Taos Health Systems, Inc.

Independent Auditor's Report and
Consolidated Financial Statements

May 31, 2019 and 2018

Taos Health Systems, Inc.
May 31, 2019 and 2018

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, 2019 and 2018, 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, 2019 and 2018, 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.

Emphasis of Matter

As described in Note 2 to the financial statements, in 2019, the Organization adopted ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.* Our opinion is not modified with respect to this matter.

BKD, LLP

Denver, Colorado
October 30, 2019

Taos Health Systems, Inc.
Consolidated Balance Sheets
May 31, 2019 and 2018

Assets

	2019	2018
Current Assets		
Cash and cash equivalents	$ 2,871,979	$ 1,477,014
Short-term investments	23,838	23,728
Patient accounts receivable, net of allowance; 2019 - $3,428,992 and 2018 - $2,465,650	7,711,272	10,469,815
Estimated amounts due from third-party payers	848,468	1,965,042
Supplies	1,446,379	1,413,333
Other receivables	69,451	134,324
Estimated insurance recovery receivable *	-	800,000
Prepaid expenses and other	864,185	597,790
Total current assets	13,835,572	16,881,046
Assets Limited as to Use		
Internally designated	85,617	90,837
Investments		
Investment in equity investee	56,578	114,601
Property and Equipment, at Cost		
Land and land improvements	2,461,483	2,466,483
Buildings and leasehold improvements	17,055,746	17,063,290
Equipment	21,781,687	25,216,173
Construction in progress	1,631,020	315,249
	42,929,936	45,061,195
Less accumulated depreciation	(25,969,386)	(28,387,552)
	16,960,550	16,673,643
Other Assets		
Other	194,196	195,676
Total assets	$ 31,132,513	$ 33,955,803

* Refer to Note 13, Professional Liability Insurance

Taos Health Systems, Inc.
Consolidated Balance Sheets (continued)
May 31, 2019 and 2018

Liabilities and Net Assets

	2019	2018
Current Liabilities		
Line of credit	$ -	$ 1,794,713
Accounts payable	8,274,577	7,303,434
Accrued expenses	2,504,519	2,491,488
Estimated amounts due to third-party payers	1,278,372	1,128,113
Estimated contingent liability *	-	800,000
Current portion of accounts payable on payment plans	276,383	1,083,518
Current portion of capital lease obligations	456,147	594,092
Total current liabilities	12,789,998	15,195,358
Long-term Liabilities		
Long-term portion of accounts payable on payment plans	-	277,563
Capital lease obligations, less current portion	637,540	1,057,023
Total long-term liabilities	637,540	1,334,586
Total liabilities	13,427,538	16,529,944
Net Assets		
Without donor restrictions	17,402,975	17,011,858
With donor restrictions	302,000	414,001
Total net assets	17,704,975	17,425,859
Total liabilities and net assets	$ 31,132,513	$ 33,955,803

* Refer to Note 13, Professional Liability Insurance

Taos Health Systems, Inc.
Consolidated Statements of Operations
Years Ended May 31, 2019 and 2018

	2019	2018
Revenues, Gains and Other Support Without Donor Restrictions		
Net patient service revenue	$ 60,971,809	$ 54,907,805
Provision for uncollectible accounts	5,404,106	3,580,017
Net patient service revenue less provision for uncollectible accounts	55,567,703	51,327,788
Other revenue	7,223,164	5,284,187
Net assets released from restriction used for operations	199,480	123,185
Total revenues, gains and other support without donor restrictions	62,990,347	56,735,160
Expenses and Losses		
Salaries and wages	26,378,215	26,223,055
Purchased services	10,549,615	10,158,857
Supplies and minor equipment	9,638,506	9,323,951
Payroll taxes and benefits	5,232,710	4,912,361
Professional fees	2,435,727	2,596,522
Depreciation	2,088,203	1,951,517
Leases and rentals	1,328,552	1,397,462
Repairs and maintenance	1,071,017	1,460,134
Other	2,707,496	1,944,551
Insurance	1,559,262	1,339,549
Telephone and utilities	888,428	897,494
Travel, meals and entertainment	73,124	76,205
Interest	107,756	114,574
Total expenses and losses	64,058,611	62,396,232
Operating Loss	(1,068,264)	(5,661,072)
Other Income (Expense)		
Investment return, net	22,906	184,052
Mill levy income	1,491,348	396,647
Other income (loss)	(54,906)	(104,134)
Total other income (expense)	1,459,348	476,565
Excess (Deficiency) of Revenues Over Expenses	391,084	(5,184,507)
Net unrealized gains (losses) on assets limited as to use other than trading securities	33	(1,268)
Increase (Decrease) in Net Assets Without Donor Restrictions	$ 391,117	$ (5,185,775)

Taos Health Systems, Inc.

Consolidated Statements of Changes in Net Assets

Years Ended May 31, 2019 and 2018

	2019	2018
Net Assets Without Donor Restrictions		
Excess (deficiency) of revenues over expenses	$ 391,084	$ (5,184,507)
Net unrealized gains (losses) on assets limited as to use other than trading securities	33	(1,268)
Increase (decrease) in net assets without donor restrictions	391,117	(5,185,775)
Net Assets with Donor Restrictions		
Restricted grants and donations	87,479	221,134
Net assets released from restrictions	(199,480)	(123,185)
Increase (decrease) in net assets with donor restrictions	(112,001)	97,949
Change in Net Assets	279,116	(5,087,826)
Net Assets, Beginning of Year	17,425,859	22,513,685
Net Assets, End of Year	$ 17,704,975	$ 17,425,859

Taos Health Systems, Inc.

Consolidated Statements of Cash Flows

Years Ended May 31, 2019 and 2018

	2019	2018
Operating Activities		
Change in net assets	$ 279,116	$ (5,087,826)
Items not requiring (providing) operating cash flows		
Provision for uncollectible accounts	5,404,106	3,580,017
Depreciation	2,088,203	1,951,517
Loss (gain) on disposal of equipment	(117)	171,550
Net unrealized losses (gains) on assets limited as to use	(33)	1,268
Realized gain on sale of assets limited as to use	-	(132,112)
Loss (gain) on investment in equity investee	58,023	(39,344)
Changes in		
Patient accounts receivable	(2,645,563)	(8,106,317)
Other receivables	64,873	(19,582)
Inventories	(33,046)	320,807
Prepaid expenses	(266,395)	232,818
Other assets	1,480	80,697
Accounts payable, including payables on payment plans	(451,851)	5,330,453
Accrued expenses	13,031	(171,611)
Net amounts due to (from) third-party payers	1,266,833	(1,275,430)
Net cash provided by (used in) operating activities	5,778,660	(3,163,095)
Investing Activities		
Purchase of property and equipment	(2,038,515)	(1,708,262)
Proceeds from sale of equipment	1,818	-
Proceeds from the sale of short-term investments	-	302,862
Proceeds from the sale of assets limited as to use	5,143	2,218,544
Net cash provided by (used in) investing activities	(2,031,554)	813,144
Financing Activities		
Net borrowings (repayments) on line of credit	(1,794,713)	1,241,112
Principal payments under capital lease obligations	(557,428)	(427,736)
Net cash provided by (used in) financing activities	(2,352,141)	813,376
Increase (Decrease) in Cash and Cash Equivalents	1,394,965	(1,536,575)
Cash and Cash Equivalents, Beginning of Year	1,477,014	3,013,589
Cash and Cash Equivalents, End of Year	$ 2,871,979	$ 1,477,014
Supplemental Cash Flows Information		
Cash payments for interest	$ 107,756	$ 114,574
Capital lease obligation incurred for property and equipment	$ -	$ 1,544,146
Property and equipment financed in accounts payable	$ 382,445	$ 44,149

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:

- Holy Cross Women's Health Institute (WHI), which provides obstetrics and gynecology services.
- Holy Cross Surgical Specialties (HCSS), 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.
- Taos Dermatology, Breast and Plastic Surgery, provides dermatology services.
- Holy Cross Pediatrics and Primary Care, 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, 2019 and 2018, cash equivalents consisted primarily of money market accounts with brokers and certificates of deposit.

At May 31, 2019, the Organization's cash accounts exceeded federally insured limits by approximately $3,222,000.

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, less external and direct internal investment expense.

Investment return that is initially restricted by donor stipulation and for which the restriction will be satisfied in the same year is included in net assets without donor restrictions. Other investment return is reflected in the consolidated statements of operations and changes in net assets as with or without donor restrictions 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 the First Steps program and nursing scholarships, 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 decreased from 77% to 67% of self-pay accounts receivable at May 31, 2018 and 2019, respectively. In addition, the Organization's provisions increased approximately $1.8 million from approximately $3.6 million for the year ended May 31, 2018 to approximately $5.4 million for the year ended May 31, 2019. 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 in 2018. Delays encountered due to the system implementation increased aging of accounts resulting in increased allowance estimates an accounts written off.

Supplies

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

Property and Equipment

Property and equipment acquisitions are recorded at cost. Assets are capitalized if the cost is greater than $5,000 and have an asset life of two years or more. 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, 2019 and 2018.

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.

Net Assets

Net assets, revenues, gains and losses are classified based on the existence or absence of donor restrictions.

Net assets without donor restrictions are available for use in the general operations and not subject to donor restrictions.

Net assets with donor restrictions 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 $83,000 and $96,000 in 2019 and 2018, respectively.

Professional Liability Claims

The Organization 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 13.

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 net assets without donor restrictions 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 2019 and 2018.

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 November 2016. The taxes are reported as revenue in the year in which the funds are approved to be spent. During the year ended May 31, 2019 and 2018, the Organization recorded $1,491,348 and $396,647, respectively, in revenue from the mill levy.

Subsequent Events

Subsequent events have been evaluated through October 30, 2019, which is the date the consolidated financial statements were available to be issued.

Note 2: Change in Accounting Principle

In 2019, the Organization adopted ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. A summary of the changes is as follows:

Consolidated Balance Sheet

The consolidated balance sheet distinguishes between two new classes of net assets – those with donor-imposed restrictions and those without. This is a change from the previously required three classes of net assets – unrestricted, temporarily restricted and permanently restricted.

Consolidated Statement of Operations

Investment income is shown net of external and direct internal investment expenses. Disclosure of the expenses netted against investment income is no longer required.

Notes to the Consolidated Financial Statements

Enhanced quantitative and qualitative disclosures provide additional information useful in assessing liquidity and cash flows available to meet operating expenses for one-year from the date of the Consolidated Statement of Operations.

Amounts and purposes of Governing Board designations and appropriations as of the end of the period are disclosed.

Expenses are reported by both nature and function in one location.

This change had no impact on previously reported total change in net assets.

Note 3: 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. 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, 2019 and 2018, was approximately:

	2019	2018
Medicare	$ 24,022,970	$ 19,891,149
Medicaid	13,039,570	12,624,816
Other third-party payers	23,179,255	21,874,996
Self-pay	730,014	516,844
Total	$ 60,971,809	$ 54,907,805

Note 4: 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:

	2019	2018
Medicare	29%	33%
Medicaid	18%	20%
Other third-party payers	41%	42%
Self-pay	12%	5%
	100%	100%

Note 5: Investments and Investment Return

Assets Limited as to Use

Assets limited as to use at May 31 include:

	2019	2018
Internally designated for nursing scholarships		
Cash and cash equivalents	$ 4,423	$ 12,339
Internally designated for First Steps program		
Cash and cash equivalents	17	-
Mutual funds	81,177	78,498
	81,194	78,498
Total assets limited as to use	$ 85,617	$ 90,837

Investments

Short-term investments consist of a beneficial interest in investments held by Taos Community Foundation. The Organization's beneficial interest amounted to $23,838 and $23,728 in 2019 and 2018, respectively.

Investment Return

Total investment return is comprised of the following:

	2019	2018
Interest and dividend income, net	$ 22,178	$ 51,930
Realized and unrealized gains and losses on investments, net	761	130,854
	$ 22,939	$ 182,784

Total investment return is reflected in the consolidated statements of operations and changes in net assets as follows:

	2019	2018
Net assets without donor restrictions		
Other income (expense)	$ 22,906	$ 184,052
Change in unrealized gains and losses on investments	33	(1,268)
	$ 22,939	$ 182,784

Note 6: 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:

	2019	2018
Condensed income statement information		
Operating revenues	$ 147,178	$ 367,073
Net income (loss)	$ (116,046)	$ 78,688
The Organization's portion of change in operations	$ (58,023)	$ 39,344
Condensed balance sheet information		
Total assets	$ 112,142	$ 229,703
Liabilities	$ -	$ 502
Equity	112,142	229,201
Total liabilities and equity	$ 112,142	$ 229,703
The Organization's ending equity in affiliate	$ 56,578	$ 114,601

Note 7: 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.

The line of credit was paid off during the year ended May 31, 2019 and was not extended. At May 31, 2018, there was $1,794,713, borrowed on the line of credit. The line was collateralized by property owned by the Organization and had incurred interest at prime plus 1.00% which was 4.75% at May 31, 2018.

Note 8: Capital Lease Obligation

Capital lease obligations consisted of the following at May 31:

	2019	2018
Capital lease obligations	$ 1,093,687	$ 1,651,115
Less current maturities	456,147	594,092
	$ 637,540	$ 1,057,023

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.

	2019	2018
Equipment	$ 2,461,042	$ 3,066,105
Less accumulated depreciation	1,112,166	1,162,196
	$ 1,348,876	$ 1,903,909

The maturities of the capital lease obligations for each of the five years subsequent to May 31, 2019 and the aggregate amount thereafter are shown below:

Fiscal Year Ending May 31,	Lease Obligations
2020	$ 465,205
2021	341,364
2022	273,276
2023	24,383
	1,104,228
Less amount representing interest	10,541
Present value of future minimum lease payments	1,093,687
Less current maturities	456,147
Noncurrent portion	$ 637,540

Note 9: Net Assets

Net Assets With Donor Restrictions

Net assets with donor restrictions are available for the following purposes or periods:

	2019	2018
Subject to expenditure for specified purpose		
Health education	$ 7,050	$ 7,050
Purchase of equipment	18,770	15,750
Health Care Programs	276,180	391,201
Total	$ 302,000	$ 414,001

Net Assets Released from Restrictions

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of the passage of time or other events specified by donors.

	2019	2018
Purpose restrictions accomplished		
Health Care Programs	$ 199,480	$ 123,185

Net Assets Without Donor Restrictions

Net assets without donor restrictions are designated as of May 31 as shown below:

	2019	2018
Undesignated	$ 17,317,358	$ 16,921,021
Board-designated for First Steps program	81,194	78,498
Board-designated for nursing scholarships	4,423	12,339
Total	$ 17,402,975	$ 17,011,858

Note 10: Liquidity and Availability

The Organization's financial assets available within one year of the balance sheet date for general expenditure are:

	2019
Financial assets at year-end	
Cash and cash equivalents	$ 2,871,979
Short-term investments	23,838
Patient accounts receivable, net	7,711,272
Estimated amounts due from third-party payers	848,468
Other receivables	69,451
Assets limited as to use	85,617
Total financial assets	11,610,625
Less amounts not available to be used within one year	
Assets limited as to use	85,617
Short-term investments	23,838
Financial assets not available to be used within one year	109,455
Financial assets available to meet general expenditures within one year	$ 11,501,170

The Hospital has certain board-designated and donor-restricted assets limited to use which are available for general expenditure within one year in the normal course of operations. Accordingly, these assets have been included in the qualitative information above for financial assets to meet general expenditures within one year. The Hospital has other assets limited to use for donor-restricted purposes. In addition, certain other board-designated assets are designated for the First Step program and scholarships. These assets limited to use, which are more fully described in Notes 1 and 5, are not available for general expenditure within the next year. However, the board-designated amounts could be made available, if necessary.

As part of the Organization's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities and other obligations come due. In addition, the Organization invests cash in excess of daily requirements in short-term investments.

Note 11: 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 $342,000 and $325,000 for 2019 and 2018, respectively.

Note 12: Operating Leases

The Organization has entered into a lease arrangement with the county of Taos, New Mexico. The 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 for the county every two years on a calendar year basis. These 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 $1,328,552 in 2019 and $1,397,462 in 2018 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, 2019 which have initial or remaining lease terms in excess of one year:

2020	$ 454,449
2021	350,598
2022	200,498
Total minimum lease payments	$ 1,005,545

Note 13: Commitments and Contingencies

Labor Agreements

At May 31, 2019, 100 of the Organization's 310 union-eligible employees were active under the collective bargaining agreements. At May 31, 2018, 99 employees out of 343 union-eligible employees were active. Total employee count at year-end May 31, 2019 and 2018 was 410 and 452, 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, 2019 and 2018, the Organization accrued employee insurance claims of $441,531 and $367,483, respectively, which are included in accounts payable in the accompanying consolidated balance sheets.

Stop-loss premiums and claims payments totaling $2,556,727 and $2,256,657 were expended during the years ended May 31, 2019 and 2018, respectively, and are included in payroll taxes and 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 $1,144,000 and $353,000 as of May 31, 2019 and 2018, respectively. In addition, an estimated insurance recovery receivable and offsetting estimated contingent liability of $0 and $800,000 are shown on the consolidated balance sheets and represent amounts estimated to be covered by insurance as of May 31, 2019 and 2018, 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 $347,000 and $341,000 in workers' compensation premiums during 2019 and 2018, 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 receivable of approximately $0 and $1,250,000 at May 31, 2019 and 2018, 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 2019 and 2018, the Organization recognized SNCP funding of approximately $6,233,000 and $4,634,000, respectively. Such amounts are reported as other revenue in the accompanying consolidated statements of operations. Management has estimated a third-party receivable for the years ended May 31, 2019 and 2018 of approximately $848,000 and $715,000, respectively, and an estimated liability of approximately $1,278,000 and $1,128,000, respectively, related to the SNCP funding. 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. Funding in future periods is uncertain; however, management expects to receive a similar amount of funding in fiscal year 2020 as in fiscal year 2019.

Note 14: 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.

Allowance for Net Patient Service Revenue Adjustments

Estimates of allowances for adjustments included in net patient service revenue are described in Notes 1, and 3.

Professional Liability Claims

Estimates related to the accrual for professional liability claims are described in Notes 1, and 13.

Litigation

In the normal course of business, the Organization is, from time to time, subject to allegations that may or do result in litigation. Some of these allegations are in areas not covered by the Organization's self-insurance program (discussed elsewhere in these notes) or by commercial insurance; for example, allegations regarding employment practices or performance of contracts. The Organization evaluates such allegations by conducting investigations to determine the validity of each potential claim. Based upon the advice of counsel, management records an estimate of the amount of ultimate expected loss, if any, for each of these matters. Events could occur that would cause the estimate of ultimate loss to differ materially in the near term.

Note 15: Functional Expense Classification

The Organization provides health care services primarily to residents within its geographic area. Certain costs attributable to more than one function have been allocated among the health care services and general and administrative classifications based on the time and effort and other methods. In accordance with the adoption of ASU 2016-14, the following schedule for the year ended May 31, 2019 presents natural classification of expenses by function. The year ended May 31, 2018 schedule presents only the totals for the year.

	2019		
	Health care Services	General and Administrative	Total
Salaries and wages	$ 22,225,064	$ 4,153,151	$ 26,378,215
Purchased services	7,589,997	2,959,618	10,549,615
Supplies and minor equipment	9,077,334	561,172	9,638,506
Payroll taxes and benefits	4,368,635	864,075	5,232,710
Professional fees	2,215,688	220,039	2,435,727
Depreciation	1,485,048	603,155	2,088,203
Leases and rentals	865,053	463,499	1,328,552
Repairs and maintenance	541,095	529,922	1,071,017
Other	342,121	2,365,375	2,707,496
Insurance	1,502,724	56,538	1,559,262
Telephone and utilities	61,463	826,965	888,428
Travel, meals and entertainment	16,891	56,233	73,124
Interest	-	107,756	107,756
Total expenses	$ 50,291,113	$ 13,767,498	$ 64,058,611

	2018		
	Health care Services	General and Administrative	Total
Total expenses	$ 48,256,977	$ 14,139,255	$ 62,396,232

Note 16: 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, 2019 and 2018.

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, 2019 and 2018.

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

The following tables disclose by level the fair value hierarchy of the Organization's assets at fair value as of May 31, 2019 and 2018:

		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, 2019				
Mutual funds	$ 81,177	$ 81,177	$ -	$ -
Beneficial interest in Taos Community Foundation investments	23,838	-	23,838	-

		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				
Mutual funds	$ 78,498	$ 78,498	$ -	$ -
Beneficial interest in Taos Community Foundation investments	23,728	-	23,728	-

Investments Held at a Private Foundation

The organization has an investment held at the Taos Community Foundation. The investment is a diversified portfolio consisting of various mutual funds. All of the securities are priced on observable inputs. Due to the nature of the valuation inputs, the interest is classified within Level 2 of the hierarchy.

Note 17: Liquidity Considerations

The Organization has incurred recurring losses from operations and negative cash flow from operations in the prior 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 fiscal years 2018 and 2019. These steps include engaging a third party to assist in working the account receivable balances and on redesigning the revenue cycle and pursuing a special election requesting additional mill levy tax support.

During 2019, the Organization paid off the line of credit in full (see Note 7). The Organization has and continues to monitor staffing levels and make adjustments where necessary to control costs.

Note 18: Future Change in Accounting Principle

Revenue Recognition

The Financial Accounting Standards Board amended its standards related to revenue recognition. This amendment replaces all existing revenue recognition guidance and provides a single, comprehensive revenue recognition model for all contracts with customers. The guidance provides a five-step analysis of transactions to determine when and how revenue is recognized. Other major provisions include capitalization of certain contract costs, consideration of the time value of money in the transaction price and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. The amendment also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in those judgments and assets recognized from costs incurred to fulfill a contract. The standard allows either full or modified retrospective adoption effective for annual periods beginning after December 15, 2018, for nonpublic entities, and any interim periods within annual reporting periods that begin after December 15, 2019, for nonpublic entities. The Organization is in the process of evaluating the impact the amendment will have on the consolidated financial statements.