	$ 34,363,099

* Refer to Note 10, Professional Liability Insurance

Taos Health Systems, Inc.
Consolidated Balance Sheets (continued)
May 31, 2018 and 2017

Liabilities and Net Assets

	2018	2017
Current Liabilities		
Line of credit	$ 1,794,713	$ 535,709
Accounts payable	7,303,434	3,289,913
Accrued expenses	2,491,488	2,663,099
Estimated amounts due to third-party payers	1,128,113	838,096
Estimated contingent liability *	800,000	3,970,000
Current portion of accounts payable on payment plans	1,083,518	-
Current portion of capital lease obligations	594,092	230,085
Total current liabilities	15,195,358	11,526,902
Long-term Liabilities		
Long-term portion of accounts payable on payment plans	277,563	-
Capital lease obligations, less current portion	1,057,023	322,512
Total long-term liabilities	1,334,586	322,512
Total liabilities	16,529,944	11,849,414
Net Assets		
Unrestricted	17,011,858	22,197,633
Temporarily restricted	414,001	316,052
Total net assets	17,425,859	22,513,685
Total liabilities and net assets	$ 33,955,803	$ 34,363,099

* Refer to Note 10, Professional Liability Insurance

Taos Health Systems, Inc.

Consolidated Statements of Operations

Years Ended May 31, 2018 and 2017

	2018	2017
Unrestricted Revenues, Gains and Other Support		
Net patient service revenue	$ 54,907,805	$ 54,404,766
Provision for uncollectible accounts	3,580,017	2,791,168
Net patient service revenue less provision for uncollectible accounts	51,327,788	51,613,598
Other revenue	5,284,187	7,407,157
Net assets released from restriction used for operations	123,185	306,612
Total unrestricted revenues, gains and other support	56,735,160	59,327,367
Expenses and Losses		
Salaries and wages	26,223,055	25,215,906
Purchased services	10,158,857	8,419,391
Supplies and minor equipment	9,323,951	9,516,062
Payroll taxes and benefits	4,912,361	5,189,682
Professional fees	2,596,522	2,352,603
Depreciation	1,951,517	1,760,540
Leases and rentals	1,397,462	1,321,286
Repairs and maintenance	1,460,134	1,523,924
Other	1,944,551	2,236,732
Insurance	1,339,549	979,025
Telephone and utilities	897,494	809,272
Travel, meals and entertainment	76,205	89,909
Interest	114,574	49,120
Total expenses and losses	62,396,232	59,463,452
Operating Loss	(5,661,072)	(136,085)
Other Income		
Investment return	184,052	133,445
Mill levy income	396,647	-
Other income (loss)	(104,134)	28,504
Total other income	476,565	161,949
Excess (Deficiency) of Revenues Over Expenses	(5,184,507)	25,864
Net unrealized gains (losses) on assets limited as to use other than trading securities	(1,268)	112,812
Increase (Decrease) in Unrestricted Net Assets	$ (5,185,775)	$ 138,676

Taos Health Systems, Inc.

Consolidated Statements of Changes in Net Assets

Years Ended May 31, 2018 and 2017

	2018	2017
Unrestricted Net Assets		
Excess (deficiency) of revenues over expenses	$ (5,184,507)	$ 25,864
Net unrealized gains (losses) on assets limited as to use other than trading securities	(1,268)	112,812
Increase (decrease) in unrestricted net assets	(5,185,775)	138,676
Temporarily Restricted Net Assets		
Restricted grants and donations	221,134	213,124
Net assets released from restrictions	(123,185)	(306,612)
Increase (decrease) in temporarily restricted net assets	97,949	(93,488)
Change in Net Assets	(5,087,826)	45,188
Net Assets, Beginning of Year	22,513,685	22,468,497
Net Assets, End of Year	$ 17,425,859	$ 22,513,685

Taos Health Systems, Inc.
Consolidated Statements of Cash Flows
Years Ended May 31, 2018 and 2017

	2018	2017
Operating Activities		
Change in net assets	$ (5,087,826)	$ 45,188
Items not requiring (providing) operating cash flows		
Provision for uncollectible accounts	3,580,017	2,791,168
Depreciation	1,951,517	1,760,540
Loss on disposal of equipment	171,550	-
Net unrealized losses (gains) on assets limited as to use	1,268	(112,812)
Realized gain on sale of assets limited as to use	(132,112)	(65,948)
Gain on investment in equity investees	(39,344)	(25,069)
Changes in		
Patient accounts receivable	(8,106,317)	(3,684,585)
Other receivables	(19,582)	311,245
Inventories	320,807	(211,558)
Prepaid expenses	232,818	(207,537)
Other assets	80,697	41,413
Accounts payable, including payables on payment plans	5,330,453	(244,552)
Accrued expenses	(171,611)	354,599
Net amounts due to (from) third-party payers	(1,275,430)	1,461,647
Net cash provided by (used in) operating activities	(3,163,095)	2,213,739
Investing Activities		
Purchase of property and equipment	(1,708,262)	(2,106,360)
Purchase of assets limited as to use	-	(239,080)
Proceeds from the sale of short-term investments	302,862	-
Proceeds from the sale of assets limited as to use	2,218,544	65,948
Net cash provided by (used in) investing activities	813,144	(2,279,492)
Financing Activities		
Net borrowings on line of credit	1,241,112	13,682
Principal payments under capital lease obligations	(427,736)	(225,085)
Net cash provided by (used in) financing activities	813,376	(211,403)
Decrease in Cash and Cash Equivalents	(1,536,575)	(277,156)
Cash and Cash Equivalents, Beginning of Year	3,013,589	3,290,745
Cash and Cash Equivalents, End of Year	$ 1,477,014	$ 3,013,589
Supplemental Cash Flows Information		
Cash payments for interest	$ 114,574	$ 49,120
Capital lease obligation incurred for property and equipment	$ 1,544,146	$ -
Property and equipment financed in accounts payable	$ 44,149	$ 34,304

Taos Health Systems, Inc.
Notes to Consolidated Financial Statements
May 31, 2018 and 2017

Note 1: Nature of Organization and Summary of Significant Accounting Policies

Organization

Taos Health Systems, Inc. (the Organization), located in Taos, New Mexico, is a not-for-profit hospital along with specialty clinics as further described below. As of July 20, 2017, the organization changed from a 29-bed acute care hospital to a 25-bed critical access hospital. The Organization provides inpatient, outpatient, emergency care and clinical services for residents of Taos County and surrounding areas. The consolidated financial statements of the Organization include Holy Cross Hospital (the Hospital) and Taos Professional Services (TPS).

TPS, formed in 2008, is currently comprised of the following distinct clinical units:

- Women's Health Institute (WHI), which provides obstetrics and gynecology services.
- Taos Surgical Specialties (TSS), which provides surgical services.
- Center for Physical Health (CPH), provides rehabilitation services including physical therapy and speech therapy. As of October 1, 2017, CPH was converted from a freestanding clinic to a department of the hospital.
- High Road Dermatology (HRD), provides dermatology services.
- Taos Primary Care Clinic, provides basic family clinic services.

Principles of Consolidation

The consolidated financial statements include the accounts of the Hospital and TPS. All material intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Organization considers all liquid investments other than those included in assets limited as to use or held for investment purposes, with original maturities of three months or less to be cash equivalents. At May 31, 2018 and 2017, cash equivalents consisted primarily of money market accounts with brokers and certificates of deposit.

At May 31, 2018, the Organization's cash accounts exceeded federally insured limits by approximately $1,935,000.

Short-term Investments

Short-term investments include investments with original maturities between three months and one year. The short-term investments consist of certificates of deposit. At times, such investments may be in excess of the FDIC insurance limit; however, the Organization has not experienced any losses in such accounts.

Investments and Investment Return

Investments in equity securities having a readily determinable fair value and in all debt securities are carried at fair value. The investment in equity investee is reported on the equity method of accounting. Other investments are valued at the lower of cost (or fair value at time of donation, if acquired by contribution) or fair value. Investment return includes dividend, interest and other investment income; realized and unrealized gains and losses on investments carried at fair value; and realized gains and losses on other investments.

Investment return that is initially restricted by donor stipulation and for which the restriction will be satisfied in the same year is included in unrestricted net assets. Other investment return is reflected in the consolidated statements of operations and changes in net assets as unrestricted, or temporarily restricted based upon the existence and nature of any donor or legally imposed restrictions.

Assets Limited as to Use

Assets limited as to use primarily include designated assets set aside by the Board of Directors (the Board) for future capital improvements, over which the Board retains control and may at its discretion subsequently use for other purposes.

Patient Accounts Receivable

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the Organization analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for uncollectible accounts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Organization records a significant provision for uncollectible accounts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated or provided by policy) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The Organization's allowance for doubtful accounts for self-pay patients increased from 69% to 77% of self-pay accounts receivable at May 31, 2017 and 2018, respectively. In addition, the Organization's write-offs increased approximately $790,000 from approximately $2.8 million for the year ended May 31, 2017 to approximately $3.6 million for the year ended May 31, 2018. The increase in bad debt is due to overall increases in revenues and a higher number of patients not paying their portion of co-pay and deductible amounts associated with their bills. In addition, the Organization implemented a new electronic medical record (EMR) software system. Delays encountered due to the system implementation increased aging of accounts resulting in increased allowance estimates.

Supplies

The Organization states supply inventories at cost, determined using the first-in, first-out method.

Property and Equipment

Property and equipment acquisitions are recorded at cost. Assets are capitalized if the cost is greater than $2,000. Depreciation is provided over the estimated useful life of each class of depreciable assets and is computed on the straight-line method. Equipment under capital lease obligations is depreciated on the straight-line method over a shorter period of the lease term or the estimated useful life of the equipment.

The estimated useful lives for each major depreciable classification of property and equipment are as follows:

Buildings and improvements	3–40 years
Equipment	3–10 years

Long-lived Asset Impairment

The Organization evaluates the recoverability of the carrying value of long-lived assets whenever events or circumstances indicate the carrying amount may not be recoverable. If a long-lived asset is tested for recoverability and the undiscounted estimate future cash flows expected to result from the use and eventual disposition of the asset are less than the carrying amount of the asset, the asset cost is adjusted to fair value and an impairment loss is recognized as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

No asset impairment was recognized during the years ended May 31, 2018 and 2017.

Investment Accounted for Under the Equity Method

The Organization has a 50% ownership interest in Taos Community Health Plan, Inc., a Physician Hospital Organization (PHO) created to present a united group of health care providers to negotiate contracts with managed care organizations. This investment is accounted for under the equity method of accounting. Under the equity method, the original investment is recorded at cost and adjusted by the Organization's share of undistributed earnings or losses of this entity.

Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use by the Organization has been limited by donors to a specific time period or purpose.

Net Patient Service Revenue

The Organization has agreements with third-party payers that provide for payments to the Organization at amounts different from its established rates. Net patient service revenue is reported at the estimated net amounts realizable from patients, third-party payers and others for services rendered, and includes estimated retroactive revenue adjustments. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and such amounts are revised in future periods as adjustments become known.

Charity Care

The Organization provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Organization does not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient service revenue. The Organization's direct and indirect costs for services furnished under its charity care policy aggregated approximately $96,000 and $114,000 in 2018 and 2017, respectively.

Professional Liability Claims

The Hospital recognizes an accrual for claim liabilities based on estimated ultimate losses and costs associated with settling claims and a receivable to reflect the estimated insurance recoveries, if any. Professional liability claims are described more fully in Note 10.

Income Taxes

The Organization has been recognized as exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code and a similar provision of state law. However, the Organization is subject to federal income tax on any unrelated business taxable income.

The Organization files tax returns in the U.S. federal jurisdiction.

Excess (Deficiency) of Revenues Over Expenses

The consolidated statements of operations includes excess (deficiency) of revenues over expenses. Changes in unrestricted net assets which are excluded from excess (deficiency) of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

Self-insurance

The Organization has elected to self-insure certain costs related to employee health and accident benefit programs. Costs resulting from noninsured losses are charged to income when incurred. The Organization has purchased insurance that limits its exposure for individual claims and that limits its aggregate exposure to $85,000.

Electronic Health Records Incentive Program

The Electronic Health Records Incentive Program, enacted as part of the *American Recovery and Reinvestment Act of 2009*, provides for one-time incentive payments under both the Medicare and Medicaid programs to eligible hospitals that demonstrate meaningful use of certified electronic health records technology (EHR). Payments under the Medicare program are generally made for up to four years based on a statutory formula. Payments under the Medicaid program are generally made for up to four years based upon a statutory formula, as determined by the state, which is approved by the Centers for Medicare and Medicaid Services. Payment under both programs is contingent on the Organization continuing to meet escalating meaningful use criteria and any other specific requirements that are applicable for the reporting period. The final amount for any payment year is determined based upon an audit by the fiscal intermediary. Events could occur that would cause the final amounts to differ materially from the initial payments under the program.

The Organization recognizes revenue during the period in which management was reasonably assured meaningful use objectives were met and any other specific requirements achieved. The Organization has not recorded Medicare EHR revenue during 2018 and 2017.

Mill Levy

The voters of Taos County New Mexico passed a levy of one mill for funding infrastructure maintenance and improvements for Holy Cross Hospital. The tax is expected to provide approximately $1.3 million each year for the next four years starting in 2018. The taxes are reported as revenue in the year in which the funds are approved to be spent. During the year ended May 31, 2018, the Organization recorded $396,647 in revenue from the mill levy.

Reclassifications

Certain reclassifications have been made to the 2017 financial statements to conform to the 2018 financial statement presentation. These reclassifications had no effect on the change in net assets.

Subsequent Events

Subsequent events have been evaluated through December 5, 2018, which is the date the consolidated financial statements were available to be issued.

Note 2: Net Patient Service Revenue

Arrangements with Third-party Payers

The Organization recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the Organization 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 Organization's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Organization records a significant provision for uncollectible accounts related to uninsured patients in the period the services are provided. This provision for uncollectible accounts is presented on the consolidated statements of operations as a component of net patient service revenue.

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

Medicare. As of July 20, 2017, the Organization converted to a critical access hospital. This designation changed the Organization's reimbursement from payments at prospectively determined rates to cost reimbursement. Inpatient, non-acute services, and defined capital are paid based on a cost reimbursement methodology. The Organization is reimbursed for certain services at a tentative rate with final settlement determined after submission of annual cost reports by the Organization and audits thereof by the Medicare fiscal intermediary.

Medicaid. Inpatient acute care services rendered to Medicaid program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Outpatient services and defined capital are paid based on a percentage above the state determined fee schedule. Cost reports are required; however cost report settlements have been discontinued.

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

Patient service revenue, net of contractual allowances and discounts (but before the provision for uncollectible accounts), recognized in the years ended May 31, 2018 and 2017, was approximately:

	2018	2017
Medicare	$ 19,891,149	$ 18,098,416
Medicaid	12,624,816	9,826,519
Other third-party payers	21,874,996	24,739,785
Self-pay	516,844	1,740,046
Total	$ 54,907,805	$ 54,404,766

Note 3: Concentration of Credit Risk

The Organization grants credit without collateral to its patients, most of whom are area residents and are insured under third-party payer agreements, including Medicare and Medicaid. The mix of net receivables from patients and third-party payers at May 31 is:

	2018	2017
Medicare	44%	26%
Medicaid	14%	16%
Other third-party payers	42%	45%
Self-pay	0%	13%
	100%	100%

Note 4: Investments and Investment Return

Assets Limited as to Use

Assets limited as to use at May 31 include:

	2018	2017
Cash and cash equivalents	$ -	$ 290,169
Equity securities	78,498	1,271,545
Mutual funds	-	592,296
	78,498	2,154,010
Internally designated for nursing scholarships		
Certificates of deposit	12,339	25,346
Total assets limited as to use	$ 90,837	$ 2,179,356

Investments

Short-term investments at May 31 include:

	2018	2017
Certificates of deposit	$ -	$ 302,862
Taos Community Foundation	23,728	22,909
	$ 23,728	$ 325,771

Investment Income

Total investment return is comprised of the following:

	2018	2017
Interest and dividend income	$ 51,930	$ 67,497
Realized gains	132,122	65,948
	184,052	133,445
Net unrealized gains (losses)	(1,268)	112,812
	$ 182,784	$ 246,257

Note 5: Investment in and Advances to Equity Investee

The following table provides a condensed income statement and balance sheet of the PHO as of and for the years ended May 31:

	2018	2017
Condensed income statement information		
Operating revenues	$ 367,073	$ 239,386
Net income	$ 78,688	$ 50,138
The Hospital's equity in net income of affiliate	$ 39,344	$ 25,069
Condensed balance sheet information		
Total assets	$ 229,703	$ 151,029
Liabilities	$ 502	$ 516
Equity	229,201	150,513
Total liabilities and equity	$ 229,703	$ 151,029
The Hospital's equity in net assets of affiliate	$ 114,601	$ 75,257

Note 6: Line of Credit

The Organization entered into a new open-ended revolving line of credit on January 1, 2018 with a borrowing limit originally expiring October 3, 2018. Payment terms were subsequently extended to $300,000 due the week of October 1, 2018, $1,000,000 due upon receipt of the quarterly Safety Net Care Pool funds from the State of New Mexico, and the remainder due by December 31, 2018.

At May 31, 2018 and 2017, there was $1,794,713 and $535,709, respectively, borrowed on the line of credit. The line is collateralized by property owned by the Organization and is payable on demand. The revolving credit agreement bears interest at prime plus 1.00% which was 4.75% at May 31, 2018. The previously held line of credit was paid in full and had an interest rate of LIBOR plus 1.75% and was 2.72% at May 31, 2017.

Note 7: Capital Lease Obligation

Capital lease obligations consisted of the following at May 31:

	2018	2017
Capital lease obligations	$ 1,651,115	$ 552,597
Less current maturities	594,092	230,085
	$ 1,057,023	$ 322,512

Capital lease agreements have varying rates of imputed interest from 2.8% to 7.1%, due through June 1, 2022; collateralized by property and equipment. The Organization leases certain equipment under agreements that are classified as capital leases. Depreciation of assets under capital leases is included in depreciation expense in the accompanying consolidated financial statements.

	2018	2017
Equipment	$ 3,066,105	$ 2,388,081
Less accumulated depreciation	1,162,196	1,871,744
	$ 1,903,909	$ 516,337

The maturities of the capital lease obligations for each of the five years subsequent to May 31, 2018 and the aggregate amount thereafter are shown below:

Fiscal Year Ending May 31,	Lease Obligations
2019	$ 632,826
2020	477,188
2021	335,524
2022	242,001
	1,687,539
Less amount representing interest	36,424
Present value of future minimum lease payments	1,651,115
Less current maturities	594,092
Noncurrent portion	$ 1,057,023

Note 8: Pension Plan

Under a collective bargaining agreement between the Organization and the Professional Performance Association, affiliated with District 1199 NM, National Union of Hospital and Health Care Employees, AFSCME AFL-CIO, a defined contribution pension plan (the Plan) was established under Section 403(b) of the Internal Revenue Code. The current collective bargaining agreement will expire on May 31, 2021.

Under the agreement as amended, the Organization maintains a qualified, long-term, tax-deferred savings plan. Effective January 1, 2013, for employees earning less than $35,250 annually, the Organization will match the employee's contribution to the Plan up to $705 annually. For employees earning more than $35,250 annually and who contribute at least $705, the Organization will match the employee's contribution up to 2.0% of the employee's annual compensation, not to exceed $2,500 annually. Only employees eighteen (18) years of age or older qualify. Members of the Plan will be vested in the Plan on a five (5) year graduated schedule, but fully vested no later than the employee's sixty-fifth (65th) birthday. The Organization appoints a plan administrator, prepares and distributes summary plan descriptions, and assists the plan administrator in distributing reports to individual participants no less frequently than annually. The Organization also pays all direct administrative costs to operate the Plan.

All employees, whether represented by the bargaining unit or not, who meet the eligibility requirements are eligible to participate and receive the contributions as noted above. Pension expense was approximately $325,000 and $353,000 for 2018 and 2017, respectively.

Note 9: Operating Leases

The Organization has entered into two lease arrangements with the county of Taos, New Mexico. The first agreement, entered into during fiscal year 2009, is a co-ownership purchase of equipment between the two entities requiring a 10-year annual lease payment of $12,500. The second agreement, entered into during fiscal year 2011, is a 10-year rent prepayment on the hospital building and includes the requirement that the Organization purchase a new ambulance every two years on a calendar year basis. Prepaid assets are included in prepaid expenses and other in the consolidated balance sheets.

The Organization has various operating leases for buildings and equipment. Total expense approximated $1,397,462 in 2018 and $1,321,286 in 2017 for all operating leases. The following is a schedule by year of future minimum lease payments for the building and equipment under non-cancelable operating leases as of May 31, 2018 which have initial or remaining lease terms in excess of one year:

2019	$ 535,806
2020	404,310
2021	335,453
2022	218,790
2023	20,381
Total minimum lease payments	$ 1,514,740

Note 10: Commitments and Contingencies

Labor Agreements

At May 31, 2018, 99 of the Organization's 343 union-eligible employees were active under the collective bargaining agreements. At May 31, 2017, 126 employees out of 309 union-eligible employees were active. Total employee count at year-end May 31, 2018 and 2017 was 452 and 444, respectively. The current collective bargaining agreement is set to expire on May 31, 2021, with wage renegotiations permissible in years two and three under the agreement.

Employee Health Insurance

The Organization maintains a stop-loss agreement with an insurance company to limit its losses on individual claims related to group employee insurance. Under the current terms of this agreement, the Organization's claims liability is limited to $85,000 per employee per plan year. As of May 31, 2018 and 2017, the Organization accrued employee insurance claims of $367,483 and $364,976, respectively, which are included in accounts payable in the accompanying consolidated balance sheets.

Stop-loss premiums and claims payments totaling $2,029,656 and $2,126,768 were expended during the years ended May 31, 2018 and 2017, respectively, and are included in the employee benefits expense in the accompanying consolidated statements of operations.

Professional Liability Insurance

The Organization purchases medical malpractice insurance under a claims-made policy. Under such a policy, only claims made and reported to the insurer during the policy term, regardless of when the incidents giving rise to the claims occurred, are covered. The Organization also purchases excess umbrella liability coverage, which provides additional coverage above the basic policy limits up to the amount specified in the umbrella policy.

Based upon the Organization's claims experience, an accrual had been made for the Organization's estimated medical malpractice costs, including costs associated with litigating or settling claims, under its malpractice insurance policy, amounting to approximately $353,000 and $667,000 as of May 31, 2018 and 2017, respectively. In addition, an estimated insurance recovery receivable and offsetting estimated contingent liability of $800,000 and $3,970,000 are shown on the consolidated balance sheets and represent amounts estimated to be covered by insurance as of May 31, 2018 and 2017, respectively. Professional liability reserve estimates represent the estimated cost of reported and unreported losses incurred through the respective consolidated balance sheets dates. The reserve for unpaid losses and loss expenses are estimated using individual case-basis valuations. Those estimates are subject to the effects of trends in loss severity and frequency. The estimates are continually reviewed and adjustments are recorded as experience develops or new information becomes known. The time period required to resolve these claims can vary depending upon whether the claim is settled or litigated. The estimation of the timing of payments beyond a year can vary significantly. Although considerable variability is inherent in professional liability reserve estimates, we believe the reserves for losses and loss expenses are adequate based on information currently known. It is reasonably possible that this estimate could change materially in the near term.

Workers' Compensation Insurance

The Organization is insured under the New Mexico Hospital Workers' Compensation Group for the purpose of providing insurance coverage for workers' compensation. The policy is a retrospectively rated policy whose premiums accrue based on the ultimate cost of the experience of a group of participating health care entities. The Organization expensed approximately $341,000 and $378,000 in workers' compensation premiums during 2018 and 2017, respectively. Such amounts are included in employee benefits expense in the accompanying consolidated statements of operations.

Cost Report Settlements

The Organization's Medicare cost reports have been final settled for fiscal years through May 31, 2016, and Medicaid cost reports have been final settled for fiscal years through May 31, 2015. In management's opinion, the estimated third-party settlement receivable of approximately $1,250,000 and payable of $35,000 at May 31, 2018 and 2017, respectively, is currently management's best estimate of the remaining cost reports settlements. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Estimates are continually monitored and reviewed, and as settlements are made or more information is available to improve estimates, differences are reflected in current operations.

Safety Net Care Pool

The Organization receives Safety Net Care Pool (SNCP) funding to compensate the Organization for providing health care to the indigent population in Taos County. The funding is subject to annual reviews and approvals by Taos County as well as the State of New Mexico Human Services Department. In fiscal years 2018 and 2017, the Organization recognized SNCP funding of approximately $4,634,000 and $5,700,000, respectively. Such amounts are reported as other revenue in the accompanying consolidated statements of operations. Funding in future periods is uncertain; however, management expects to receive a similar amount of funding in fiscal year 2018 as in fiscal year 2017.

Note 11: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations.

Note 12: Functional Expense Classification

In recording the activities of the Organization, expenses are specifically tracked or allocated on the basis of periodic time and expense studies, and recorded in the following functional categories for the years ended May 31:

	2018	2017
Health care services	$ 48,256,977	$ 46,419,928
Management general	14,139,255	13,043,524
Total expenses	$ 62,396,232	$ 59,463,452

Note 13: Fair Value Measurements

Management uses a framework for measuring fair value. That framework provides 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 measurement) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described as follows:

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date

Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly

Level 3 Unobservable inputs for the asset or liability

The asset 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. The Organization has no Level 3 investments. In addition, the Organization had no transfers between levels during the years ended May 31, 2018 and 2017.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at May 31, 2018 and 2017.

Equity securities and mutual funds are valued at the closing price reported on the active market on which the individual securities are traded.

Corporate bonds are valued at the closing price reported in the active market in which the bond is traded.

The following tables disclose by level the fair value hierarchy of the Organization's assets at fair value as of May 31, 2018 and 2017:

		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
May 31, 2018				
Equity securities	$ 78,498	$ 78,498	$ -	$ -

		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
May 31, 2017				
Equity securities	$ 1,271,545	$ 1,271,545	$ -	$ -
Mutual funds	592,296	592,296	-	-

Note 14: Management's Plan

The Organization has incurred recurring losses from operations and negative cash flow from operations in the current year. During fiscal year 2018, the conversion to a critical access hospital and new electronic medical record system caused delays in billing and reimbursement, resulting in reduced liquidity and an increased account receivable balance. The Organization has taken many steps to manage costs and improve cash positions during and following the fiscal year 2018, including engaging a third party to assist in working the account receivable balances and on redesigning the revenue cycle. In addition, the Organization has negotiated extended payment terms with their line of credit lender (see Note 6). In addition, the Organization is monitoring staffing levels and making adjustments where necessary to control costs.