

PUBLIC HOSPITAL DISTRICT NO. 1 OF KING COUNTY
VALLEY MEDICAL CENTER
Management's Discussion and Analysis
September 30, 2012 and 2011
(unaudited)

Public Hospital District No. 1 of King County, Washington (the District), doing business as Valley Medical Center (VMC), is a full-service, public hospital serving over 400,000 District residents. Licensed for 303 beds, VMC has approximately 2,800 employees, including approximately 130 employed physicians, and is the largest nonprofit healthcare provider between Seattle and Tacoma. In addition to the hospital, VMC operates a network of more than two dozen primary care, urgent care, and specialty clinics throughout Southeast King County.

On July 1, 2011, VMC became the eighth member of UW Medicine through an approved strategic alliance agreement executed between the District and UW Medicine. The District continues to own the hospital, the clinic network, and all other assets and liabilities, and all employees are employees of VMC/the District. VMC is managed as a component unit of the University of Washington, subject to the oversight of the Board of Trustees (the Valley Board). The Valley Board oversees the healthcare operations of the District, while a publicly elected Board of Commissioners (the District Board) oversees the District's property taxes and certain non-healthcare related functions.

Summary of Revenue and Expense

The financial statements for the three months ended September 30, 2012 compared to the three months ended September 30, 2011, respectively, have been prepared by VMC's management. The unaudited financial information includes all adjustments that VMC's management considers necessary for a fair presentation of the financial position and results of operations for these periods.

The District changed its fiscal year from a December 31 year-end to a June 30 year-end, effective with the year ending June 30, 2012. Consequently, this Management's Discussion and Analysis discusses the three months spanning July 1 through September 30.

Operating Income and Margin; Total Income and Margin

VMC's net operating loss through September 30, 2012 was (\$4.6 million), and an operating margin of (4.2%) year-to-date. The primary reason for the loss was due to \$9.1 million in operating expenses related to the implementation of the EPIC electronic health record information technology system throughout the organization.

Prior year's year-to-date performance was net operating income of approximately \$867,000, or a .8% operating margin. The District's total income was (\$4.6 million), with a total margin of (4.2%), compared to prior year's total income of \$2.7 million and 2.5% total margin.

Revenues

VMC's total operating revenues increased by 5.3% from approximately \$104.7 million for the three months ended September 30, 2011 to \$110.3 million for the three months ended September 30, 2012.

Net patient revenues increased 4.8% from \$99.8 million for the three months ended September 30, 2011 to \$104.6 million for the three months ended September 30, 2012. Overall, volumes increased year over year. Total patient days increased 8.0%. Surgeries increased 1.7%. Emergency department visits increased 1.8% and births increased 19.2%, respectively, over prior year. Clinic network visits (primary, urgent, and specialty care) increased 6.5% between years.

Other operating revenue increased 16.4% from \$4.9 million for the three months ended September 30, 2011 to \$5.7 million for the three months ended September 30, 2012, due primarily to increased revenue from the outpatient and contracted pharmacies.

Expenses

Total operating expenses increased 10.7% from \$103.9 million for the three months ended September 30, 2011 to \$114.9 million for the three months ended September 30, 2012. The increase in salary and wages between years is primarily related to the patient volume increases, as well as the implementation of EPIC. Employee benefits are correlated to salaries and wages; therefore, a portion of the employee benefit increase is related to the increased labor required by increased volumes and utilization.

Salaries and wages increased 8.6% from \$46.4 million for the three months ended September 30, 2011 to \$50.4 million for the three months ended September 30, 2012. The increase is primarily related to patient volume increases, as well as additional staffing required for the implementation of EPIC, which went live in two phases: July 1, 2012 for the clinic network and October 1, 2012 for the hospital.

Employee benefits increased 8.3% between years. Employee benefits are correlated to salaries and wages; therefore, a significant portion of the increase is related to the increased labor required by increased volumes. There has also been an increase in enrollees over prior year.

Supply and related expenses, such as purchased services, increased 19.3% from \$34.7 million to \$41.4 million between respective September 30 years-to-date figures. Much of the increase (\$5.5 million) is due to consulting and purchased services expense related to the EPIC implementation, as well as increases in medical and pharmaceutical supply expense due to increased volumes.

Depreciation expense decreased 9.3% between September year-to-date figures.

Non-Operating Income and Expense

On a year-to-date basis, tax revenues decreased 15.2%, from \$4.9 million in fiscal year 2011 to \$4.2 million in fiscal year 2012. The District was notified in late January 2012 by the King County Assessor's Office that the District-approved tax levied amount of approximately \$20.1 million would be statutorily reduced in calendar year 2012 to approximately \$16.7 million, due primarily to reductions in assessed property valuations within the District.

Interest and amortization expense increased 5.5% from \$4.3 million at September 30, 2011 to \$4.6 million at September 30, 2012 and directly corresponds to scheduled long term debt/bond payments.

Balance Sheet/Financial Position

Total current assets decreased by 8.7% from \$159.9 million at September 30, 2011 to \$146.0 million at September 30, 2012.

As of September 30, 2012, the District's unrestricted cash and investments, excluding unspent bond proceeds, were \$132.8 million compared with \$160.6 million as of September 30, 2011. Days cash on hand was 113 at September 30, 2012 compared to 138 at September 30, 2011.

Restricted unspent bond proceeds shown under current assets decreased 64.6% between year-to-date figures, representing the spend-down of the bonds on capital projects. Accounts receivable, net of the allowance for uncollectible accounts, increased 17.9% between years; the increase is related to the increase in gross revenues attributable primarily to volumes.

Prepaid expenses and other assets increased 63.6% between September year-to-date figures. The increase was due to prepaid IT maintenance agreements (for EPIC), as well as a Medicaid receivable for prior years.

As of September 30, 2012, capital assets were \$389.0 million compared to \$343.8 million at September 30, 2011. Construction in progress increased 283.8% from \$20.8 million to \$79.9 million. The increases are related to the EPIC implementation, as well as the completion of the top two floors of the Emergency Services Tower, and the construction of the Covington medical building. Depreciable capital assets, net of accumulated depreciation, decreased 4.5%, which is primarily related to the removal of older assets replaced by EPIC or by the construction and opening of the Emergency Services Tower.

Goodwill, intangible assets, and other assets, net, decreased by 28.5%, or approximately \$1.9 million, between September 2011 and September 2012. The decrease was related to accumulated amortization related to goodwill.

Total current liabilities increased by 27.3%, from \$61.1 million at September 30, 2011 to \$77.8 million at September 30, 2012. There are three primary reasons for the increase. The increase in accounts payable is due to timing, as well as capital transactions related to both construction and information technology. The increase in accrued salaries and wages between years is due to timing. The September 30, 2012 date occurred at the end of a full bi-weekly payroll period, resulting in a large accrual comparative to the prior year. Finally, VMC now shows anticipated property taxes as both a property tax receivable (under current assets) and as deferred property tax revenue (under current liabilities); previously, it was shown net. At September 30, 2012, VMC had \$4.2 million in deferred property tax revenue shown under current liabilities.

Long-term debt decreased by 1.3%, from \$335.7 million at September 30, 2011 to \$331.2 million at September 30, 2012. The \$4.4 million decrease is due to repayment of principal.

Valley Medical Center
BALANCE SHEET
For the Three Months Ending September 30, 2012

	(unaudited) September 09/30/12	(unaudited) September 09/30/11
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$26,347,632	\$26,204,641
Short-term investments	12,223,330	25,917,852
Restricted unspent bond proceeds	4,790,375	13,545,857
Accounts receivable, less allowance for uncollectible accounts	54,921,155	46,588,215
Property tax receivable	8,050,202	9,444,995
Noncurrent assets, required for current obligations	26,874,435	28,433,796
Supplies inventory	4,338,968	4,635,177
Prepaid expenses and other assets	8,428,216	5,153,125
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Total current assets	145,974,312	159,923,658
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LONG-TERM INVESTMENTS	26,422,111	22,409,861
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NONCURRENT ASSETS		
Unrestricted for general capital improvements and operations	67,814,106	86,082,527
Restricted for self-insurance reserve funds	6,580,113	2,165,893
Restricted unspent bond proceeds	5,564,087	33,975,489
Restricted under deferred compensation arrangements	3,714,042	3,739,922
Restricted under revenue bond indenture agreements	7,379,681	7,411,050
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	91,052,029	133,374,882
Less amounts required for current obligations	(26,874,435)	(28,433,796)
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Total noncurrent assets	64,177,594	104,941,086
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CAPITAL ASSETS		
Land	13,299,496	13,299,496
Construction in progress	79,887,106	20,816,482
Depreciable capital assets, net of accumulated depreciation	295,840,758	309,713,190
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Total capital assets	389,027,360	343,829,168
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DEFERRED FINANCING COSTS	3,695,206	4,605,345
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GOODWILL, INTANGIBLE ASSETS & OTHER	4,774,616	6,674,102
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Total assets	\$634,071,200	\$642,383,219
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**Valley Medical Center
BALANCE SHEET
For the Three Months Ending September 30, 2012**

	<u>(unaudited) September 09/30/12</u>	<u>(unaudited) September 09/30/11</u>
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$15,043,489	\$7,258,905
Accrued salaries, wages and benefits	33,446,075	28,625,602
Other accrued liabilities, including estimated third-party payor settlements	4,443,143	3,402,638
Interest, patient refunds and other	12,677,103	9,263,637
Deferred property tax revenue	4,196,523	0
Current portion of long-term debt and capital lease obligations	7,998,285	12,549,404
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Total current liabilities	77,804,617	61,100,186
DEFERRED COMPENSATION	3,413,267	3,176,332
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, net of current portion	331,246,315	335,666,585
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Total liabilities	412,464,200	399,943,103
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NET ASSETS		
Invested in capital assets net of related debt	60,103,092	45,120,811
Restricted		
For debt service	7,379,681	7,411,050
Expendable for specific operating activities	358,183	332,180
Unrestricted	153,766,044	189,576,074
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Total net assets	221,607,001	242,440,116
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Total liabilities and net assets	\$634,071,200	\$642,383,219
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Valley Medical Center
STATEMENT OF REVENUE AND EXPENSE AND CHANGES IN NET ASSETS
For the Three Months Ending September 30, 2012

	(unaudited) September 09/30/12	(unaudited) September 09/30/11
OPERATING REVENUES		
Net patient service revenue (net of Provision for bad debts)	\$104,609,812	\$99,825,456
Other operating revenue	5,704,209	4,901,329
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Total operating revenues	110,314,020	104,726,785
OPERATING EXPENSES		
Salaries and wages	50,408,024	46,414,625
Employee benefits	15,227,732	14,055,714
Supplies and other expenses	41,388,430	34,680,471
Depreciation	7,902,366	8,708,992
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Total operating expenses	114,926,552	103,859,802
OPERATING INCOME	(4,612,532)	866,983
NONOPERATING INCOME (EXPENSE)		
Revenue from taxation	4,153,456	4,896,174
Interest income	570,528	1,065,018
Interest and amortization expense	(4,554,760)	(4,315,354)
Net increase (decrease) in FV of investments	(157,357)	210,528
Other, net	(43,331)	(69,002)
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Net nonoperating income (expense)	(31,463)	1,787,365
INCREASE IN NET ASSETS	(4,643,995)	2,654,347
NET ASSETS, beginning of year	226,250,996	234,865,822
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NET ASSETS, end of year	\$221,607,001	\$237,520,170
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Valley Medical Center
Statement of Cash Flows
For the Three Months Ending September 30, 2012

Increase (Decrease) in Cash and Cash Equivalents

	UNAUDITED	AUDITED
	PERIOD ENDED	
	September 30,	June 30,
	<u>2012</u>	<u>2012</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from and on behalf of patients	\$ 103,627,282	\$ 401,653,878
Payments to suppliers and contractors	(37,078,568)	(149,832,926)
Payments to employees	(65,104,678)	(254,536,668)
Other cash receipts	4,657,514	18,298,958
	<u>6,101,550</u>	<u>15,583,242</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Cash received from tax levy	388,425	17,831,507
Other	(342)	27,294
	<u>388,083</u>	<u>17,858,801</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Proceeds from issuance of refunding bonds	-	35,636,412
Payment to refunding bond escrow agent	-	(34,630,000)
Cash paid for bond issuance	-	(115,637)
Principal payments on long-term debt and capital lease obligations	(27,076)	(7,575,868)
Interest paid, net of amounts capitalized	265,743	(17,424,855)
Purchases of capital assets	(18,666,729)	(66,436,800)
Purchase of VM Oncology	-	(1,370,000)
Purchase of Valley Women's Healthcare Clinic	-	(865,000)
Other	(25,812)	(919,410)
	<u>(18,453,874)</u>	<u>(93,701,158)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Distributions from joint venture	1,064,742	4,227,979
Sale of investments and noncurrent assets	19,102,175	88,049,091
Purchases of investments and noncurrent assets	(7,009,784)	(48,473,001)
Investment and interest income, net of amounts capitalized	570,528	3,900,299
	<u>13,727,661</u>	<u>47,704,368</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	1,763,420	(12,554,747)
CASH AND CASH EQUIVALENTS, beginning of year	24,584,212	37,138,959
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 26,347,632</u>	<u>\$ 24,584,212</u>
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE STATEMENT OF NET ASSETS		
Cash and cash equivalents	<u>\$ 26,347,632</u>	<u>\$ 24,584,212</u>

Valley Medical Center
Statement of Cash Flows
For the Three Months Ending September 30, 2012

Increase (Decrease) in Cash and Cash Equivalents

	UNAUDITED PERIOD ENDED September 30, <u>2012</u>	AUDITED PERIOD ENDED June 30, <u>2012</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH FROM OPERATING ACTIVITIES		
Operating income	\$ (4,612,532)	\$ (8,677,598)
Adjustments to reconcile operating income to net cash from operating activities		
Interest expense considered a capital financing activity		
Revenue from tax levies considered a noncapital financing activity		
Interest income considered an investing activity		
Depreciation	7,902,366	32,528,941
Amortization		
Provision for bad debts	8,320,139	33,915,355
Income recognized from joint venture	(1,046,695)	(4,635,286)
Amount expensed from purchase of VM Healthcare Clinic		184,000
Changes in assets and liabilities		
Accounts receivable	(10,108,252)	(37,987,367)
Supplies inventory	(92,257)	314,528
Prepaid expenses and other assets	2,173,901	(3,662,486)
Accounts payable	3,067,279	690,912
Accrued salaries, wages, and benefits	373,510	141,874
Estimated third-party payor settlements	805,583	109,821
Other liabilities	(839,060)	2,440,940
Deferred compensation	157,568	219,609
NET CASH FROM OPERATING ACTIVITIES	<u>\$ 6,101,550</u>	<u>\$ 15,583,243</u>
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Increase (decrease) in capital assets included in accounts payable	<u>\$ (7,330,204)</u>	<u>\$ 7,922,116</u>
Equipment financed with capital lease obligations	<u>\$ -</u>	<u>\$ -</u>

Valley Medical Center

FY 13 Quarter 1 (July - September 2012)

Key Statistics

	<u>July - September</u> <u>FY13</u>	<u>July - September</u> <u>FY12</u>	<u>FY13 to FY12</u> <u>Variance</u>
Discharges	4,333	4,172	3.9%
Patient Days	16,471	15,247	8.0%
Average Daily Census	179	166	7.8%
Length of Stay	3.80	3.65	4.0%
Occupancy	66%	64%	3.1%
Case Mix Index	1.28	1.27	0.8%
OR Inpatient/Outpatient Cases	2,835	2,788	1.7%
Emergency Room Visits	19,290	18,956	1.8%
Births	1,169	981	19.2%
Hospital Outpatient Visits	47,040	48,785	-3.6%
VMG Primary and Urgent Care visits	49,904	48,148	3.6%
VMG Specialty Care visits	35,996	32,521	10.7%
FTEs	2,478	2,413	2.7%