Baystate Health, Inc. and Subsidiaries

Consolidated Financial Statements as of and for the Years Ended September 30, 2018 and 2017, and Independent Auditors' Report

BAYSTATE HEALTH, INC. AND SUBSIDIARIES

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of
Baystate Health, Inc.
Springfield, Massachusetts

We have audited the accompanying consolidated financial statements of Baystate Health, Inc. and subsidiaries ("Baystate Health"), which comprise the consolidated statements of financial position as of September 30, 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 consolidated 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.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 Baystate Health'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 Baystate Health's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Baystate Health as of September 30, 2018 and 2017, and the results of its operations, its changes in net assets, and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte + Touche LLP

December 20, 2018

BAYSTATE HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 2018 AND 2017
(In thousands)

	2018	2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 168,478	$ 172,116
Investments	332,036	302,517
Accounts receivable, patients, less allowance for uncollectible accounts of $45,871 in 2018 and $41,732 in 2017	151,480	146,534
Accounts receivable, other	72,673	82,071
Estimated final settlements receivable	33,284	28,529
Inventories	30,757	30,537
Prepaid expenses and other current assets	22,682	25,832
Total current assets	811,390	788,136
LONG-TERM ASSETS:		
Investments	66,927	61,108
Equity investment in unconsolidated affiliates	4,268	2,466
Deferred expenses and other long-term assets	43,337	37,132
Goodwill	5,684	5,684
Land, buildings, and equipment—net	728,114	732,988
Total long-term assets	848,330	839,378
ASSETS WHOSE USE IS LIMITED:		
Board-designated funds	291,374	284,048
Investments of captive insurance company	119,838	114,801
Investments held by trustee under debt agreements	1,427	10,882
Beneficial interest in perpetual trusts	40,155	37,872
Deferred compensation investments	62,597	58,272
Total assets whose use it limited	515,391	505,875
TOTAL ASSETS	$2,175,111	$2,133,389

	2018	2017
LIABILITIES		
CURRENT LIABILITIES:		
Accounts payable	$ 148,878	$ 136,717
Medical claims payable	64,893	71,746
Accrued salaries and wages	89,638	89,366
Accrued interest payable	1,544	2,471
Estimated final settlements payable	39,203	43,614
Deferred revenue	14,299	20,220
Current portion of long-term debt	13,412	10,216
Current portion of capital lease obligations	2,962	5,560
Total current liabilities	374,829	379,910
Long-term debt	450,307	468,933
Capital lease obligations	14,860	14,823
Pension liability	25,367	68,818
Insurance liability loss reserves	140,433	136,543
Other liabilities	67,490	65,767
Total liabilities	1,073,286	1,134,794
NET ASSETS:		
Unrestricted:		
Operating	1,316,155	1,238,547
Pension adjustment	(331,755)	(357,144)
Total unrestricted	984,400	881,403
Temporarily restricted	59,110	61,388
Permanently restricted	58,315	55,804
Total net assets	1,101,825	998,595
TOTAL LIABILITIES AND NET ASSETS	$2,175,111	$2,133,389

See notes to consolidated financial statements.

BAYSTATE HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED SEPTEMBER 30, 2018 AND 2017
(In thousands)

	2018	2017
OPERATING REVENUES:		
Net patient service revenue	$ 1,429,530	$ 1,382,983
Bad debts	(35,379)	(33,091)
Net patient service revenue, net of bad debts	1,394,151	1,349,892
Premiums	820,432	917,422
Other revenue	147,742	125,259
Net assets released from restrictions for operations	4,702	4,712
Total operating revenues	2,367,027	2,397,285
OPERATING EXPENSES:		
Salaries and wages	893,842	860,177
Supplies and expense	827,233	758,743
Medical claims and capitation	502,283	643,010
Depreciation and amortization	78,874	78,779
Interest expense	12,970	13,766
Total operating expenses	2,315,202	2,354,475
INCOME FROM OPERATIONS BEFORE OTHER EXPENSE	51,825	42,810
OTHER EXPENSE	-	(18,896)
INCOME FROM OPERATIONS	51,825	23,914
NONOPERATING INCOME (LOSS):		
Investment income	3,931	3,631
Net realized gain on investments	30,950	24,500
Net unrealized (loss) gain on investments	(9,320)	25,643
Equity gain (loss) in unconsolidated affiliates	1,963	(613)
Net interest cost on swap agreements	(745)	(1,182)
Change in fair value of swap agreements	1,487	2,034
Loss on extinguishment of debt	(5,716)	-
Income taxes and other	(6,243)	(7,288)
Total nonoperating income—net	16,307	46,725
EXCESS OF REVENUES OVER EXPENSES	68,132	70,639
OTHER CHANGES IN UNRESTRICTED NET ASSETS:		
Net assets released from restrictions for capital	6,044	2,150
Funds utilized for property and equipment	3,430	8,822
Contributed capital asset	-	12,543
Pension adjustment	25,391	48,312
Other	-	78
INCREASE IN UNRESTRICTED NET ASSETS	$ 102,997	$ 142,544

See notes to consolidated financial statements.

BAYSTATE HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEARS ENDED SEPTEMBER 30, 2018 AND 2017
(In thousands)

	2018	2017
UNRESTRICTED NET ASSETS:		
Excess of revenues over expenses	$ 68,132	$ 70,639
Net assets released from restrictions for capital	6,044	2,150
Funds utilized for property and equipment	3,430	8,822
Contributed capital asset	-	12,543
Pension adjustment	25,391	48,312
Other	-	78
Increase in unrestricted net assets	102,997	142,544
TEMPORARILY RESTRICTED NET ASSETS:		
Restricted investment income	606	250
Net realized and unrealized gain on investments	3,775	5,435
Contributions	4,838	5,800
Net assets released from restrictions:		
For operations	(4,702)	(4,712)
For capital	(6,044)	(2,150)
Other	(751)	(616)
(Decrease) increase in temporarily restricted net assets	(2,278)	4,007
PERMANENTLY RESTRICTED NET ASSETS:		
Contributions	228	2
Change in fair value of perpetual trusts	2,283	2,303
Increase in permanently restricted net assets	2,511	2,305
INCREASE IN NET ASSETS	103,230	148,856
NET ASSETS—Beginning of year	998,595	849,739
NET ASSETS—End of year	$ 1,101,825	$998,595

See notes to consolidated financial statements.

BAYSTATE HEALTH, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED SEPTEMBER 30, 2018 AND 2017
(In thousands)

	2018	2017
OPERATING ACTIVITIES:		
Increase in net assets	$ 103,230	$ 148,856
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation	78,874	78,779
Accretion on notes receivable	-	(287)
Pension adjustment	(25,391)	(48,312)
Net realized and unrealized gain on investments	(29,539)	(63,130)
Provision for bad debts	35,379	33,091
Gain on sale of assets, net	(3,753)	-
Change in fair value of perpetual trusts	(2,283)	(2,303)
Restricted contributions	(5,066)	(5,802)
Changes in equity investments in unconsolidated affiliates	271	125
Contributed capital asset	-	(12,543)
Extinguishment of debt	5,716	-
Changes in operating assets and liabilities:		
Accounts receivable, patients	(40,925)	(43,451)
Net estimated final settlements	(9,166)	(6,537)
Accounts payable and accrued expenses	7,898	(19,699)
Pension liability	(18,060)	(16,782)
Medical claims payable	(6,853)	11,868
Insurance liability loss reserves	3,890	9,833
Other	(360)	(24,391)
Net cash provided by operating activities	93,862	39,315
INVESTING ACTIVITIES:		
Proceeds from sale and maturities of investments	89,652	893,866
Proceeds from sale of assets	10,054	-
Purchase of investments	(104,688)	(862,678)
Purchase of land, buildings, and equipment	(74,297)	(97,135)
Net cash used in investing activities	(79,279)	(65,947)
FINANCING ACTIVITIES:		
Proceeds from restricted contributions	5,066	5,802
Repayment of notes receivable	-	117
Proceeds from debt issuance	67,060	17,700
Repayments of debt and capital lease obligations	(90,347)	(18,738)
Loss on extinguishment of debt	-	977
Net cash (used in) provided by financing activities	(18,221)	5,858
NET DECREASE IN CASH AND CASH EQUIVALENTS	(3,638)	(20,774)
CASH AND CASH EQUIVALENTS—Beginning of year	172,116	192,890
CASH AND CASH EQUIVALENTS—End of year	$ 168,478	$ 172,116
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION—		
Cash paid for interest	$ 13,897	$ 13,649
Land, buildings, and equipment purchases included in accounts payable	$ 3,349	$ -

See notes to consolidated financial statements.

1. ORGANIZATION

Baystate Health, Inc. (BH), based in Springfield, Massachusetts, is the parent corporation of an integrated health care delivery system with the mission "to improve the health of the people in our community every day, with quality and compassion."

BH and its consolidated subsidiaries (collectively "Baystate Health") currently include the following:

- Baystate Medical Center, Inc. (BMC), located in Springfield, Massachusetts, is the largest of the four hospitals in the Baystate Health system. BMC, the leading health facility in western Massachusetts, is the only tertiary care referral medical center and Level 1 trauma center in the region. It is also home to western New England's only neonatal and pediatric intensive care units. BMC is a 718-bed, tax-exempt, not-for-profit, academic teaching hospital.

- Baystate Total Home Care, Inc. (BTHC) is a tax-exempt, not-for-profit corporation, wholly owned by BMC, which is organized to benefit, support, and further the charitable activities of BMC by holding, leasing, improving, and managing real estate held by, or acquired on behalf of, BMC. BTHC served as the operating entity in connection with the new markets tax credit (NMTC) financing for the BMC Expansion Project. All of the assets, liabilities, and net assets of BTHC were transferred to BMC in December 2016.

- Baystate Franklin Medical Center, Inc. (BFMC), located in Greenfield, Massachusetts, is an 89-bed, tax-exempt, not-for-profit, acute care community hospital. BFMC serves the northern tier of northwestern Massachusetts and southern Vermont.

- Baystate Wing Hospital Corporation (BWH), located in Palmer, Massachusetts, is a 74-bed, tax-exempt, not-for-profit, acute care community hospital.

- Baystate Noble Hospital, Inc. and subsidiaries ("BNH consolidated") consists of two tax-exempt, not-for-profit corporations located in Westfield, Massachusetts:

  - Baystate Noble Hospital, Inc. (BNH) is a 97-bed, tax-exempt, not-for-profit acute care community hospital. BNH provides inpatient, outpatient, and emergency care services for residents in the greater Westfield community. BNH is the sole corporate member of Baystate Westfield Medical Corporation (WMC).

  - WMC is a tax-exempt, not-for-profit physician practice that provides medical services to residents of the greater Westfield community.

- Baystate Medical Practices, Inc. (BMP) is a tax-exempt, not-for-profit organization. BMP includes a multispecialty academic group practice established to support the educational and research programs of Baystate Health, as well as numerous primary care and outreach services. BMP also includes community-based primary care (internists and pediatricians), medical and surgical practices, obstetrical and gynecological, and hospitalist physicians dedicated to the care and management of patients hospitalized at BH-affiliated hospitals. BMP also provides preventative, diagnostic, and therapeutic health services enhancing the cardiovascular clinical, educational, community, and research activities for BH and its service area.

- Baystate Visiting Nurse Association & Hospice (BVNAH) is a tax-exempt, not-for-profit organization that provides comprehensive home health care committed to providing the highest quality care to patients and families, primarily in the home setting. BVNAH meets individual needs by bringing experienced nurses, rehabilitation therapists, social workers, and home care aides to patients' homes.

- Health New England, Inc. (HNE) is a tax-exempt, not-for-profit health maintenance organization located in Springfield, Massachusetts. HNE's service area in Massachusetts includes Franklin, Berkshire, Hampden, and Hampshire counties and parts of Worcester County. HNE also serves Hartford, Litchfield, and Tolland counties in Connecticut. HNE includes the following subsidiaries:

  – HNE Holding Company is the parent company of HNE Advisory Services, Inc. (HAS); Health New England Insurance Services, Inc. (HIS); and HNE Insurance Company, Inc. (HIC); three for-profit subsidiaries. Through HAS, HNE provides administrative services for self-insured employee health benefit plans sponsored by employer groups. HIS provides insurance brokerage services. Through HIC, an insurance subsidiary, HNE provides the Medicare Supplement line of business.

  – HNE of Connecticut, Inc. is a not-for-profit insurance subsidiary that services the health insurance needs of the Connecticut population.

- Ingraham Corporation (IC) is a for-profit, taxable corporation.

- Baystate Administrative Services, Inc. (BAS) is a tax-exempt, not-for-profit corporation that provides management support for the BH subsidiaries, including human resources, marketing, strategic planning, information services, and financial services.

- Baystate Health Foundation, Inc. (BHF) is a tax-exempt, charitable organization established for the purpose of fund-raising for healthcare-related activities, in support, and for the benefit, of BH and those subsidiaries of BH that are tax-exempt, not-for-profit corporations and to hold endowment, charitable donations, and other funds for their benefit.

- Baystate Health Insurance Company, Ltd. (BHIC) is a captive insurance company organized and licensed in the Cayman Islands, British West Indies. BHIC provides professional liability and other insurance coverage to the corporate members of BH and its employees. BHIC offers malpractice insurance to members of BH's medical staff who meet criteria for participation.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation—The accompanying consolidated financial statements include the accounts of BH and its subsidiaries noted above. All intercompany and subsidiary accounts and transactions have been eliminated in consolidation.

Use of Estimates—The preparation of 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of the allowance for uncollectible accounts receivable, reserve for contractual allowances, investment valuation, estimated final settlements receivable and payable, medical claims payable, insurance liability loss reserves, income taxes, and the pension liability.

Net Assets—Baystate Health reports net assets and revenues, expenses, gains, and losses based upon the existence or absence of donor-imposed restrictions. In the accompanying consolidated financial statements, net assets that have similar characteristics have been combined into the following categories:

Unrestricted—Net assets that are not subject to donor-imposed stipulations. Net assets may be designated for specific purposes by action of the Board of Trustees or may otherwise be limited by contractual agreements with outside parties.

Temporarily Restricted—Net assets whose use by Baystate Health are subject to donor-imposed stipulations that can be fulfilled by actions of Baystate Health or that expire by the passage of time. At September 30, 2018 and 2017, temporarily restricted net assets consist of amounts restricted as to spending for various purposes, such as education, research, clinical, and health care programs, as well as cumulative net appreciation of permanently restricted funds which is available for governing board appropriation.

Permanently Restricted—Net assets subject to donor-imposed stipulations that they be maintained permanently by Baystate Health. At September 30, 2018 and 2017, permanently restricted net assets consist of the original cost of permanent endowment gifts and beneficial interests in perpetual trusts.

Revenues from sources other than donor-restricted contributions are reported as increases in unrestricted net assets. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments are reported as increases or decreases in unrestricted net assets, unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions recognized on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as releases from temporarily restricted net assets to unrestricted net assets. Temporary restrictions on gifts to acquire long-lived assets are considered met in the period in which the assets are acquired or placed in service.

Contributions, including unconditional promises to give and grant awards, are recognized as revenue in the period received. Contributions received with donor-imposed restrictions are reported as permanently or temporarily restricted, depending upon the specific restriction. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair values at the date of the gift. Contributions to be received after one year are discounted at a risk-free rate commensurate with the expected payment term. Amortization of the discount is recorded as contribution revenue in the appropriate net asset category. Allowance is made for uncollectible contributions based upon management’s judgment and analysis of the creditworthiness of the donors, past collection experience, and other relevant information.

Cash and Cash Equivalents—Cash and cash equivalents include all highly liquid investments with a maturity of three months or less when purchased.

Investments—Investments include cash equivalents, mutual funds, fixed-income securities, and equity securities, as well as interests in limited partnerships, hedge funds, and commingled funds. Investments in equity securities with readily determinable fair values and all investments in debt securities are recorded at estimated fair value in the consolidated statements of financial position.

Interest and dividends on investments are included in other revenue or nonoperating income (loss) in the consolidated statements of operations, unless the income or loss is restricted by donor or law. Realized and unrealized gains and losses on investments are included in other revenue, nonoperating income (loss) or temporarily restricted net assets, as applicable. Investment-related expenses, such as custodial fees and investment fees, are netted against investment income and are immaterial for the years ended September 30, 2018 and 2017.

Baystate Health has elected the fair value option for its investments, and reflects changes in the fair value of its investments, including both increases and decreases, whether realized or unrealized, in its excess of revenue over expenses. Within excess revenues over expenses, Baystate Health recognized net unrealized (losses) gains on investments totaling ($9,320,000) and $25,643,000 for the years ended September 30, 2018 and 2017, respectively.

Certain investments are included in pooled investment funds. Current market value is used to determine the percent of each fund in the pool. Income from investments of a pool, including gains or losses, is allocated to participating funds based on the respective fund's percentage of the pool.

Inventories—Inventories are stated at the lower of cost (principally first-in, first-out method) or market.

Equity Investment in Unconsolidated Affiliates—Baystate Health participates in joint ventures with 50% or less ownership and accounts for the investment in those unconsolidated affiliates as equity investments.

Costs of Borrowing—Deferred financing costs are amortized over the weighted-average term of the bonds. At September 30, 2018 and 2017, deferred financing costs totaled $2,293,000 and $2,836,000, respectively, and are classified as long-term debt in the accompanying consolidated statements of financial position.

Goodwill—Baystate Health tests its goodwill for impairment annually, or whenever events or changes in circumstances indicate an impairment may have occurred. Baystate Health tested its goodwill for impairment as of July 1. There was no impairment of goodwill for the years ended September 30, 2018 and 2017.

Assets Whose Use is Limited—Assets whose use is limited include assets held by the trustee under indenture agreements and designated assets set aside by the Board of Trustees for future capital improvements and other strategic initiatives, which are in furtherance of Baystate Health's exempt and charitable purposes. Also included are investments of the captive insurance company, deferred compensation investments, and beneficial interests in perpetual trusts.

Land, Buildings, and Equipment-net—Land, buildings, and equipment are stated at cost, less depreciation and amortization determined on the straight-line basis. Useful life is assigned using the American Hospital Association's guide, *Estimated Useful Lives of Depreciable Hospital Assets*.

Maintenance and repairs are charged to expense as incurred. Betterments and major renewals are capitalized. Cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal and the resulting gain or loss is included in other revenue. Buildings and equipment under capital lease obligations are amortized using the straight-line method over the shorter period of the lease term or the estimated useful life. Such amortization is included in depreciation and amortization in the consolidated statements of operations. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Consolidated Statements of Operations—All activities of Baystate Health deemed by management to be ongoing and central to the provision of health care services are reported as operating revenues and expenses.

Other expense in the consolidated statement of operations for the year ended September 30, 2017, consisted of a pension settlement charge of approximately $16,000,000 (see Note 17) and severance costs of approximately $2,900,000. Other activities are considered nonoperating and include investment income for the non-insurance entities, realized gains and losses on investments, unrealized gains and losses on investments, investment return on deferred compensation plan investments and related compensation expense, equity gains and losses in unconsolidated affiliates, interest on swap agreements, changes in fair value of swap agreements, loss on debt extinguishment, and income taxes.

The consolidated statements of operations include excess of revenues over expenses as the performance indicator. Changes in unrestricted net assets which are excluded from excess of revenues over expenses include net assets released from restrictions for capital, contributed capital asset, funds utilized for property and equipment, and the pension adjustment.

Net Patient Service Revenue—Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payers, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. 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 adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations. Contracts, laws, and regulations governing Medicare, Medicaid, Blue Cross, and the Health Safety Net (HSN) programs are 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. Blue Cross and other managed care plans have negotiated with Baystate Health various forms of contractual payment rates. The most common payment rates include discounted charges, per case, per diems, and fee schedules.

Medicaid payment rates are negotiated between the Division of Medical Assistance and individual hospitals. Medicare Prospective Payment System (PPS) regulations determine payments due to acute care hospitals for inpatient services provided to Medicare beneficiaries. Medicare payments for outpatient services are a blend of PPS and fee schedules.

During 2018 and 2017, Baystate Health recorded adjustments to amounts accrued for settlements related to prior fiscal years. The net effect of such adjustments was an increase in net patient service revenue of approximately $8,548,000 and $17,305,000 in 2018 and 2017, respectively.

HSN—In April 2006, the Commonwealth of Massachusetts passed Chapter 58 of the Acts of 2006, "An Act Providing Access to Affordable, Quality, Accountable Health Care;" the goal of which is to provide near-universal health insurance coverage to Massachusetts residents through a combination of Medicaid expansions, subsidized private insurance programs, insurance market reforms, and the HSN.

The HSN reimburses hospitals for uncompensated care based on actual services provided at rates approximating the PPS, subject to available funds. Like its predecessor, the uncompensated care pool, the HSN is partially funded by acute hospitals through an assessment on gross charges billed to nongovernmental payers.

Charity Care and Community Support—It is the policy of Baystate Health to provide care to any patient in need of medical care, regardless of the patient's ability to pay for such care. Based upon the patient's financial capability to pay, such care is provided free of charge or at amounts below normal charges. Because amounts determined to qualify as charity care are not pursued, they are not reported as revenue. The net cost of charity care includes the direct and indirect cost of providing charity care services, offset by revenues received from indigent care pools (primarily the HSN). The cost is estimated by utilizing a ratio of cost to gross charges applied to the gross uncompensated care charges associated with providing charity care.

The costs of charity care provided during the years ended September 30, 2018 and 2017, are as follows (in thousands):

	2018	**2017**
HSN assessment	$ 6,651	$ 6,828
HSN receipts	(4,828)	(4,154)
Free care (at cost)	11,751	13,221
Total	$13,574	$15,895

In addition to the charity care provided to patients, Baystate Health has ongoing community outreach initiatives in the areas of health services access, education, safety, and community reinvestment. The initiatives include freestanding health centers, improving school-based health services, implementing an immunization tracking system to link preschool-aged children to primary care providers, youth development programs, increasing minority employment, improving the community's health status, wellness, health and safety programs for senior citizens, and health screenings and forums.

Allowance for Uncollectible Accounts—Accounts receivable are reduced by an allowance for uncollectible accounts. In evaluating the collectability of accounts receivable, Baystate Health analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for uncollectible accounts and provision for bad debts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For receivables associated with services provided to patients who have third-party coverage, Baystate Health analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if necessary. For receivables associated with self-pay patients, Baystate Health records a provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

Baystate Health's allowance for uncollectible accounts for self-pay patients increased from 88% of self-pay accounts receivable at September 30, 2017, to approximately 90% of self-pay accounts receivable at September 30, 2018. In addition, Baystate Health's self-pay write-offs, net of recoveries increased approximately $876,000 from $50,445,000 for fiscal year 2017 to $51,321,000 for fiscal year 2018. Baystate Health has not changed its charity care or uninsured discount policies during fiscal year 2017 or 2018 other than adopting the required Internal Revenue Code Section 501(r) regulations. Baystate Health does not maintain a material allowance for uncollectible accounts from third-party payers nor did it have significant write-offs from third-party payers. Baystate Health 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 who do not qualify for charity care, Baystate Health 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).

Net patient service revenue (after contractual allowances and discounts) recognized during the years ended September 30, 2018 and 2017, from Baystate Health's major payer sources is as follows (in thousands):

	2018	2017
Medicare	$ 636,585	$ 586,515
Medicaid	260,578	240,449
Commercial and other	520,860	545,128
Self-pay	11,507	10,891
Total	$ 1,429,530	$ 1,382,983

Premium Revenue—Premium revenue represents insurance membership contract revenue at HNE. The contracts generally cover a 12-month period and are subject to cancellation by the employer group or HNE upon 30 days' written notice. Premiums are due monthly and are recognized as revenue during the period in which HNE is obligated to provide services to members.

HNE enters into risk-sharing arrangements with certain providers and payors, whereby a settlement amount is calculated based on actual medical claims experience as compared to budgeted amounts or a predetermined risk corridor, based upon contractual arrangements. These settlements are estimated and accrued during the period the related services were rendered and adjusted in future periods as final settlements are determined. During 2018 and 2017, HNE recorded adjustments to amounts accrued for risk-sharing settlements related to the prior fiscal year as a change in estimate. The net effect of the adjustments was an increase in premium revenue of approximately $1,489,000 and $6,923,000 in 2018 and 2017, respectively.

Risk Adjustment—The Affordable Care Act established a permanent risk adjustment program to transfer funds from qualified individual and small group insurance plans with below-average risk scores to plans with above-average risk scores. Based on the risk score of our qualified plan members relative to the average risk score of members of other qualified plans throughout the Commonwealth of Massachusetts, HNE estimates the ultimate risk adjustment receivables or payables and reflects the impact as an adjustment to premium revenue. At September 30, 2018 and 2017, HNE recorded a net payable of approximately $3,215,000 and $3,208,000, respectively, under the risk adjustment program.

Medical Claims and Capitation—The cost of medical claims and capitation including claims related to self-insurance is accrued for in the period in which services are provided and includes certain estimated amounts. The estimates for claims expense may be more or less than the amounts ultimately paid when the claims are settled. Such changes in estimates are reflected in the consolidated statements of operations in the year the change occurs.

Impairment of Long-Lived Assets—Long-lived assets to be held and used are reviewed for impairment whenever circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets to be disposed of are reported at the lower of the carrying amount or fair value, less cost to sell.

Research Grants and Contracts—Revenue related to research grants and contracts is recognized as the related costs are incurred. Indirect costs relating to certain government grants and contracts are reimbursed at fixed rates negotiated with the government agencies. Research grants and contracts have been accounted for as exchange transactions. Amounts received in advance of incurring the related expenditures are recorded as unexpended research grants and are included with deferred revenue in the accompanying consolidated statements of financial position.

Accounting for Defined Benefit Pension and Other Postretirement Plans—Baystate Health recognizes the overfunded or underfunded status of its defined benefit and postretirement plans as an asset or liability in its consolidated statements of financial position. Changes in the funded status of the plans are reported as a change in unrestricted net assets presented below the excess of revenues over expenses in the consolidated statements of operations and changes in net assets in the year in which the changes occur.

Income Taxes—All of Baystate Health's consolidated entities are recognized by the Internal Revenue Service as tax-exempt, not-for-profit organizations under Section 501(c)(3) of the Internal Revenue Code (IRC); except for BHIC, IC, HAS, HIS, and HIC, which are taxable entities; and HNE, which is exempt under IRC 501(c)(4).

New Accounting Pronouncements—On September 30, 2018, Baystate Health adopted Accounting Standards Update (ASU) No. 2015-09, *Disclosures about Short-Duration Contracts*. This guidance expands the disclosures that an insurance entity must provide about its short-duration contracts. The adoption did not have an impact on Baystate Health's consolidated financial statements other than expanded disclosure in Note 13.

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU No. 2014-09 affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards. The core principle of the guidance in ASU No. 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606), Deferral of the Effective Date*. ASU No. 2015-14 defers the effective date of ASU No. 2014-09 for all affected entities. As a result, ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those reporting periods. In March 2016, the FASB issued ASU No. 2016-08, *Revenue from Contracts with Customers: Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*. This guidance amends the principal versus agent implementation guidance and illustrations in FASB revenue standard ASU No. 2014-09. In May 2016, the FASB issued ASU No. 2016-12, *Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients*, which amends certain aspects of FASB revenue standard ASU No. 2014-09. After the deferral of the effective date, ASU No. 2014-09 is effective for Baystate Health beginning on October 1, 2018. Baystate Health has completed its evaluation of the requirements of the new standard to ensure that it has processes, systems and internal controls in place to collect the necessary information to implement the standard. The modified retrospective approach will be used to adopt ASU No. 2014-09. For health care operations, Baystate Health will use a portfolio approach to apply the new model to classes of patients with similar characteristics and will analyze cash collection trends over an appropriate collection look-back period, depending on the payor. Adoption of ASU No. 2014-09 will result in changes to the presentation and disclosure of revenue related to uninsured or self-pay patients as under ASU No. 2014-09, the estimated uncollectible amounts due from these patients are generally considered a direct reduction to unrestricted revenue and, correspondingly, result in a material reduction in the amounts presented separately as bad debts. Baystate Health has completed the assessment of the impact of ASU No. 2014-09 on various reimbursement programs that represent variable consideration and believes that accounting for these programs under the new standard is substantially consistent with historical accounting practices. These include supplemental state Medicaid programs, disproportionate share payments, and settlements with third-party payors. While the adoption of ASU No. 2014-09 will have a material effect on the presentation of unrestricted revenue in the consolidated statements of operations and will impact certain disclosures, it will not materially impact the financial position, results of operations, or cash flows of Baystate Health.

In January 2016, the FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This guidance revises accounting related to (a) the classification and measurement of investments in equity securities and (b) the presentation of certain fair value changes for financial liabilities measured at fair value. It also amends certain disclosure requirements associated with the fair value of financial instruments. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2020. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. This guidance introduces a lessee model that brings substantially all leases into the consolidated balance sheet. In July 2018, the FASB issued ASU No. 2018-10, *Codification Improvements to Topic 842, Leases*, which clarifies some of the provisions of ASU No. 2016-02. In July 2018, the FASB issued ASU No. 2018-11, *Leases (Topic 842)—Targeted Improvements*, which provides an additional transition method when adopting ASU No. 2016-02, and also provides additional guidance to lessors with a practical expedient for separating components of a contract. This guidance is effective for Baystate Health beginning on October 1, 2019. Retrospective application is required. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In August 2016, the FASB issued ASU No 2016-14, *Presentation of Financial Statements of Not-For-Profit Entities*. This guidance simplifies and improves how not-for-profit entities classify net assets as well as the information presented in financial statements and notes about liquidity, financial performance, and cash flows. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2019. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. This guidance adds or clarifies guidance on the classification of certain cash receipts and payments in the consolidated statement of cash flows. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2020. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows—Restricted Cash*, which requires the statement of cash flows to explain changes during the period in total cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. This ASU is effective for Baystate Health for the annual reporting period ending September 30, 2020. Upon adoption, Baystate Health will include restricted cash and restricted cash equivalents within cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts on the consolidated statement of cash flows and related disclosures. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, *Business Combinations (Topic 805)—Clarifying the Definition of a Business*, which provides a framework to use in determining when a set of assets and activities is a business. This ASU is effective for Baystate Health for the annual reporting period ending September 30, 2020. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which amends the requirements related to the presentation of the components of net periodic benefit cost in the statement of operations for an entity's sponsored defined benefit pension and other postretirement plans. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2020. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-08, Not-For-Profit Entities (Topic 958): *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*, which clarifies whether a transfer of assets is a contribution or an exchange transaction. This guidance is effective for Baystate Health beginning October 1, 2018. Baystate Health has concluded that this guidance will not have a material impact on its consolidated statements.

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement*, which modifies the disclosure requirements on fair value measurements. This guidance is effective for Baystate Health beginning October 1, 2020. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-14, *Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*, which modifies the disclosure requirements for entities with defined benefit plans. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2022. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-15, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customers Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*, which helps entities evaluate the fees paid by a customer in a cloud computing arrangement by providing guidance for determining when an arrangement includes a software license. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2022. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

In November 2018, the FASB issued ASU No. 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 806*, which provides guidance on whether certain transactions between collaborative arrangement participants should be accounted for with revenue under Topic 606. This guidance is effective for Baystate Health for the annual reporting period ending September 30, 2022. Baystate Health has not determined the impact the adoption of this standard will have on its consolidated financial statements.

3. CASH, INVESTMENTS, AND ASSETS WHOSE USE IS LIMITED

The composition of cash, investments, and assets whose use is limited at September 30, 2018 and 2017, is as follows (in thousands):

	2018	2017
Cash and cash equivalents	$ 165,055	$ 172,212
Mutual funds	237,708	232,940
Fixed-income securities	188,997	156,688
Domestic equity securities	105,356	37,806
Beneficial interests in perpetual trusts	40,155	37,872
Limited partnerships	42,833	34,030
Commingled equity mutual funds	77,088	86,661
Commingled emerging markets funds	35,905	47,504
Commingled commodity funds	15,158	14,305
Commingled other funds	86,604	92,731
Hedge fund of funds	54,711	64,484
Commingled master limited partnership	12,415	31,462
Commingled hedge fund	20,847	32,921
	$ 1,082,832	$ 1,041,616

Cash, investments, and assets whose use is limited at September 30, 2018 and 2017, are included in the consolidated statements of financial position as follows (in thousands):

	2018	2017
Cash and cash equivalents	$ 168,478	$ 172,116
Investments	332,036	302,517
Long-term investments	66,927	61,108
Board-designated cash and investments	291,374	284,048
Investments of captive insurance company	119,838	114,801
Investments held by trustee under debt agreements	1,427	10,882
Beneficial interests in perpetual trusts	40,155	37,872
Deferred compensation investments	62,597	58,272
	$ 1,082,832	$ 1,041,616
Investment income and realized gains included in other revenue	$ 8,663	$ 10,644

BHIC and HNE investment income and realized gains are included in other revenue, as this revenue is integral to their operations.

4. FAIR VALUE MEASUREMENTS

Baystate Health calculates fair value as described in Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, to value its financial assets and liabilities, when applicable. Fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, ASC 820 establishes a three-level valuation hierarchy that prioritizes observable and unobservable inputs used to measure fair value. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1—Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2—Observable inputs that are based on inputs not quoted in active markets, but corroborated by market data.

Level 3—Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. In determining fair value, Baystate Health utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, as well as consider counterparty credit risk in its assessment of fair value.

Investments for which the fair value is measured using the net asset value (NAV) per share as a practical expedient are not categorized within the fair value hierarchy.

Financial assets and liabilities carried at fair value for the years ended September 30, 2018 and 2017, are classified in the table below in one of the three categories described above (in thousands):

	Assets at Fair Value at September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	$165,055	$ -	$ -	$ 165,055
Mutual funds:				
Corporate bond funds	92,871	-	-	92,871
Deferred compensation investments:				
Corporate bond funds	5,498	-	-	5,498
Equity index funds	57,099	-	-	57,099
Equity index funds	82,240	-	-	82,240
Total mutual funds	237,708	-	-	237,708
Fixed-income securities—corporate bonds and US government securities	-	188,997	-	188,997
Domestic equity securities	105,356	-	-	105,356
Beneficial interests in perpetual trusts	-	-	40,155	40,155
Total assets at fair value	$508,119	$188,997	$40,155	737,271
Limited partnerships				42,833
Investments measured at NAV:				
Commingled international equity funds				77,088
Commingled emerging markets funds				35,905
Commingled commodity funds				15,158
Commingled—other funds				86,604
Hedge fund of funds				54,711
Commingled master limited partnerships				12,415
Commingled hedge fund				20,847
Total investments measured at NAV				302,728
Total assets				$1,082,832
Liabilities—interest rate swap agreement	$ -	$ 1,400	$ -	$ 1,400

	Assets at Fair Value at September 30, 2017			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$172,212	$ -	$ -	$ 172,212
Mutual funds:				
Corporate bond funds	88,022	-	-	88,022
Deferred compensation investments:				
Corporate bond funds	6,631	-	-	6,631
Equity index funds	51,641	-	-	51,641
Equity index funds	86,646	-	-	86,646
Total mutual funds	232,940	-	-	232,940
Fixed-income securities—corporate bonds and US government securities	-	156,688	-	156,688
Domestic equity securities	37,806	-	-	37,806
Beneficial interests in perpetual trusts	-	-	37,872	37,872
Total assets at fair value	$442,958	$156,688	$37,872	637,518
Limited partnerships				34,030
Investments measured at NAV:				
Commingled domestic equity funds				21,489
Commingled international equity funds				65,172
Commingled emerging markets funds				47,504
Commingled commodity funds				14,305
Commingled—other funds				92,731
Hedge fund of funds				64,484
Commingled master limited partnerships				31,462
Commingled hedge fund				32,921
Total investments measured at NAV				370,068
Total assets				$1,041,616
Liabilities—interest rate swap agreements	$ -	$ 3,122	$ -	$ 3,122

The amounts classified in the tables above exclude assets invested in Baystate Health's defined benefit plan (see note 17).

A summary of changes in the fair value of the Level 3 assets for the years ended September 30, 2018 and 2017, is as follows (in thousands):

	2018	**2017**
Balance at beginning of year	$37,872	$35,569
Unrealized gains relating to investments still held at the reporting date	2,283	2,303
Balance at end of year	$40,155	$37,872

There were no transfers of Level 3 assets as of September 30, 2018 and 2017.

A summary of investments (by major class) that use NAV or a NAV equivalent as a practical expedient to estimate fair value, that have restrictions on Baystate Health's ability to redeem its investment at the measurement date as of September 30, 2018 and 2017, is as follows (in thousands):

	September 30, 2018		
Description of Investment	**Fair Value**	**Redemption Frequency**	**Redemption Notice Period**
Commingled international equity funds	$ 77,088	Monthly	5–30 days
Commingled emerging markets funds	35,905	Monthly	14-30 days
Commingled commodity funds	15,158	Monthly	5 days
Commingled—other funds	86,604	Daily/monthly	1–30 days
Hedge fund of funds	54,711	Quarterly	95 days
Commingled master limited partnership	12,415	Monthly	30 days
Commingled hedge fund	20,847	Monthly	3 days
Total	$302,728		

	September 30, 2017		
Description of Investment	**Fair Value**	**Redemption Frequency**	**Redemption Notice Period**
Commingled domestic equity funds	$ 21,489	Monthly	5 days
Commingled international equity funds	65,172	Monthly	5–30 days
Commingled emerging markets funds	47,504	Monthly	30 days
Commingled commodity funds	14,305	Monthly	5 days
Commingled—other funds	92,731	Daily/monthly	1–30 days
Hedge fund of funds	63,734	Quarterly	95 days
Hedge fund of funds	750	Every 2–3 years	95 days
Commingled master limited partnership	31,462	Monthly	30 days
Commingled hedge fund	32,921	Monthly	5 days
Total	$370,068		

Valuation Techniques—Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs. The following is a description of the valuation methodologies used for assets and liabilities measured at fair value on a recurring basis. There have been no changes in the methodologies used at September 30, 2018 and 2017.

The fair value of investments is determined in accordance with the current fair value guidance and as described below.

Cash Equivalents—The carrying value of cash equivalents approximates fair value as maturities are less than three months and/or include money market funds that are based on quoted prices and are actively traded.

Mutual Funds—The fair values of mutual funds are based on quoted market prices or net assets values. These funds are required to publish their NAV and to transact at that price and are actively traded.

Commingled Funds—The fair value of commingled funds is based on the NAV of the fund, representing the fair value of the underlying investments, which is generally securities traded on an active market. The NAV is used as a practical expedient to estimate fair value.

Commingled Master Limited Partnerships and Commingled Hedge Funds—The estimated fair values of commingled master limited partnerships and commingled hedge funds, for which no quoted market prices are readily available, are determined based upon the information provided by the fund managers. Such information is generally based on NAV or NAV equivalent of the fund, which is used as a practical expedient to estimate fair value. Certain funds are subject to a minimum holding period or lockup, cannot be redeemed at the measurement date or within 90 days thereof, are subject to redemption notice periods in excess of 90 days, or have the ability to limit the aggregate amount of shareholder redemptions. The commingled master limited partnerships and commingled hedge funds allocate gains, losses, and expenses to the partners based on the ownership percentage as described in the respective partnership or hedge fund agreements.

Limited Partnerships—Baystate Health has also entered into partnership agreements with limited partnerships ("alternative investments"), a majority of which are in private markets, whereby they have agreed to certain capital commitments. Baystate Health's policy is to record its ownership interest in these alternative investments of less than 5% at the lower of cost or market. For those alternative investments where the ownership interest is more than 5%, the ownership interests are reported using the equity method of accounting. As of September 30, 2018, approximately $63,447,000 of total capital commitments, including those held within the pension plan assets discussed in Note 17, remain outstanding. Certain of the partnerships may hold some securities without readily determinable fair values and, consequently, the general partner may estimate fair value for such securities. These estimates may differ significantly from the values that would have been used had a ready market existed and may also differ significantly from the values at which such investments may be sold and the differences could be material.

Fixed-Income Securities—Bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. When quoted prices are not available for identical or similar bonds, the bond is valued under a discounted cash flows approach that maximizes observable inputs, such as current yields of similar instruments, but includes adjustments for certain risks that may not be observable, such as credit and liquidity risks.

Domestic Equity Securities—The fair value of domestic equity securities is based on quoted market prices that are traded in an active market.

Beneficial Interest in Perpetual Trusts—The estimated fair values of Baystate Health's beneficial interests in perpetual trusts are determined based upon information provided by the trustees. Such information is generally based on the pro rata interest in the net assets of the underlying investments. The assets held in trust consist primarily of cash equivalents and marketable securities. The fair values of the perpetual trusts are measured using the fair value of the assets contributed to the trusts. The measurement for a beneficial interest in a perpetual trust is categorized as a Level 3 fair value measurement because Baystate Health will never receive the trusts' assets.

Interest Rate Swaps—Baystate Health uses inputs other than quoted prices that are observable to value the interest rate swaps. Baystate Health considers these inputs to be Level 2 inputs in the context of the fair value hierarchy. The fair values represent the estimated amounts Baystate Health would receive or pay to terminate agreements, taking into consideration current interest rates and the current creditworthiness of the counterparty.

The following methods and assumptions were used by Baystate Health in estimating the fair value of its financial instruments that are not measured at fair value on a recurring basis for disclosures in the consolidated financial statements:

Receivables and Payables—The carrying value of Baystate Health's receivables and payables approximates fair value, as maturities are short term.

Long-Term Debt—The estimated fair value of Baystate Health's bonds is based on current traded value or a discounted cash flows analysis based on Baystate Health's current incremental borrowing rates for similar types of borrowing arrangements. The fair value inputs for long-term debt are considered to be Level 2 within the fair value hierarchy.

The fair value of long-term debt at September 30, 2018 and 2017, approximates $463,191,000 and $500,951,000, respectively.

5. PLEDGES RECEIVABLE

Pledges receivable at September 30, 2018 and 2017, are as follows (in thousands):

	2018	2017
Receivable in less than one year	$2,030	$2,213
Receivable in one to five years	1,443	2,602
Receivable in more than five years	10	-
Total pledges receivable	3,483	4,815
Less allowance for uncollectible pledges	(352)	(510)
Net pledges receivable	$3,131	$4,305

The current portion of net pledges receivable is included in accounts receivable—other in the consolidated statements of financial position. The long-term portion of net pledges receivable is recorded in deferred expenses and other long-term assets in the consolidated statements of financial position.

6. LAND, BUILDINGS, AND EQUIPMENT

Details of land, buildings, and equipment at September 30, 2018 and 2017, are as follows (in thousands):

	2018	2017
Land, land improvements, and leasehold improvements	$ 55,639	$ 55,303
Buildings	968,644	908,283
Fixed equipment	108,592	109,043
Moveable equipment	737,310	713,319
Assets under capital leases	35,500	30,526
Construction in progress	15,109	40,205
	1,920,794	1,856,679
Less accumulated depreciation and amortization	(1,192,680)	(1,123,691)
Total land, buildings, and equipment—net	$ 728,114	$ 732,988

Depreciation expense for the years ended September 30, 2018 and 2017, was $78,874,000 and $78,779,000, respectively. As of September 30, 2018, and 2017, the accumulated amortization on assets under capital lease is approximately $26,518,000 and $23,462,000, respectively.

7. RELATED PARTY TRANSACTIONS

Baystate Health has a 50% ownership in Baycare Health Partners, Inc. ("Baycare"), a physician hospital organization and accountable care organization (ACO). BMC has provided an unconditional guarantee for a line of credit Baycare has obtained from a financial institution for $9,000,000 and $7,000,000 as of September 30, 2018 and 2017, respectively. There were no amounts outstanding under the line of credit at September 30, 2018 or 2017. This line of credit expires on July 31, 2019.

In 2017, Baycare formed the Baystate Health Care Alliance LLC (BCHA), who partnered with HNE to create the BeHealthy Partnership Plan (BHPP), an ACO serving Medicaid members in western Massachusetts. An ACO is a group of providers willing and capable of accepting accountability for the cost and quality of care for a defined population. In August 2017, HNE and BHCA executed agreements to participate in a major restructuring of the MassHealth Medicaid program through BHPP. Under this arrangement, BHCA contracts with the four BMC community health centers as well as an unrelated entity to provide health care services and care coordination for enrolled members effective March 1, 2018 through December 31, 2022. Both HNE and BMC (through its contract with BHCA) are subject to certain risk-sharing provisions under this agreement that will be calculated annually. As of September 30, 2018, Baystate Health has accrued $500,000 in accounts payable in the accompanying consolidated statements of financial position.

BHPP also receives Delivery System Reform Incentive Payments (DSRIP) from the Commonwealth of Massachusetts to support infrastructure creation. HNE oversees disbursement of DSRIP funds to BHCA, as appropriate, as ACO infrastructure initiatives and transformation activities are incurred. HNE records the DSRIP funds that have not been disbursed as a liability. During 2018 and 2017, HNE received approximately $9,400,000 and $2,200,000 in DSRIP funds, respectively. At September 30, 2018 and 2017, the DSRIP fund liability amounted to approximately $4,400,000 and $2,200,000, respectively, and is recorded in accounts payable in the accompanying consolidated statements of financial position. In 2018, Baystate Health has recognized approximately $3,300,000 of DSRIP funding, respectively, in other revenue in the accompanying consolidated statements of operations. Under certain termination provisions, Baystate Health may be required to repay some or all of the DSRIP funding received.

In 2015, Baycare formed the Pioneer Valley Accountable Care LLC (PVAC), an ACO serving Medicare members in western Massachusetts. Effective January 1, 2016, through PVAC, certain Baystate Health providers participate in the Medicare Next Generation ACO model. Under this arrangement PVAC contracts with certain employed providers as well as unrelated entities to provide health care services and care coordination to Medicare members. Through its contract with PVAC, Baystate Health is subject to certain risk-sharing provisions under this agreement that will be calculated annually. As of September 30, 2018, and 2017, Baystate Health has accrued $6,400,000 and $701,000 in accounts receivable, other in the accompanying consolidated statements of financial position. During 2018, Baystate Health recorded an adjustment to amounts accrued for settlements related to prior fiscal years. The net effect of such adjustment was an increase in other revenue of $637,000 in 2018. There was no such adjustment in 2017.

8. SHORT-TERM OBLIGATIONS AND COMMITMENTS

At September 30, 2018 and 2017, a financial institution has issued irrevocable letters of credit on behalf of BHIC totaling $300,000, respectively. Investments with a fair value of approximately $429,000 were pledged as security for these letters of credit as of

September 30, 2018 and 2017, respectively. The letters of credit are subject to annual renewal and there are no amounts outstanding under the letters of credit as of September 30, 2018 and 2017.

9. LEASES

Baystate Health leases certain real property and equipment under noncancelable leases expiring at various dates through 2033 with varying renewal options. Rentals generally include insurance and maintenance costs.

On November 15, 2017, BMC entered into a tax-exempt lease financing agreement with the Massachusetts Development Finance Agency (MDFA) and a financial institution in the amount of $2,937,100. Proceeds from the financing were used to fund certain equipment related to a linear accelerator. Interest on the borrowing is fixed at 1.943% with principal and interest due monthly until maturity on November 15, 2024. This lease is classified as a capital lease and is included in the table below.

On December 29, 2016, BMC entered into a tax-exempt lease financing agreement with the Massachusetts Development Finance Agency (MDFA) and a financial institution in the amount of $3,000,000. Proceeds from the financing were used to fund certain equipment related to a linear accelerator. Interest on the borrowing is fixed at 1.860% with principal and interest due monthly until maturity on December 29, 2023. This lease is classified as a capital lease and is included in the table below.

On September 22, 2016, BMC entered into a tax-exempt lease financing agreement with the MDFA and a financial institution in the amount of $14,063,000. Proceeds from the financing were used to fund certain equipment related to a cogeneration combined heat and power plant project. Interest on the borrowing is fixed at 1.593% with principal and interest payments due monthly until maturity on September 22, 2026. This lease is classified as a capital lease and is included in the table below.

On November 2, 2011, BMC entered into a tax-exempt lease financing agreement with the MDFA and a financial institution in the amount of $20,000,000. Proceeds from the financing were used to fund certain equipment, related to a BMC expansion project. Interest on the borrowing is fixed at 2.19%, with principal and interest payments due monthly until maturity on November 2, 2018. This lease is classified as a capital lease and is included in the table below. Subsequent to September 30, 2018, the final payment on the lease was made on November 1, 2018.

Future minimum lease payments at September 30, 2018, are as follows (in thousands):

Year Ending September 30	Capital Leases	Operating Leases
2019	$ 3,261	$12,048
2020	2,648	10,895
2021	2,616	7,849
2022	2,616	6,720
2023	2,519	6,473
Thereafter	5,267	20,596
Total minimum lease payments	18,927	$64,581
Less amount representing interest	(1,105)	
Present value of net minimum lease payments	17,822	
Less current portion	(2,962)	
Long-term portion	$14,860	

Rental expense of operating leases amounted to approximately $17,420,000 and $16,604,000 for the years ended September 30, 2018 and 2017, respectively.

10. LONG-TERM DEBT

BMC, BFMC and BWH have loan agreements with the MDFA (effective October 1, 2010, Massachusetts Health and Educational Facilities Authority (MHEFA) merged into MDFA) and with the MHEFA for construction projects and equipment. Long-term obligations outstanding at September 30, 2018 and 2017, consist of the following (in thousands):

	Amount Outstanding	
	2018	**2017**
MDFA and MHEFA issues:		
BMC Series P-1	$ 39,315	$ -
BMC Series P-2	25,714	-
BWH Series A	14,700	14,700
BMC Series O	18,058	18,897
BMC Series N	55,115	55,115
BFMC Series A	20,841	21,362
BMC Series M	32,917	34,297
BMC Series L	21,113	21,745
BMC Series I	-	63,380
BMC Series J-1	45,000	45,000
BMC Series J-2	45,000	45,000
BMC Series K-1	20,045	20,045
BMC Series K-2	26,365	26,365
BMC Series M-2	4,431	5,168
BMC Series H	2,222	2,889
BFMC Series M-4A	3,967	4,500
BMC Series G	32,900	36,490
Subtotal	407,703	414,953
BH note payable—line of credit	27,461	33,741
BH note payable—Wing	13,340	16,280
BWH note payable	12,319	12,703
BNH financing arrangements	375	889
Original issue premium	4,814	3,419
Issuance costs	(2,293)	(2,836)
Total long-term debt	463,719	479,149
Less current portion	(13,412)	(10,216)
Long-term debt, excluding current portion	$450,307	$468,933

Summary information for each issue is as follows:

Series P-1—On December 21, 2017, BMC issued Series P-1 MDFA Revenue Bonds in the aggregate principal amount of $40,595,000. Proceeds from the bonds were used to advance refund a portion of the outstanding BMC Series I MHEFA Revenue Bonds. The

Bonds are subject to a mandatory tender on December 21, 2027. Interest on the bonds is fixed at 2.34% with a final maturity on December 21, 2036. An annual average balance of $15,000,000 must be maintained on deposit with the financial institution or the interest rate on such bonds may be adjusted upward, not to exceed 2.94%.

Series P-2—On December 21, 2017, BMC issued Series P-2 MDFA Revenue Bonds in the aggregate principal amount of $26,465,000. Proceeds from the bonds were used to advance refund a portion of the outstanding BMC Series I MHEFA Revenue Bonds. The Bonds are subject to a mandatory tender on December 21, 2027. Interest on the bonds is fixed at 3.38% with a final maturity on December 21, 2036. An annual average balance of $15,000,000 must be maintained on deposit with the financial institution or the interest rate on such bonds may be adjusted upward, not to exceed 3.98%.

BWH Series A—On April 13, 2017, BWH issued Series A MDFA Revenue Bonds in the aggregate principal amount of $14,700,000. Proceeds from the bonds financed the construction of a new emergency department at BWH. The bonds are subject to a mandatory tender on September 30, 2024. Interest on the bonds is fixed at 2.61%. BH and BMC have entered into a guaranty agreement on behalf of BWH in connection with this bond.

Series O—On May 12, 2016, BMC issued Series O MDFA Revenue Bonds in the aggregate principal amount of $20,000,000. Proceeds from the bonds were used to redeem 100% of a loan from a financial institution. The bonds are subject to a mandatory tender on May 12, 2026. Interest on the bonds is fixed at 1.98% through May 12, 2026, with final maturity on May 12, 2036.

Series N—On October 6, 2014, BMC issued Series N MDFA Revenue Bonds in the aggregate principal amount of $55,115,000. The proceeds from the bonds financed the build-out of inpatient rooms, operating rooms, inpatient pharmacy, medical equipment, information technology equipment, and other capital projects. The bonds are 30-year bonds with final maturity on July 1, 2044, and carry a fixed 5% interest rate.

BFMC Series A—On December 4, 2014, BFMC issued Series A MDFA Revenue Bonds in the aggregate principal amount of $22,000,000. The proceeds from the bonds financed the construction of a new surgical unit at BFMC. The bonds are 30-year bonds with final maturity on December 4, 2044, and carry a fixed 2.9% interest rate. BMC has entered into a guaranty agreement on behalf of BFMC in connection with this bond.

Series M Bonds—On August 9, 2012, BMC issued Series M MDFA Revenue Bonds in the aggregate principal amount of $40,137,000. BMC used the proceeds from the bonds to redeem 100% of Series F MHEFA Revenue Bonds, exercising an early redemption option related to the Series F obligation. The bonds are subject to mandatory tender on August 8, 2022. Interest on the bonds is fixed at 2.37% through August 8, 2022, with final maturity on July 1, 2033. An annual average balance of $15,000,000 must be maintained on deposit with the financial institution or the interest rate on such bonds may be adjusted upward, not to exceed 2.97%.

Series L Bonds—On November 2, 2011, BMC issued Series L MDFA Revenue Bonds in the aggregate principal amount of $25,000,000. Proceeds from the bonds were used to fund the construction of a new emergency department in conjunction with a BMC expansion Project. Interest on the bonds is initially fixed at 2.95% through November 1, 2021, with final maturity on July 1, 2041.

BMC Hospital Expansion MHEFA Bond Issuances—On June 25, 2009, BMC issued Series I, Series J-1, Series J-2, Series K-1, and Series K-2 MHEFA Revenue Bonds in a combined aggregate principal amount of $199,790,000. Proceeds from the bonds were used to pay off the Banc of America, NA loan of $65,000,000 (borrowed in October 2008) and fund the construction, improvement, equipping, and other related capital expenditures of a seven-story building located at 759 Chestnut Street in Springfield, Massachusetts ("BMC Expansion Project"). Details of the related MHEFA bond issuances are as follows:

Series I Bonds—BMC issued Series I MHEFA Revenue Bonds in the aggregate amount of $63,380,000. Interest rates ranged from 5.5% to 5.75%. Final maturity on the bonds was July 1, 2036. On December 21, 2017, BMC issued $67.1 million in revenue bonds with an average fixed interest rate of 2.6% to advance refund $63.4 million of outstanding Series I Bonds with an average interest rate of 5.6%. The net proceeds were used to purchase US Government securities. Those securities were deposited with an escrow agent to provide for all future debt service payments on the Series I Bonds. As a result, the Series I Bonds are considered deceased. A loss of $5.7 million on the debt extinguishment is reflected as a nonoperating loss in the 2018 consolidated statement of operations.

Series J-1 Bonds—BMC issued Series J-1 MHEFA Revenue Bonds in the aggregate amount of $45,000,000. Interest on the bonds is variable and is 1.56% and 0.95% at September 30, 2018 and 2017, respectively. Final maturity on the bonds is July 1, 2044. The bonds are secured by an irrevocable letter of credit issued by a financial institution that terminates in January 2020.

Series J-2 Bonds—BMC issued Series J-2 MHEFA Revenue Bonds in the aggregate amount of $45,000,000. Interest on the bonds is variable and is 1.62% and 0.95% at September 30, 2018 and 2017, respectively. Final maturity on the bonds is July 1, 2044. The bonds are secured by an irrevocable letter of credit issued by a financial institution that terminates in January 2020.

Series K-1 Bonds—BMC issued Series K-1 MHEFA Revenue Bonds in the aggregate amount of $20,045,000. The bonds were subject to mandatory tender on July 1, 2013. The initial interest on the bonds was fixed at 5% through June 30, 2013, with final maturity on July 1, 2039.

On July 1, 2013, the Series K-1 MHEFA Revenue Bonds were purchased pursuant to a mandatory tender and remarketed on such date. The reoffering of the bonds contained a conversion of the interest rate from the long-term fixed rate to a daily rate of 1.63% and 0.92% at September 30, 2018 and 2017, respectively, along with a provision of a letter of credit from a financial institution. The daily interest rate is determined by the remarketing agent and the letter of credit will expire on October 21, 2020.

Series K-2 Bonds—BMC issued Series K-2 MHEFA Revenue Bonds in the aggregate amount of $26,365,000. The bonds were subject to mandatory tender on July 1, 2015. The initial interest on the bonds was fixed at 5% through June 30, 2015, with final maturity on July 1, 2039.

On July 1, 2015, the Series K-2 MHEFA Revenue Bonds were purchased pursuant to the mandatory tender and remarketed on such date. The reoffering of the bonds contained a conversion of the interest rate from the long-term fixed rate to a weekly rate of 1.55% and 0.94% at September 30, 2018 and 2017, respectively, along with a provision of a letter of credit from a financial institution. The weekly rate is determined by the remarketing agent and the letter of credit will expire on July 1, 2020.

Series M-2—On June 30, 2008, BMC entered into a loan commitment under a capital asset program financed by MHEFA through the issuance of variable-rate demand Revenue Bonds, Series M-2. Proceeds of $10,158,000 were used to refund the then-outstanding Revenue Bonds, BMC Issue, Series J-2, which were issued in 1995 ("Series J-2-1995"). Interest on the Series M-2 bonds is variable and resets weekly to reflect current market rates and was 1.61% and 1.03% at September 30, 2018 and 2017, respectively. Final maturity of the bonds is June 15, 2023. These bonds are supported by a pooled letter of credit, which expires on October 31, 2019.

Series H Bonds—On January 18, 2007, BMC issued Series H MHEFA Revenue Bonds in the aggregate principal amount of $10,000,000. Proceeds from the bonds were used to reimburse and fund certain capital additions and fund the construction of a new parking garage. Interest on the bonds is variable based on monthly resets and is 2.44% and 1.84% at September 30, 2018 and 2017, respectively. Final maturity of the bonds is January 1, 2022.

Series M-4A Bonds—On February 1, 2005, BFMC entered into a loan commitment under a capital asset program financed by MHEFA through the issuance of variable-rate demand Revenue Bonds, Series M-4A. Proceeds of $9,100,000 were used to fund certain capital additions, renovations, and equipment expenditures related to the emergency department, radiology department, and in-patient facilities. Interest on the bonds is variable and resets weekly to reflect current market rates and is 1.67% and 1.03% at September 30, 2018 and 2017, respectively. Final maturity of the bonds is June 15, 2024. These bonds are supported by a pooled letter of credit, which expires on October 31, 2019.

Series G Bonds—On October 27, 2005, BMC issued Series G MHEFA Revenue Bonds in the aggregate principal amount of $71,740,000. Proceeds from the bonds were used to advance refund a portion of the outstanding Revenue Bonds, BMC Issue, Series E. Series G bonds' proceeds were also used to finance routine capital construction, renovations, and equipping of various facilities of BMC. Interest on the bonds is variable and resets every 35 days and is 1.43% and 0.92% at September 30, 2018 and 2017, respectively. Final maturity of the bonds is July 1, 2026. The bonds were secured by an irrevocable letter of credit issued by a financial institution that terminates on December 12, 2022.

Significant Debt Covenants—The bond agreements include various financial covenants, the most restrictive of which are a pledge of revenues and the maintenance of a ratio of net revenue available to meet debt service to total principal and interest requirements of at least 1.1 (as defined by the agreement).

A debt service fund has been established in accordance with these debt agreements. Debt services fund balances amounted to approximately $1,138,000 and $1,488,000 at September 30, 2018 and 2017, respectively, in investments held by trustee under debt agreements in the accompanying consolidated statement of financial position.

Construction funds were established in accordance with these debt agreements. Construction fund balances amounted to approximately $289,000 and $9,394,000 at September 30, 2018 and 2017, respectively.

BH Notes Payable—On December 28, 2015, BH entered into a three-year $40,000,000 line of credit with a financial institution with an original maturity date of December 28, 2018. Subsequent to September 30, 2018, this term was extended to mature on December 28, 2021. The interest rate on the borrowing is variable at London InterBank Offered Rate (LIBOR), plus 0.70% per annum. The interest rate on this loan was 3.02% and 2.02% at September 30, 2018 and 2017, respectively. BMC has entered into a guaranty agreement on behalf of BH in connection with this note.

On August 29, 2014, BH entered into a variable rate, 10-year term loan through a financial institution in the amount of $18,500,000. The interest rate on this term loan is equivalent to LIBOR, plus 0.475%. The interest rate on this loan was 2.59% and 1.71% on September 30, 2018 and 2017, respectively. Proceeds from the term loan were used in the financing of BH's September 1, 2014, purchase of BWH. Cash and short-term investments have been pledged as collateral for this borrowing.

BWH Note Payable—On September 30, 2014, BWH entered into a 10-year loan through a financial institution in the amount of $13,745,000 at a fixed rate of 3.542%. Proceeds from the loan were used to repay debt held by BWH in the same amount at a rate of 5.15%.

BNH Long-Term Debt—BNH consolidated has various current and long-term debt outstanding totaling approximately $375,000 as of September 30, 2018, of which approximately $101,000 is classified as current. The agreement with the longest duration extends through 2024. BNH consolidated has a combination of fixed-rate debt, with interest rates ranging from 0% to 5.05% as of September 30, 2018 and 2017.

The combined aggregate future principal payments of all long-term debt are as follows (in thousands):

Year Ending September 30	
2019	$ 13,412
2020	14,367
2021	14,783
2022	42,661
2023	15,629
Thereafter	360,346
	$461,198

BMC has entered into a guaranty agreement on behalf of BFMC and BWH in connection with outstanding MHEFA bonds and BWH note payable, respectively.

Interest Rate Swap Agreements—BMC periodically enters into interest rate swap agreements to moderate its exposure to interest rate changes and to lower the overall cost of borrowings. Gains and losses realized on termination of contracts are deferred and amortized over the remaining life of the associated contract.

In 2004, BMC entered into an interest rate swap agreement with a financial institution with an original notional amount of $67,470,000. The Series D interest rate swap was unwound and settled on February 20, 2018 for $235,000. The notional amount outstanding at

September 30, 2017, was $9,340,000. Under the terms of the agreement, BMC paid a fixed rate of 3.26% and received variable payments based upon the Securities Industry and Financial Markets Association rate.

In September 2005, BMC, in anticipation of the issuance of the Series G bonds, entered into an interest rate swap agreement with a financial institution with an original notional amount of $71,740,000. The notional amount outstanding at September 30, 2018 and 2017, was $32,900,000 and $36,490,000, respectively. The agreement provides for the financial institution to pay variable-rate payments to BMC equal to 56.9% of one-month LIBOR, plus 0.32%, and for BMC to pay the financial institution a fixed rate of 3.021%. The LIBOR was 2.16% and 1.24% at September 30, 2018 and 2017, respectively. There are termination provisions to this contract for each party.

The fair value of these agreements resulted in swap liabilities of approximately $1,400,000 and $3,122,000 at September 30, 2018 and 2017, respectively, and is included in other long-term liabilities in the consolidated statements of financial position.

The net interest cost and the change in the fair value of the associated interest rate swaps are included in nonoperating income (loss) in the consolidated statements of operations.

11. INTEREST EXPENSE

Baystate Health capitalizes interest cost as part of the historical cost of acquiring certain significant qualifying assets. During the years ended September 30, 2018 and 2017, interest cost was as follows (in thousands):

	2018	**2017**
Total interest cost	$13,447	$13,973
Net interest cost capitalized	(477)	(207)
Net interest cost expensed	$12,970	$13,766

12. INSURANCE LIABILITY LOSS RESERVES

Baystate Health, with the exception of HNE, addresses its professional and general liability expense, in part, through insurance coverage provided by BHIC, and, in part, by purchasing commercial excess liability insurance. The commercial insurance generally provides coverage on a "claims-made" basis. Under the claims-made policies, claims based on occurrences during their term, but reported subsequently, will be uninsured should the policy not be renewed or replaced with other coverage. Management has the intention of renewing its insurance policies in the future and believes it will have the ability to obtain such policy renewals. BH and certain of its subsidiaries have also purchased excess professional and general coverage from other insurers. In addition, BHIC insures the workers' compensation, employer's liability, excess workers' compensation, and long-term disability of certain of BH's subsidiaries.

BHIC reinsures a portion of its risks in order to limit its exposure to losses. Reinsurance contracts do not relieve Baystate Health from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to Baystate Health. Consequently, Baystate Health evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

Reinsurance recoverables were based on actuarial reports prepared by independent consulting actuaries. At September 30, 2018 and 2017, reinsurance recoverables of $19,383,000 and $16,742,000, respectively, were recorded as deferred expense and other long-term assets in the consolidated statements of financial position. There were no specifically identified claims subject to reinsurance recoverables at September 30, 2018 and 2017, or deducted from losses incurred and paid during the years then ended.

Reserves have been provided with the assistance of a consulting actuary for asserted claims and for unasserted claims probable of assertion arising from both reported and unreported incidents, which are based on historical experience and existing reported incidents.

Activity in the BHIC liability for losses and loss adjustment expenses for the years ended September 30, 2018 and 2017, is summarized as follows (in thousands):

	2018	**2017**
Balance at beginning of year	$100,801	$ 15,552
Opening adjustment—insurance accounting	-	73,382
	100,801	88,934
Incurred (recovered) related to:		
Current year	27,522	27,878
Prior years	(3,705)	(3,592)
Total incurred	23,817	24,286
Paid related to:		
Current year	(1,588)	(1,412)
Prior years	(21,268)	(11,007)
Total paid	(22,856)	(12,419)
Balance at end of year	$101,762	$100,801

For the period from October 1, 2004, to September 30, 2016, BHIC had written all of its hospital program policies to allow for unlimited retrospective premiums. The liabilities associated with these policies were included in a deposit liability. Effective October 1, 2016, BHIC amended all of its in-force hospital program policies (including those related to prior years) to limit retrospective premiums in order to transfer sufficient risk to BHIC, and thus the financial results for the hospital program are presented using insurance accounting. On October 1, 2016, BHIC recorded an adjustment for this insurance accounting transition which effectively reclassified the deposit liability to liability for losses and loss-adjustment expenses.

13. MEDICAL CLAIMS PAYABLE AND LIABILITIES FOR UNPAID CLAIMS

Activity in medical claims payable for the years ended September 30, 2018 and 2017 are as follows (in thousands):

	2018	2017
Medical claims payable:		
Claims payable—beginning of year	$ 44,679	$ 35,356
Risk-sharing payable—beginning of year	27,067	24,522
	71,746	59,878
Claims incurred:		
Current year	582,557	645,274
Prior years	1,020	(7,291)
	583,577	637,983
Claims paid:		
Current year	(528,536)	(575,711)
Prior years	(61,894)	(50,404)
	(590,430)	(626,115)
Risk-sharing payable—end of year	35,338	27,067
Medical claims payable—end of year	29,555	44,679
Total medical claims payable	$ 64,893	$ 71,746

Amounts incurred related to prior years vary from previously estimated liabilities as the claims are ultimately settled.

The following is information about the development of paid and incurred health claims as of September 30, 2018 for HNE, which is presented net of reinsurance. The tables present claims development and cumulative claim payments by incurred year. The information about paid and incurred claims development prior to 2018 is presented as unaudited supplementary information ($ in thousands):

Commercial	**Cumulative Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance For the Years Ended September 30,**			**Total of IBNR Liabilities Plus Expected Development on Reported Claims**	**Cumulative Number of Reported Claims**
Incurred Year	**(Unaudited) 2016**	**(Unaudited) 2017**	**2018**		
2016	$ 289,567	$ 289,183	$ 290,638	$ -	2,159,622
2017		298,789	297,585	50	2,145,863
2018			290,587	24,795	1,868,302
Cumulative incurred claims for the periods presented			$ 878,810	$ 24,845	
Claims adjustment expenses:	$ 800	$ 772	$ 772		

	Cumulative Paid Claims and Paid Allocated Claims Adjustment Expenses, Net of Reinsurance For The Years Ended September 30,		
Incurred Year	**(Unaudited) 2016**	**(Unaudited) 2017**	**2018**
2016	$ 267,975	$ 290,670	$ 290,638
2017		272,286	297,536
2018			265,792
Cumulative paid claims for the periods presented			853,966
All outstanding liabilities prior to 2016, net of reinsurance			1,042
Liability for commercial medical claims payable, net of reinsurance			$ 26,658

Medicare & Medicare Supplement	**Cumulative Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance For the Years Ended September 30,**			**Total of IBNR Liabilities Plus Expected Development on Reported Claims**	**Cumulative Number of Reported Claims**
Incurred Year	**(Unaudited) 2016**	**2017**	**2018**		
2016	$ 78,796	$ 77,137	$ 77,105	$ -	587,079
2017		75,472	75,154	77	592,762
2018			79,416	9,086	546,354
Cumulative incurred claims for the periods presented			$ 231,675	$ 9,163	
Claims adjustment expenses:	$ 320	$ 181	$ 181		

	Cumulative Paid Claims and Paid Allocated Claims Adjustment Expenses, Net of Reinsurance For The Years Ended September 30,		
Incurred Year	**(Unaudited) 2016**	**2017**	**2018**
2016	$ 71,065	$ 77,132	$ 77,105
2017		69,277	75,077
2018			70,330
Cumulative paid claims for the periods presented			222,512
All outstanding liabilities prior to 2016, net of reinsurance			-
Liability for Medicare and Medicare Supplemental medical claims payable, net of reinsurance			$ 9,344

Medicaid Incurred Year	Cumulative Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance For the Years Ended September 30, (Unaudited) 2016	2017	2018	Total of IBNR Liabilities Plus Expected Development on Reported Claims	Cumulative Number of Reported Claims
2016	$304,657	$305,072	$305,053	$ -	2,710,851
2017		262,994	259,783	454	2,614,456
2018			202,214	16,390	1,931,183
Cumulative incurred claims for the periods presented			$767,050	$16,844	
Claims adjustment expenses:	$ 170	$ 582	$ 582		

Incurred Year	Cumulative Paid Claims and Paid Allocated Claims Adjustment Expenses, Net of Reinsurance For The Years Ended September 30, (Unaudited) 2016	2017	2018
2016	$285,046	$305,067	$305,053
2017		241,052	259,328
2018			185,824
Cumulative paid claims for the periods presented			750,205
All outstanding liabilities prior to 2016, net of reinsurance			-
Liability for Medicaid medical claims payable, net of reinsurance			$ 17,427

Reconciliation of the Disclosure of Paid and Incurred Claims Development to the Liability for Unpaid Claims and Claim Adjustment Expenses—The reconciliation of the net paid and incurred claims development tables for HNE to the liability for medical claims expense in the consolidated statement of financial position as of September 30, 2018, is as follows ($ in thousands).

Net outstanding liabilities:	
Commercial	$26,658
Medicare	9,344
Medicaid	17,427
Total gross liability for medical claims payable	$53,429

14. STATUTORY SURPLUS/CAPITAL

Minimum Surplus Requirements under Commonwealth of Massachusetts Law—In accordance with insurance laws and regulations established by the Commonwealth of Massachusetts, HNE is required to maintain a minimum surplus of the largest of the four following tests:

a) $1,000,000

b) The total of 2% of the first $150,000,000 of premium and 1% of the premium in excess of $150,000,000

c) Three months of uncovered health care expenditures

d) 4% of annual hospital expenditures, plus 8% of all other medical expenditures, excluding capitated arrangements

Based on calendar 2017 activity, the minimum capital amount as determined by each of the above tests is as follows: a) $1,000,000; b) $10,478,474; c) $14,284,474; and d) $51,207,207. At December 31, 2017, HNE's surplus exceeded the Commonwealth of Massachusetts' laws and regulations regarding minimum surplus.

National Association of Insurance Commissioners' (NAICs) Model Regulation—The Managed Care Organization Risk-Based Capital (RBC) Model Regulation (the "Model Regulation") was adopted by the NAIC in December 1997 to establish benchmarks for minimum levels of statutory RBC. The Model Regulation prescribes specific actions that insurance departments should take (i.e., action levels) when certain RBC thresholds are not met. Calculation of RBC in accordance with the Model Regulation RBC formula is required in connection with the annual statutory filing. HNE's statutory capital at December 31, 2017 exceeded the company action level.

Surplus Notes—On December 28, 2015, HNE entered into a surplus notes agreement, borrowing $20,000,000 from Baystate Health in order to maintain minimum levels of surplus and RBC. The surplus notes accrue interest payable to Baystate Health at a rate per annum equal to the three-year US Treasury rate until the principal is paid in full.

15. INCOME TAXES

As of September 30, 2018, operating loss carryforwards for federal income tax purposes were approximately $27,359,000 for BMC, which expire in various years ranging from 2019 to 2037. This results in a deferred tax asset; however, because utilization of these net operating losses is not reasonably assured, BMC has recorded a full valuation allowance offsetting this deferred tax asset.

16. FUNDS HELD IN TRUST BY OTHERS

BH and its subsidiaries are beneficiaries of certain perpetual trusts (the "Trusts"), from which they receive unrestricted income. Appreciation or depreciation in the value of the Trusts is recorded as an increase or decrease in permanently restricted net assets. During fiscal years 2018 and 2017, distributions from the Trusts were approximately $1,664,000 and $1,521,000, respectively, and are included in other revenue.

17. BENEFIT PLANS

BH and certain of its consolidated subsidiaries and other ownership interests participate in a noncontributory, defined benefit cash balance retirement plan (the "plan") covering substantially all of their eligible employees.

Baystate Health's policy is to fund amounts as are necessary on an actuarial basis to provide for benefits in accordance with the Employee Retirement Income Security Act of 1974, using the accrued benefit (net credit) actuarial cost method.

Plan Freeze—Effective December 31, 2015, participants in the plan ceased to accrue benefits. On January 1, 2016, the participants in the plan became participants in the redesigned Baystate Health defined contribution plan (the "DC plan"). In connection with the plan freeze, the period for amortizing actuarial gains and losses was changed from the average expected future service of active participants to the average expected future lifetime as a plan participant for all participants.

Settlement Charge—During 2017, lump-sum payments from the plan exceeded the settlement threshold, therefore a settlement charge of $15,960,000 was recorded in other expense in the 2017 accompanying consolidated statement of operations; there was no such charge in 2018.

The following table presents the change in the plan's projected benefit obligation, change in plan assets, and funded status of the plan at September 30, 2018 and 2017, (in thousands):

Change in Pension Obligation	**2018**	**2017**
Pension obligation—beginning of year	$944,786	$ 1,010,220
Service cost	4,000	3,600
Interest cost	35,078	36,043
Actuarial (gain) loss	(56,835)	(36,087)
Benefits paid	(61,266)	(26,959)
Net prior service cost	2,798	-
Settlements	-	(42,031)
Pension obligation—end of year	$868,561	$ 944,786
Change in Plan Assets		
Fair value of plan assets—beginning of year	$878,569	$ 879,904
Actual return on plan assets	23,726	52,655
Employer contributions	5,000	15,000
Benefits paid	(61,266)	(26,959)
Settlements	-	(42,031)
Fair value of plan assets—end of year	$846,029	$ 878,569
Funded Status		
Funded status of the plan	$ (22,533)	$ (66,217)
Pension liability	$ (22,533)	$ (66,217)
Amounts Recognized in Unrestricted Net Assets Consist of		
Net actuarial loss	$333,218	$ 358,777
Accumulated pension adjustment	$333,218	$ 358,777

Exclusive of other ownership interest, the underfunded status of the plan at September 30, 2018, is approximately $22,734,000, the change in the pension adjustment is $25,391,000 and the accumulated pension adjustment in unrestricted net assets is $331,755,000.

Exclusive of other ownership interest, the underfunded status of the plan at September 30, 2017, is approximately $66,130,000, the change in the pension adjustment is $48,312,000 and the accumulated pension adjustment in unrestricted net assets is $357,144,000.

The net actuarial loss and prior service credit expected to be recognized in benefit cost in 2018 is approximately $11,084,000 and $133,000, respectively.

The assumptions used to develop the projected benefit obligation at September 30, 2018 and 2017, are as follows:

	2018	2017
Discount rate	4.40 %	3.85 %
Rate of compensation increase	N/A	N/A

The mortality assumption was RP-2014 with generational projection from 2006 using Scale MP-2016 modified to converge to a 0.75% long-term rate of mortality improvement after 15 years diagonally starting in 2012 for ages 65-84 (lesser mortality improvement rates are used at older ages) at September 30, 2018 and 2017.

The accumulated benefit obligation was approximately $868,561,000 and $944,786,000 at September 30, 2018 and 2017, respectively.

Net Periodic Pension Cost—Net pension cost for the defined benefit plan for the years ended September 30, 2018 and 2017, includes the following components (in thousands):

	2018	2017
Service cost	$ 4,000	$ 3,600
Interest cost	35,078	36,043
Expected return on plan assets	(64,064)	(68,328)
Recognized net actuarial loss	11,860	12,266
Settlement	-	15,960
Net pension cost	$(13,126)	$ (459)

The assumptions used to determine net pension cost for the years ended September 30, 2018 and 2017, are as follows:

	2018	2017
Discount rate	3.85 %	3.70 %
Expected return on plan assets	7.50	7.75
Rate of compensation increase	N/A	N/A

Plan Assets—The plan's investment objectives are to achieve long-term growth in excess of inflation and to provide a rate of return that meets or exceeds the actuarial expected long-term rate of return on plan assets. In order to minimize risk, the plan attempts to minimize the variability in yearly returns. The plan diversifies its holdings among sectors, industries, and companies. The target allocations of assets at September 30, 2018, were equities 45%, fixed income 40%, and other 15%.

To develop the expected long-term rate of return on plan assets assumption, Baystate Health considered the historical return and the future expectations for returns for each asset class, as well as the target asset allocation of the pension investment portfolio.

Baystate Health's pension plan asset allocation, by asset category, at September 30, 2018 and 2017, is as follows:

	2018	2017
Common and preferred equity securities	46 %	47 %
US government and domestic fixed-income securities	40	39
Other investments	14	14
	100 %	100 %

Financial assets invested in the plan, in one of the three categories described previously, at September 30, 2018 and 2017, are classified as follows (in thousands). See Note 4 for definitions of Level 1, Level 2, and Level 3 of the fair value hierarchy.

	Assets at Fair Value as of September 30, 2018			
	Level 1	Level 2	Level 3	Total
Money market	$ 5,414	$ 4,386	$ -	$ 9,800
Mutual funds:				
Equity index funds	38,415	-	-	38,415
Total mutual funds	38,415	-	-	38,415
Fixed-income securities—US government securities	-	314,272	-	314,272
Domestic equity securities	160,975	-	-	160,975
Total assets—at fair value	$204,804	$318,658	$ -	523,462
Plan assets—at contract value				15,778
Investments measured at NAV:				
Commingled international equity funds				124,192
Commingled emerging markets funds				45,695
Commingled master limited partnerships				20,207
Commingled hedge funds				12,144
Hedge fund of funds				42,242
Private market funds				62,309
Total investments measured at NAV				306,789
Total plan assets				$846,029

	Assets at Fair Value as of September 30, 2017			
	Level 1	Level 2	Level 3	Total
Money market	$ 5,914	$ 2,923	$ -	$ 8,837
Mutual funds:				
Corporate bond fund	159,221	-	-	159,221
Equity index funds	74,383	-	-	74,383
Total mutual funds	233,604	-	-	233,604
Fixed-income securities—US government securities	-	163,498	-	163,498
Domestic equity securities	66,434	-	-	66,434
Total assets—at fair value	$305,952	$166,421	$ -	472,373
Plan assets—at contract value				15,441
Investments measured at NAV:				
Commingled domestic equity funds				33,933
Commingled international equity funds				108,646
Commingled emerging markets funds				76,831
Commingled master limited partnerships				49,771
Commingled hedge funds				44,721
Hedge fund of funds				29,342
Private market funds				47,511
Total investments measured at NAV				390,755
Total plan assets				$878,569

A summary of investments (by major class) that use NAV or an NAV equivalent as a practical expedient to estimate fair value, that have restrictions on the plan's ability to redeem its investment at the measurement date at September 30, 2018 and 2017, is as follows (in thousands):

	September 30, 2018		
Description of Investment	**Fair Value**	**Redemption Frequency**	**Redemption Notice Period**
Commingled international equity funds	$ 124,192	Monthly	5–30 days
Commingled emerging markets funds	45,695	Monthly	14-30 days
Commingled master limited partnerships	20,207	Monthly	30 days
Commingled hedge funds	12,144	Monthly	3 days
Hedge fund of funds	42,242	Quarterly	95 days
Private market investments	62,309	*	*
Total	$ 306,789		

* Liquidity data not available, funds are considered to be highly illiquid.

	September 30, 2017		
Description of Investment	**Fair Value**	**Redemption Frequency**	**Redemption Notice Period**
Commingled equity mutual funds	$ 33,933	Monthly	5 days
Commingled international equity funds	108,646	Monthly	5–30 days
Commingled emerging markets funds	76,831	Monthly	30 days
Commingled master limited partnerships	49,771	Monthly	30 days
Commingled hedge funds	44,721	Weekly	5 days
Hedge fund of funds	28,151	Quarterly	95 days
Hedge fund of funds	1,191	Every 2–3 years	95 days
Private market investments	47,511	*	*
Total	$390,755		

* Liquidity data not available, funds are considered to be highly illiquid.

Contributions—Baystate Health expects to contribute $5,000,000 to the plan in 2019.

Estimated Future Benefit Payments—The following approximate benefit payments, which reflect expected future service, as appropriate, are expected to be paid over the next 10 calendar years (in thousands):

Calendar Years	**Pension Benefits**
2019	$ 68,234
2020	59,853
2021	55,914
2022	56,385
2023	56,122
Years 2024–2028	264,000
	$560,508

Defined Contribution Plans—BH and certain of its consolidated subsidiaries and other ownership interest participate in the DC plan, which covers all employees hired after December 31, 2004. Effective January 1, 2016, the DC plan also covers all employees previously participating in the defined benefit plan. Under the DC plan, Baystate Health contributes up to 5% of the employee's compensation based on years of service. Excluding the deferred compensation plan discussed below, total expense under the DC plan was approximately $42,283,000 in 2018 and $41,134,000 in 2017. The DC plan offers an employee contribution matching feature where the employer will contribute equal to 50% of the employee's contribution, subject to a maximum match of 2% of the employee's compensation. For those defined benefit participants aged 55 or older as of January 1, 2016, Baystate Health will be contributing an additional 4% transition benefit through December 31, 2020.

HNE provides a 401(k) retirement plan (the "HNE Plan") to its employees. Each year, employees may contribute up to 75% of pretax annual compensation, as defined in the HNE Plan document. HNE matches 100% of the first 6% of employee contributions to the

HNE Plan. Additional contributions may be made by HNE at its discretion. Contributions and compensation levels are subject to certain limitations under the IRC. The HNE Plan expense amounted to approximately $1,994,000 and $1,772,000 in 2018 and 2017, respectively, and is included in supplies and expense in the consolidated statements of operations.

Deferred Compensation Plan—As a component of its defined contribution retirement plan, Baystate Health established a nonqualified deferred compensation plan (the "Plan"), effective January 1, 2002, which allows certain highly compensated employees the option to defer specified amounts of their annual compensation on a pretax basis and also allows Baystate Health, at its discretion, the option to provide deferred compensation to key employees. A participant in the Plan is notified if a voluntary contribution is made by Baystate Health to that participant's account. In addition, the participant's account is credited to reflect investment returns based on measuring investments selected by either the participant or the Plan administrator in accordance with the Plan document. The participant has the option to take a distribution of his/her account in its entirety, upon severance from employment with Baystate Health. Baystate Health has recorded $62,597,000 and $58,272,000 within other liabilities in the consolidated statements of financial position as of September 30, 2018 and 2017, respectively, which represents its obligation for benefits payable under the Plan. All amounts of compensation deferred under the Plan remain the assets of Baystate Health, until paid out to a participant or his/her beneficiary. Baystate Health is not required to segregate or set aside any assets to meet its obligation under the Plan. Baystate Health's contributions amounted to approximately $1,864,000 and $3,882,000 in 2018 and 2017, respectively, and is included in supplies and expense in the consolidated statements of operations.

Baystate Noble Retirement Plans and Other Postretirement Benefits:

Retirement Plan—Through March 2005, BNH maintained a noncontributory defined benefit pension plan (the "Noble Plan") covering certain eligible employees of BNH and its subsidiaries, who have completed one year of service. The benefits were based on years of service and final average earnings. Noble's policy was to make annual cash contributions to the Noble Plan in amounts at least equal to the minimum contribution as determined by the Noble Plan's actuary.

Effective April 1, 2006, Noble amended the Noble Plan to freeze all accrued benefits for certain participants in the Noble Plan whose benefits are not subject to collective bargaining agreements. The accrued benefit for these participants is equal to the accrued benefit determined as of April 1, 2006. The amendment prohibits new or rehired employees, not subject to a collective bargaining agreement, from becoming participants in the Noble Plan. This curtailment resulted in a reduction in the Noble Plan's projected benefit obligation and unrecognized prior service cost which was recorded in 2006.

Pursuant to Noble's application for a distressed termination, the Pension Benefit Guaranty Corporation (PBGC) became the trustee of the Noble Plan on May 1, 2013. As part of the settlement, Noble has agreed to enter into a note payable to the PBGC totaling $4,200,000. The amount is payable over 15 years. The balance due at September 30, 2018, is approximately $2,791,000 of which $2,634,000 is classified as long-term and included as a pension liability in the consolidated statements of financial position. The balance due at September 30, 2017, was approximately $2,844,000 of which $2,687,000 is classified as long term and included as a pension liability in the consolidated statements of financial position.

There were $158,000 in contributions made during each of the years ended September 30, 2018 and 2017.

Defined Contribution Plan—The Noble 403(b) Savings Plan became effective on April 1, 2006. All eligible employees may elect to make contributions and BNH matches certain contributions up to the defined limits. In addition, BNH contributes between 2% and 10% of certain employee's eligible compensation based upon the employee's age and years of vesting service. Employees are fully vested in BNH's contributions after four years of employment.

18. CONCENTRATIONS OF CREDIT RISK

Baystate Health grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payer agreements. The mix of receivables from patients and third-party payers at September 30, 2018 and 2017, is as follows:

	2018	2017
Medicare	20 %	21 %
Medicaid	17	20
Blue Cross	1	1
Health maintenance organizations	37	34
Commercial	12	12
Self-pay patients	13	12
	100 %	100 %

19. FUNCTIONAL EXPENSES

Baystate Health provides general health care services to residents within their geographic location. Expenses related to providing these services for the years ended September 30, 2018 and 2017, are as follows (in thousands):

	2018	2017
Health care services	$ 2,184,194	$ 2,266,451
General and administrative	131,008	88,024
	$ 2,315,202	$ 2,354,475

20. TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Temporarily restricted net assets at September 30, 2018 and 2017, are available for the following purposes (in thousands):

	2018	2017
Research and education	$ 7,739	$ 9,024
Patient care services	51,371	52,364
	$59,110	$61,388

Permanently restricted net assets are invested in perpetuity, the income which is generally expendable to support the delivery of health care services.

ASC 958-205, *Endowment of Not-for-Profit Organizations*, provides guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA). Massachusetts enacted UPMIFA on July 2, 2009. Baystate Health is subject to ASC 958-205 disclosure requirements regarding its endowment funds.

Baystate Health's endowments consist of numerous individual funds established for a variety of purposes. As required by accounting principles generally accepted in the United States of America, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

Baystate Health requires the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, Baystate Health classifies as permanently restricted net assets: (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment funds that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure. Baystate Health considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds: (a) the duration and preservation of the fund, (b) the purpose of Baystate Health and the donor-restricted endowment fund, (c) general economic conditions, (d) the possible effect of inflation and deflation, (e) the expected total return from income and the appreciation of investments, and (f) the investment policies of Baystate Health.

Endowment net asset composition, by type of fund, as of September 30, 2018 and 2017, consisted of the following (in thousands):

As of September 30, 2018	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Donor-restricted endowment funds	$ -	$44,077	$18,160	$62,237
Board-designated endowment funds	28,867	-	-	28,867
Total endowment net assets	$28,867	$44,077	$18,160	$91,104

As of September 30, 2017	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Donor-restricted endowment funds	$ -	$42,293	$17,932	$60,225
Board-designated endowment funds	27,576	-	-	27,576
Total endowment net assets	$27,576	$42,293	$17,932	$87,801

For the year ended September 30, 2018, Baystate Health had the following endowment-related activities (in thousands):

	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Endowment net assets—October 1, 2017	$27,576	$42,293	$17,932	$87,801
Investment return:				
Investment income	242	523	-	765
Net appreciation	1,489	3,612	-	5,101
Total investment return	1,731	4,135	-	5,866
Contributions	443	-	228	671
Reclassification	159	(88)	-	71
Amounts appropriated for expenditures	(1,042)	(2,263)	-	(3,305)
Total change in endowment funds	1,291	1,784	228	3,303
Endowment net assets—September 30, 2018	$28,867	$44,077	$18,160	$91,104

For the year ended September 30, 2017, Baystate Health had the following endowment-related activities (in thousands):

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets—October 1, 2016	$ 25,267	$ 38,819	$ 17,930	$ 82,016
Investment return:				
Investment income	265	644	-	909
Net appreciation	2,393	5,202	-	7,595
Total investment return	2,658	5,846	-	8,504
Contributions	627	-	2	629
Reclassification	-	(76)	-	(76)
Amounts appropriated for expenditures	(976)	(2,296)	-	(3,272)
Total change in endowment funds	2,309	3,474	2	5,785
Endowment net assets—September 30, 2017	$ 27,576	$ 42,293	$ 17,932	$ 87,801

Baystate Health's investment and spending policies for endowment assets are intended to provide a predictable stream of funding to programs supported by its endowment, while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that Baystate Health must hold in perpetuity or for a donor-specified term. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that will generate a 6.8% return over the long term. Actual returns in any given year may vary from this amount.

To satisfy its long-term rate-of-return objectives, Baystate Health relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). Baystate Health targets a diversified asset allocation that consists of equities, fixed income, and alternative investments.

Baystate Health has a policy of appropriating for distribution each year, no more than 5% of its endowment funds' current fair value. In establishing this policy, Baystate Health considered the long-term expected return on its endowments.

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires Baystate Health to retain as a fund of perpetual duration. There was no deficiency of this nature at September 30, 2018 and 2017.

21. STATE SURPLUS REVENUE RETENTION

Through September 30, 2018, BMC had no surplus in excess of the Commonwealth of Massachusetts' regulations governing the excess of state revenues over expenses for not-for-profit organizations. The total deficit attributable to state contracting for BMC was approximately $67,800 and $126,000 as of September 30, 2018 and 2017, respectively. As of September 30, 2018 and 2017, the cumulative deficit attributable to state contracting of approximately $6,898,000 and $6,831,000, respectively, is included in the unrestricted net assets of BMC.

22. SUBSEQUENT EVENTS

Subsequent events have been evaluated for potential recognition in the consolidated financial statements through December 20, 2018, which is the date the consolidated financial statements were issued.

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