

PUBLIC HOSPITAL DISTRICT NO. 1 OF KING COUNTY
VALLEY MEDICAL CENTER
Management's Discussion and Analysis
December 31, 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 six months ended December 31, 2012 compared to the six months ended December 31, 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 six months spanning July 1 through December 31.

Operating Income and Margin; Total Income and Margin

VMC's net operating loss through December 31, 2012 was (\$17.1 million), and an operating margin of (7.8%) year-to-date. The primary reason for the loss was due to approximately \$20.0 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 loss of approximately \$(1.4 million), or a (.7%) operating margin. The District's total loss was (\$15.7 million), with a total margin of (7.2%), compared to prior year's total income of \$2.2 million and 1.0% total margin.

Revenues

VMC's total operating revenues increased by 4.1% from approximately \$210.7 million for the six months ended December 31, 2011 to \$219.3 million for the six months ended December 31, 2012.

Net patient revenues increased 3.8% from \$199.6 million for the six months ended December 31, 2011 to \$207.1 million for the six months ended December 31, 2012. Overall, volumes increased year

over year. Total patient days increased 7.8%. Surgeries increased .5%. Emergency department visits increased 3.3% and births increased 19.2%, respectively, over prior year. Clinic network visits (primary, urgent, and specialty care) increased 9.9% between years.

Other operating revenue increased 9.7% from \$11.1 million for the six months ended December 31, 2011 to \$12.2 million for the six months ended December 31, 2012, due primarily to increased revenue from the outpatient and contracted pharmacies.

Expenses

Total operating expenses increased 11.4% from \$212.1 million for the six months ended December 31, 2011 to \$236.4 million for the six months ended December 31, 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 7.3% from \$95.6 million for the six months ended December 31, 2011 to \$102.6 million for the six months ended December 31, 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 16.0% 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 19.2% from \$71.6 million to \$85.3 million between respective December 31 years-to-date figures. Much of the increase (approximately \$10.0 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 5.4% between December year-to-date figures.

Non-Operating Income and Expense

On a year-to-date basis, tax revenues decreased 14.7%, from \$9.8 million in fiscal year 2011 to \$8.4 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 3.7% from \$8.7 million at December 31, 2011 to \$9.0 million at December 31, 2012 and directly corresponds to scheduled long term debt/bond payments.

Balance Sheet/Financial Position

Total current assets decreased by 2.5% from \$137.1 million at December 31, 2011 to \$133.7 million at December 31, 2012.

As of December 31, 2012, the District's unrestricted cash and investments, excluding unspent bond proceeds, were \$105.6 million compared with \$145.8 million as of December 31, 2011. Days cash on hand was 88 at December 31, 2012 compared to 126 at December 31, 2011.

Restricted unspent bond proceeds shown under non-current assets decreased 96.6% 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 25.5% between years; the increase is related to the increase in gross revenues attributable primarily to volumes and the implementation of EPIC.

As of December 31, 2012, capital assets were \$390.2 million compared to \$364.7 million at December 31, 2011. Construction in progress decreased 32.6% from \$48.2 million to \$32.5 million. The change is due to the capitalization of the EPIC implementation, as well as the ongoing construction of the Covington medical building and the completion of the 6th and 7th floors of the Emergency Services Tower. Depreciable capital assets, net of accumulated depreciation, increased 13.6%, primarily related to the capitalization of EPIC.

Goodwill, intangible assets, and other assets, net, decreased by 1.9%, between years. The decrease was related to accumulated amortization related to goodwill.

Total current liabilities decreased by 14.2%, from \$73.2 million at December 31, 2011 to \$62.8 million at December 31, 2012. There are several reasons for the change. The decrease in accounts payable is due to the completion of construction and IT related projects. The increase in accrued salaries and wages between years is due to timing related to bi-weekly pay periods.

Long-term debt decreased by 2.5%, from \$333.8 million at December 31, 2011 to \$325.6 million at December 31, 2012. The \$8.3 million decrease is due to repayment of principal.

Valley Medical Center
BALANCE SHEET
For the Six Months Ending December 31, 2012

	December 12/31/12	December 12/31/11
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$17,478,356	\$16,515,112
Short-term investments	10,931,607	20,707,084
Restricted unspent bond proceeds	4,148,868	9,129,377
Accounts receivable, less allowance for uncollectible accounts	61,345,845	48,863,788
Property tax receivable	469,619	568,541
Noncurrent assets, required for current obligations	26,371,056	27,130,260
Supplies inventory	4,391,383	4,916,857
Prepaid expenses and other assets	8,544,229	9,223,099
	133,680,965	137,054,118
	26,721,404	26,814,280
LONG-TERM INVESTMENTS		
NONCURRENT ASSETS		
Unrestricted for general capital improvements and operations	50,814,493	81,749,423
Restricted for self-insurance reserve funds	6,664,452	2,611,453
Restricted unspent bond proceeds	1,290,042	37,759,173
Restricted under deferred compensation arrangements	3,539,551	3,554,192
Restricted under revenue bond indenture agreements	7,450,407	7,341,416
	69,758,945	133,015,656
Less amounts required for current obligations	(26,371,056)	(27,130,260)
	43,387,889	105,885,396
CAPITAL ASSETS		
Land	13,299,496	13,299,496
Construction in progress	32,499,879	48,225,847
Depreciable capital assets, net of accumulated depreciation	344,403,682	303,156,704
	390,203,058	364,682,047
DEFERRED FINANCING COSTS	3,611,504	4,551,960
GOODWILL, INTANGIBLE ASSETS & OTHER	4,654,562	4,742,292
	\$602,259,381	\$643,730,093
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Valley Medical Center
BALANCE SHEET
For the Six Months Ending December 31, 2012

	December 12/31/12	December 12/31/11
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$10,028,922	\$25,754,757
Accrued salaries, wages and benefits	32,609,084	27,708,137
Other accrued liabilities, including estimated third-party payor settlements	2,541,879	4,772,989
Interest, patient refunds and other	9,445,692	6,046,959
Current portion of long-term debt and capital lease obligations	8,198,936	8,919,220
	62,824,512	73,202,063
DEFERRED COMPENSATION	3,308,703	3,040,178
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, net of current portion	325,577,335	333,846,069
	391,710,549	410,088,310
NET ASSETS		
Invested in capital assets net of related debt	61,778,464	70,689,349
Restricted		
For debt service	7,450,407	7,341,416
Expendable for specific operating activities	358,525	348,589
Unrestricted	140,961,436	155,262,429
	210,548,832	233,641,783
Total liabilities and net assets	\$602,259,381	\$643,730,093

Valley Medical Center
STATEMENT OF REVENUE AND EXPENSE AND CHANGES IN NET ASSETS
For the Six Months Ending December 31, 2012

	December 12/31/12	December 12/31/11
OPERATING REVENUES		
Net patient service revenue (net of Provision for bad debts)	\$207,089,479	\$199,576,718
Other operating revenue	12,226,106	11,148,149
	219,315,585	210,724,867
OPERATING EXPENSES		
Salaries and wages	102,587,314	95,582,013
Employee benefits	32,249,779	27,805,986
Supplies and other expenses	85,330,806	71,610,654
Depreciation	16,198,675	17,129,394
	236,366,573	212,128,048
OPERATING INCOME	(17,050,988)	(1,403,181)
NONOPERATING INCOME (EXPENSE)		
Revenue from taxation	8,335,811	9,772,719
Interest income	1,911,079	1,724,622
Interest and amortization expense	(9,042,735)	(8,717,560)
Net increase (decrease) in FV of investments	273,657	1,230,298
Other, net	(128,989)	(423,303)
	1,348,824	3,586,777
INCREASE IN NET ASSETS	(15,702,164)	2,183,596
NET ASSETS, beginning of year	226,250,996	231,458,187
NET ASSETS, end of year	\$210,548,832	\$233,641,783

Valley Medical Center
Statement of Cash Flows
For the Six Months Ending December 31, 2012

Increase (Decrease) in Cash and Cash Equivalents

	UNAUDITED PERIOD ENDED December 31, <u>2012</u>	AUDITED PERIOD ENDED June 30, <u>2012</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from and on behalf of patients	\$ 197,780,995	\$ 401,653,878
Payments to suppliers and contractors	(84,099,063)	(149,832,926)
Payments to employees	(135,247,570)	(254,536,668)
Other cash receipts	<u>10,685,637</u>	<u>18,298,958</u>
Net cash from operating activities	<u>(10,880,001)</u>	<u>15,583,242</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Cash received from tax levy	7,954,840	17,831,507
Other	-	<u>27,294</u>
Net cash from noncapital financing activities	<u>7,954,840</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	(5,576,414)	(7,575,868)
Interest paid, net of amounts capitalized	(8,479,960)	(17,424,855)
Purchases of capital assets	(29,475,347)	(66,436,800)
Purchase of VM Oncology	-	(1,370,000)
Purchase of Valley Women's Healthcare Clinic	-	(865,000)
Other	<u>5,334</u>	<u>(919,410)</u>
Net cash from capital and related financing activities	<u>(43,526,387)</u>	<u>(93,701,158)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Distributions from joint venture	1,984,187	4,227,979
Sale of investments and noncurrent assets	55,426,141	88,049,091
Purchases of investments and noncurrent assets	(19,975,715)	(48,473,001)
Investment and interest income, net of amounts capitalized	<u>1,911,079</u>	<u>3,900,299</u>
Net cash from investing activities	<u>39,345,692</u>	<u>47,704,368</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	<u>(7,105,856)</u>	<u>(12,554,747)</u>
CASH AND CASH EQUIVALENTS, beginning of year	<u>24,584,212</u>	<u>37,138,959</u>
CASH AND CASH EQUIVALENTS, end of year	<u><u>\$ 17,478,356</u></u>	<u><u>\$ 24,584,212</u></u>
RECONCILIATION OF CASH AND CASH EQUIVALENTS TO THE STATEMENT OF NET ASSETS		
Cash and cash equivalents	<u><u>\$ 17,478,356</u></u>	<u><u>\$ 24,584,212</u></u>

Valley Medical Center
Statement of Cash Flows
For the Six Months Ending December 31, 2012

Increase (Decrease) in Cash and Cash Equivalents

	UNAUDITED PERIOD ENDED <u>December 31,</u> <u>2012</u>	AUDITED <u>June 30,</u> <u>2012</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH FROM OPERATING ACTIVITIES		
Operating income	\$ (17,050,988)	\$ (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	16,198,675	32,528,941
Amortization		
Provision for bad debts	15,830,951	33,915,355
Income recognized from joint venture	(1,540,469)	(4,635,286)
Amount expensed from purchase of VM Healthcare Clinic		184,000
Changes in assets and liabilities		
Accounts receivable	(24,043,754)	(37,987,367)
Supplies inventory	(144,672)	314,528
Prepaid expenses and other assets	1,632,217	(3,662,486)
Accounts payable	(727,822)	690,912
Accrued salaries, wages, and benefits	(463,481)	141,874
Estimated third-party payor settlements	(1,095,681)	109,821
Other liabilities	472,019	2,440,940
Deferred compensation	53,004	219,609
NET CASH FROM OPERATING ACTIVITIES	<u>\$ (10,880,001)</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>\$ (8,549,670)</u>	<u>\$ 7,922,116</u>
Equipment financed with capital lease obligations	<u>\$ -</u>	<u>\$ -</u>

Valley Medical Center

FY 13 Quarter 2 (July - December 2012)

Key Statistics

	<u>July - December</u> <u>FY13</u>	<u>July - December</u> <u>FY12</u>	<u>FY13 to FY12</u> <u>Variance</u>
Discharges	8,848	8,314	6.4%
Patient Days	33,302	30,897	7.8%
Average Daily Census	181	168	7.7%
Length of Stay	3.76	3.72	1.1%
Occupancy	67%	65%	3.1%
Case Mix Index	1.30	1.29	0.8%
OR Inpatient/Outpatient Cases	5,679	5,653	0.5%
Emergency Room Visits	37,954	36,756	3.3%
Births	2,244	1,883	19.2%
Hospital Outpatient Visits	96,096	99,864	-3.8%
VMG Primary and Urgent Care visits	107,115	100,767	6.3%
VMG Specialty Care visits	74,581	64,532	15.6%
FTEs	2,477	2,444	1.4%