

CONSOLIDATED FINANCIAL STATEMENTS

Indiana University Health, Inc. and subsidiaries  
Years Ended December 31, 2014 and 2013  
With Report of Independent Auditors

Ernst & Young LLP



Building a better  
working world

Indiana University Health, Inc. and subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2014 and 2013

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## Report of Independent Auditors

The Board of Directors  
Indiana University Health, Inc. and subsidiaries

We have audited the accompanying consolidated financial statements of Indiana University Health, Inc. and subsidiaries, which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operations and 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 Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free of material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.



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

### **Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Indiana University Health, Inc. and subsidiaries at December 31, 2014 and 2013, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

*Ernst & Young LLP*

March 26, 2015

Indiana University Health, Inc. and subsidiaries

Consolidated Balance Sheets

(Dollars in Thousands)

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 527,682	\$ 442,672
Patient accounts receivable, less allowance for uncollectible accounts of \$197,120 and \$270,743 at 2014 and 2013, respectively	684,108	659,402
Other receivables	150,264	126,552
Prepaid expenses	48,577	39,341
Inventories	75,355	75,340
Current portion of trustee-held funds	–	114
Total current assets	<u>1,485,986</u>	<u>1,343,421</u>
Assets limited as to use:		
Board-designated investment funds and other investments	3,113,805	2,524,831
Donor-restricted investment funds	76,887	94,057
Trustee-held funds for construction and debt service, less current portion	–	10,242
Total assets limited as to use, less current portion	<u>3,190,692</u>	<u>2,629,130</u>
Property and equipment:		
Cost of property and equipment in service	5,845,564	5,690,685
Less accumulated depreciation	<u>(3,177,729)</u>	<u>(3,036,691)</u>
	2,667,835	2,653,994
Construction-in-progress	<u>32,997</u>	<u>115,053</u>
Total property and equipment, net	<u>2,700,832</u>	<u>2,769,047</u>
Other assets:		
Equity interest in unconsolidated subsidiaries	49,202	44,578
Interest in net assets of foundations	13,976	13,849
Unamortized bond issuance costs	6,116	6,659
Goodwill, intangibles, and other assets	<u>219,981</u>	<u>244,390</u>
Total other assets	<u>289,275</u>	<u>309,476</u>
Total assets	<u><u>\$ 7,666,785</u></u>	<u><u>\$ 7,051,074</u></u>

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 400,269	\$ 466,772
Accrued salaries, wages, and related liabilities	293,112	269,641
Accrued health claims	56,469	57,684
Estimated third-party payor allowances	107,679	90,467
Current portion of long-term debt	78,757	116,149
Total current liabilities	<u>936,286</u>	1,000,713
Noncurrent liabilities:		
Long-term debt, less current portion	1,618,812	1,682,649
Interest rate swaps	145,339	139,072
Accrued pension obligations	96,211	23,992
Accrued medical malpractice claims	63,663	61,438
Other	57,496	51,785
Total noncurrent liabilities	<u>1,981,521</u>	1,958,936
Total liabilities	<u>2,917,807</u>	2,959,649
Net assets:		
Indiana University Health	4,464,244	3,802,631
Noncontrolling interest in subsidiaries	186,587	180,680
Total unrestricted	<u>4,650,831</u>	3,983,311
Temporarily restricted	30,905	41,554
Permanently restricted	67,242	66,560
Total net assets	<u>4,748,978</u>	4,091,425

Total liabilities and net assets	<u><u>\$ 7,666,785</u></u>	<u><u>\$ 7,051,074</u></u>
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*See accompanying notes.*

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Operations and Changes in Net Assets  
(Dollars in Thousands)

	<b>Year Ended December 31</b>	
	<b>2014</b>	<b>2013</b>
Revenues:		
Patient service revenue (net of contractuales and discounts)	<b>\$ 5,557,672</b>	\$ 5,228,038
Provision for uncollectible accounts	<b>(299,255)</b>	(343,136)
Net patient service revenue	<b>5,258,417</b>	4,884,902
Member premium revenue	<b>259,771</b>	156,564
Other revenue	<b>208,395</b>	205,416
Total operating revenues	<b>5,726,583</b>	5,246,882
Expenses:		
Salaries, wages, and benefits	<b>2,501,644</b>	2,635,648
Supplies, drugs, purchased services, and other	<b>1,735,338</b>	1,750,948
Hospital assessment fee	<b>197,994</b>	82,442
Health claims to providers	<b>170,970</b>	94,446
Depreciation and amortization	<b>251,210</b>	248,825
Interest	<b>56,630</b>	61,019
Total operating expenses	<b>4,913,786</b>	4,873,328
Operating income before educational and research support	<b>812,797</b>	373,554
Educational and research support to Indiana University	<b>(17,500)</b>	(50,000)
Total operating income	<b>795,297</b>	323,554
Nonoperating income:		
Investment income, net	<b>38,755</b>	191,083
(Losses) gains on interest rate swaps, net	<b>(21,939)</b>	11,379
Inherent contribution of acquired entities	<b>2,665</b>	-
Gain on sales and acquisitions and other	<b>926</b>	14,815
Total nonoperating income	<b>20,407</b>	217,277
Consolidated excess of revenues over expenses	<b>815,704</b>	540,831
Less amounts attributable to noncontrolling interest in subsidiaries	<b>90,175</b>	92,846
Excess of revenues over expenses attributable to Indiana University Health and subsidiaries	<b>725,529</b>	447,985

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Operations and Changes in Net Assets (continued)

(Dollars in Thousands)

	December 31, 2014			December 31, 2013		
	Total	Controlling	Noncontrolling	Total	Controlling	Noncontrolling
Unrestricted net assets:						
Excess of revenues over expenses	\$ 815,704	\$ 725,529	\$ 90,175	\$ 540,831	\$ 447,985	\$ 92,846
Change in pension obligations	(72,149)	(72,149)	–	86,055	86,055	–
Contributions for capital expenditures	5,652	5,652	–	8,142	8,142	–
Distributions to noncontrolling interests	(92,026)	–	(92,026)	(82,838)	–	(82,838)
Sale of member interest to noncontrolling member	5,194	(834)	6,028	–	–	–
Restriction reclassification	2,698	2,698	–	2,000	2,000	–
Other	2,447	717	1,730	2,286	504	1,782
	<b>667,520</b>	<b>661,613</b>	<b>5,907</b>	<b>556,476</b>	<b>544,686</b>	<b>11,790</b>
Temporarily restricted net assets:						
Change in beneficial interest in net assets of foundations	352	352	–	642	642	–
Contributions	6,416	6,416	–	4,341	4,341	–
Investment return	(1,049)	(1,049)	–	3,252	3,252	–
Net assets released from restrictions	(9,670)	(9,670)	–	(1,230)	(1,230)	–
Restriction reclassification	(2,698)	(2,698)	–	(2,000)	(2,000)	–
Other	(4,000)	(4,000)	–	–	–	–
	<b>(10,649)</b>	<b>(10,649)</b>	<b>–</b>	<b>5,005</b>	<b>5,005</b>	<b>–</b>
Permanently restricted net assets:						
Change in beneficial interest in net assets of foundations	428	428	–	52	52	–
Contributions and other	254	254	–	244	244	–
	<b>682</b>	<b>682</b>	<b>–</b>	<b>296</b>	<b>296</b>	<b>–</b>
Increase in net assets	657,553	651,646	5,907	561,777	549,987	11,790
Net assets at beginning of year	4,091,425	3,910,745	180,680	3,529,648	3,360,758	168,890
Net assets at end of year	<b>\$ 4,748,978</b>	<b>\$ 4,562,391</b>	<b>\$ 186,587</b>	<b>\$ 4,091,425</b>	<b>\$ 3,910,745</b>	<b>\$ 180,680</b>

See accompanying notes.



Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Cash Flows  
(Dollars in Thousands)

	<b>Year Ended December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Operating activities</b>		
Increase in net assets	\$ 657,553	\$ 561,777
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Change in fair value of interest rate swaps	6,267	(26,851)
Change in pension liability	72,149	(86,055)
Income in unconsolidated subsidiaries	(1,066)	(1,145)
Provision for uncollected patient accounts	299,255	343,136
Inherent contribution of acquired entities	(2,665)	–
Gain on sale of clinics	–	(12,734)
Impairment of unconsolidated subsidiaries	2,073	10,134
Depreciation and amortization	251,210	248,825
Amortization of deferred gain on sale of medical office buildings	(2,122)	(2,216)
Loss on extinguishment of debt	2,313	–
Increase in restricted net assets	(6,401)	(8,531)
Proceeds from the sale of member interests to noncontrolling member	(5,194)	–
Distributions to noncontrolling interests	92,026	82,838
Trading securities	(561,448)	(552,691)
Net changes in operating assets and liabilities:		
Patient accounts receivable	(323,961)	(384,990)
Other assets	(13,746)	26,635
Accounts payable and accrued liabilities and other liabilities	(57,909)	40,936
Salaries, wages, and related liabilities	23,471	(8,411)
Estimated third-party payor allowances	17,212	(17,085)
Net cash provided by operating activities	<u>449,017</u>	<u>213,572</u>

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Cash Flows (continued)

(Dollars in Thousands)

	<b>Year Ended December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Investing activities</b>		
Proceeds from sale of clinics	\$ —	\$ 13,050
Purchase of property and equipment, net of disposals	<b>(180,034)</b>	(245,792)
Net cash used in investing activities	<b>(180,034)</b>	(232,742)
<b>Financing activities</b>		
Increase in restricted net assets	<b>6,401</b>	8,531
Repayments on long-term debt	<b>(173,507)</b>	(78,484)
Proceeds from issuance of long-term debt	<b>69,965</b>	3,003
Proceeds from sale of member interests to noncontrolling member	<b>5,194</b>	—
Distributions to noncontrolling interests	<b>(92,026)</b>	(82,838)
Net cash used in financing activities	<b>(183,973)</b>	(149,788)
Increase (decrease) in cash and cash equivalents	<b>85,010</b>	(168,958)
Cash and cash equivalents at beginning of year	<b>442,672</b>	611,630
Cash and cash equivalents at end of year	<b>\$ 527,682</b>	\$ 442,672

*See accompanying notes.*

# Indiana University Health, Inc. and subsidiaries

## Notes to Consolidated Financial Statements (Thousands of Dollars)

December 31, 2014 and 2013

### **Mission Statement**

*The mission of Indiana University Health is to improve the health of our patients and community through innovation and excellence in care, education, research, and service.*

*Indiana University Health will preserve, strengthen, and build upon these values:*

*A patient's **total care**, including mind, body, and spirit*

*Excellence in **education** for health care providers*

*Quality of care and **respect** for life*

***Charity**, equality and justice in health care*

*Leadership in health promotion and **wellness***

*Excellence in **research***

*An internal community of **trust** and respect*

## **1. Organization and Nature of Operations**

### **History and Organization**

Indiana University Health, Inc. (Indiana University Health) and subsidiaries operate as a health care delivery system, which includes an academic health center affiliated with Indiana University, providing health care services throughout the state of Indiana. Health care services provided by Indiana University Health and its subsidiaries (hereinafter referred to as the Indiana University Health System) include acute, nonacute, tertiary, and quaternary care services on an inpatient, outpatient, and emergency basis; medical education and research; medical management services; health care diagnostic and treatment services for individuals and families in physician clinics and physician-group practices; and personal and home health care.

Indiana University Health was formed as an Indiana nonprofit corporation through a consolidation, as of January 1, 1997, under the terms of a Definitive Health Care Resources Consolidation Agreement, as amended (the Consolidation Agreement), and certain other related agreements by and between the Trustees of Indiana University and Methodist Health Group, Inc. (successor to Methodist Hospital). The facilities and operations of Indiana University Health University Hospital (University Hospital), Riley Hospital for Children of Indiana University Health (Riley Hospital), and Indiana University Health Methodist Hospital (Methodist Hospital) (collectively, the Downtown Hospitals of the Academic Health Center) were merged and consolidated to form a single corporate entity, which was then licensed as a single acute care

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **1. Organization and Nature of Operations (continued)**

hospital and operates as an academic health center. Members of the Board of Directors (the Board) of Indiana University Health are selected by its two classes of members: the Methodist Class (members of which are members of Methodist Health Group, Inc.) and the University Class (members of which are the individuals who are the Trustees of Indiana University).

The Consolidation Agreement requires that the salaries and related employee benefit costs be funded for medical doctor interns and residents of the Indiana University School of Medicine (the School of Medicine). The Board annually reviews and determines the level of support to the School of Medicine for these programs and the number of internships and residencies to be supported. The Consolidation Agreement also provides for additional support to the School of Medicine to recognize, as a result of the consolidation, the enhanced and increased level of services being provided, including services to the medically indigent through medical education and research.

#### **Nature of Operations**

The Indiana University Health System operates as an integrated health care delivery system comprising nonprofit and for-profit entities, with coordinated activities and policies designed to meet the mission of the Indiana University Health System. The principal operating activities of the Indiana University Health System are conducted at owned facilities or majority-owned or controlled subsidiaries and consist of the following.

**Downtown Hospitals of the Academic Health Center (Hospital Campuses)** – Consist of three acute, tertiary, and quaternary care, and diagnostic facilities, licensed as a single hospital, which constitutes the principal hospital activities of the academic health center and whose operations are located in the downtown area of Indianapolis, Indiana. These three hospitals, Methodist Hospital, University Hospital, and Riley Hospital, are located on or near the campus of Indiana University-Purdue University in Indianapolis and the School of Medicine.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### 1. Organization and Nature of Operations (continued)

**Central Indiana Facilities (Indiana University Health West Hospital (West), Indiana University Health North Hospital (North), Indiana University Health Tipton Hospital (Tipton), Indiana University Health Saxony Hospital (Saxony), and Rehabilitation Hospital of Indiana (RHI))** – Consist of three acute care hospitals, a critical access hospital, and an acute care rehabilitation hospital located in the western and northern suburban areas of metropolitan Indianapolis, Indiana. Saxony operates as a division of the academic health center.

**Statewide Facilities** – Consist of acute care hospitals and health care systems located in Bedford, Bloomington, Goshen, Hartford City, Knox, Lafayette, La Porte, Martinsville, Monticello, Muncie, and Paoli, Indiana. Principal hospital subsidiaries include Indiana University Health Bedford Hospital (Bedford), Indiana University Health Arnett Hospital (Arnett), Indiana University Health La Porte Hospital and subsidiaries (La Porte) including Indiana University Health Starke (Starke), Indiana University Health Goshen and subsidiaries (Goshen), Indiana University Health Ball Memorial Hospital and subsidiaries (Ball Memorial) including Indiana University Health Blackford (Blackford), Indiana University Health Bloomington Hospital and subsidiaries (Bloomington) including Indiana University Health Paoli (Paoli), Indiana University Health Morgan Hospital (Morgan), and Indiana University Health White Memorial Hospital (White).

**Physician Operations** – Consist of physician offices and physician-group practices and clinics. Principal subsidiaries or divisions include Indiana University Health Physicians (IUHP), a nonprofit organization with locations primarily in Indianapolis, Indiana, Indiana University Health Arnett Physicians, Indiana University Health Ball Memorial Physicians, Indiana University Health Southern Indiana Physicians, Indiana University Health La Porte Physicians, Indiana University Health Goshen Physicians, and Indiana University Health Transplant Institute.

**Ambulatory Care** – Consists of personal and home health care services, outpatient oncology services, and outpatient surgery centers, which are located throughout the state of Indiana. Principal subsidiaries or divisions include Indiana University Health Home Care, Central Indiana Cancer Centers, and seven joint venture surgery centers.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### 1. Organization and Nature of Operations (continued)

**Medical Risk** – Consists of the medical management of health care services of members whose health care coverage is provided by the managed care networks of the Indiana University Health System.

**Foundations** – Indiana University Health is the sole corporate member of Methodist Health Foundation, Inc. (Methodist Health Foundation), which aids and supports Methodist Hospital and other programs and areas of Indiana University Health. Tipton is the sole corporate member of Tipton County Health Care Foundation, Inc. (Tipton Foundation), which aids in carrying out the mission of Tipton. Ball Memorial is the sole corporate member of Indiana University Ball Memorial Hospital Foundation (BMH Foundation), which aids in carrying out the mission of Ball Memorial. Morgan is the sole corporate member of Indiana University Health Morgan Hospital Foundation (Morgan Foundation), which aids and supports Morgan. Arnett is the sole corporate member of Indiana University Health Arnett Hospital Foundation (Arnett Foundation), which aids and supports Arnett. RHI is the sole corporate member of Rehabilitation Hospital of Indiana Foundation (RHI Foundation), which aids and supports RHI. Goshen is the sole corporate member of Indiana University Health Goshen Foundation (Goshen Foundation), which aids and supports Goshen. Paoli is the sole corporate member of IU Health Paoli Hospital Foundation (Paoli Foundation), which aids and supports Paoli.

#### 2. Community Benefit and Charity Care

The Indiana University Health System provides health care services and other financial support through various programs that are designed, among other matters, to enhance the health of the community, improve the health of low-income patients, and foster medical education and research through its affiliation with the School of Medicine. In addition, the Indiana University Health System provides services intended to benefit the poor and underserved, including those persons who cannot afford health insurance because of inadequate resources or those who are uninsured or underinsured. Health care services to patients under government programs, such as Medicare and Medicaid, are also considered part of the Indiana University Health System's benefit provided to the community since a substantial portion of such services are reimbursed at amounts less than cost.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **2. Community Benefit and Charity Care (continued)**

The Indiana University Health System's financial assistance policies are designed to provide care to patients regardless of their ability to pay, and all uninsured patients are eligible for discounts from established charges. Patients who meet certain criteria (generally based on up to 400% of federal poverty income guidelines for in-state patients, other patients who are victims of certain catastrophic events, or those who meet criteria to be part of the Indiana University Health System's medical education and research programs) are provided care without charge or at amounts less than established rates.

Net patient service revenue is reported at estimated net realizable amounts for services rendered. The Indiana University Health System recognizes patient service revenue associated with patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, revenue is recognized on the basis of discounted rates in accordance with the uninsured discount policy.

The amount of charity care provided is determined based on the qualifying criteria, as defined in the financial assistance policies, through approved applications completed by patients and their families or beneficiaries, or based on analysis of patients without third-party insurance coverage who did not apply for charity and whose income was equal to or less than 200% of federal poverty income guidelines. No payment for services is anticipated for those patients whose charity care applications have been approved, as well as for those other patient accounts whose income is equal to or less than 200% of federal poverty income guidelines and meet certain other criteria. The cost to provide charity care using the consolidated cost to charge ratio was \$173,759 and \$170,937 for 2014 and 2013, respectively.

In addition, the Indiana University Health System provides a significant amount of uncompensated care to other uninsured and underinsured patients, which is included in the provision for uncollectible accounts in the consolidated statements of operations and changes in net assets.

The Patient Protection and Affordable Care Act (the Affordable Care Act) required, among other things, that hospital organizations establish a financial assistance policy and a policy relating to emergency medical care. The hospital organizations of the Indiana University Health System have adopted a financial assistance policy that conforms with the Affordable Care Act and includes financial assistance eligibility criteria, the basis for calculating amounts charged to patients, the method for applying for financial assistance, billing and collections policies with

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **2. Community Benefit and Charity Care (continued)**

regard to actions that may be taken in the case of nonpayment, as well as measures to widely publicize the policy within the communities served. Additionally, the Indiana University Health System's hospital organizations have adopted policies requiring the organizations to provide, without discrimination, care for emergency medical conditions to individuals regardless of their eligibility under their financial assistance policy. These hospital organizations have also adopted policies to limit the amount charged for emergency or other medically necessary care that is provided to individuals eligible for assistance under the organizations' financial assistance policy to not more than the amounts generally billed to individuals who have insurance covering such care.

Reimbursements are received by the Indiana University Health System for Medicare and Medicaid beneficiaries in accordance with reimbursement agreements and related regulatory rules and regulations. Also, the Indiana University Health System receives certain additional Medicaid Disproportionate Share (DSH) payments and payments under the Medicaid Assessment Fee program from the state of Indiana (see Note 3). These reimbursements and payments are less than the cost of providing the related services.

The Indiana University Health System also provides education for health care providers, including support to the School of Medicine; chaplaincy programs that support patients' medical, spiritual, and emotional needs; programs to enhance quality of and respect for life, including neighborhood revitalization, community health clinics, and school-based health programs; charity, equality, and justice programs; including education programs available to independent health providers, and obesity prevention programs such as Garden on the Go and Indy Urban Acres; other medical research, and support to the Children's Values Fund; and fosters an internal community of trust, respect, and empowerment.

Through the statewide facility-by-facility community health needs assessments Indiana University Health conducted, the following community health needs were identified and selected as priority areas in which Indiana University Health will focus on community benefit efforts: access to affordable health care, behavioral health, obesity prevention, and Pre-K education. The costs of providing these programs and services are included in expenses in the accompanying consolidated statements of operations and changes in net assets.



## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **3. Summary of Significant Accounting Policies**

##### **Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of Indiana University Health and all majority-owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

##### **Use of Estimates**

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

##### **Fair Values of Financial Instruments**

Financial instruments include cash and cash equivalents, patient and other accounts receivable, assets limited as to use, accounts payable and accrued expenses, estimated third-party payor allowances, notes payable to banks, long-term debt, derivative financial instruments (i.e., fixed payor and basis swaps), and certain other current assets and liabilities.

The fair values for cash and cash equivalents, patient and other accounts receivable, accounts payable and accrued expenses, estimated third-party payor allowances, and certain other current assets and liabilities approximate the carrying amounts reported in the consolidated balance sheets and, in the opinion of management, represent highly liquid assets or short-term obligations. The fair values for assets limited as to use, debt, and derivative financial instruments are described in Notes 5, 7, 8, and 9.

##### **Derivative Financial Instruments**

The Indiana University Health System has entered into certain interest rate swap transactions (fixed-pay swaps and basis swaps). As of and for the years ended December 31, 2014 and 2013, the Indiana University Health System's fixed-pay swap and basis swap agreements did not qualify for hedge accounting. Therefore, the changes in fair value of these interest rate swaps during these years are reported with nonoperating income in the consolidated statements of operations and changes in net assets.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **3. Summary of Significant Accounting Policies (continued)**

##### **Patient Service Revenue**

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors, and others at the time services are rendered. Certain revenue is subject to estimated retroactive revenue adjustments under reimbursement agreements with third-party payors due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period that the related services are rendered, and such amounts are adjusted in future periods as adjustments become known.

For the year ended December 31, 2014, the percentage of patient service revenue (net of contractually and discounts) derived under Medicare, Medicaid, and managed care programs approximated 23%, 7%, and 57%, respectively (24%, 6%, and 58%, respectively, in 2013). A managed care provider represented 30% and 29% of patient service revenue in 2014 and 2013, respectively. Provision has been made, by a charge to contractual allowances as an offset to patient service revenue, for the differences between gross charges for patient services and estimated reimbursement from these government and insurance programs.

During 2012, the Indiana General Assembly approved a hospital assessment fee program (Medicaid Assessment Fee). Under this program, the Office of Medicaid Policy and Planning collects a fee from eligible hospitals. The fee is used in part to increase reimbursement to eligible hospitals for services provided in both fee-for-service and managed care programs, and as the state share of DSH payments. The program was effective retroactively from July 1, 2011 and continued through June 30, 2013. The Indiana General Assembly approved the extension of the Medicaid Assessment Fee program for another four years. As of December 31, 2013, this extension was awaiting approval from the Centers for Medicare and Medicaid Services (CMS). Because the approval had not been obtained as of December 31, 2013, no Medicaid Assessment Fee program revenue or assessment fee expense was recorded for Medicaid claims with a service date of July 1, 2013, and after. Subsequently, on March 21, 2014, the CMS approved the extension of the program for another four years. This approval reinstated the program retroactively to July 1, 2013. The Indiana University Health System recorded the increased revenue and assessment fee expense related to claims occurring after July 1, 2013 in the first quarter of 2014.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **3. Summary of Significant Accounting Policies (continued)**

During the year ended December 31, 2014, increased reimbursement related to the Medicaid Assessment Fee program totaled \$514,703, of which \$166,729 related to 2013. During the year ended December 31, 2013, reimbursement related to the Medicaid Assessment Fee program totaled \$176,184, of which \$9,622 related to 2012. During the year ended December 31, 2014, an assessment fee was recognized of \$197,994, of which \$72,906 related to 2013. During the year ended December 31, 2013, an assessment fee was recognized of \$82,442, of which \$11,574 related to 2012. This fee was recorded within the hospital assessment fee on the consolidated statements of operations and changes in net assets.

Indiana University Health is a Medicaid DSH provider under Indiana law (IC 12-15-16(1-3)) and, as such, is eligible to receive state DSH payments. The amount of these additional state DSH funds is dependent on regulatory approval by agencies of the federal and state governments and is determined by the level, extent, and cost of uncompensated care (as defined) and various other factors. For the years ended December 31, 2014 and 2013, state DSH payments have been made by the state of Indiana, and amounts were recorded as revenue based on data acceptable to the state of Indiana, less any amounts management believes may be subject to adjustment. State DSH payments by the state of Indiana are based on the fiscal year of the state, which ends June 30 of each year. State DSH reimbursement is recognized as revenue after eligibility is determined by the state and payments are probable and reasonably estimable. The state fiscal year 2014 state DSH payments of \$14,794 recognized by Indiana University Health and certain subsidiaries were recorded in net patient service revenue in the accompanying consolidated statements of operations and changes in net assets for the year ended December 31, 2014. The state fiscal year 2012 through 2013 state DSH payments of \$63,261 recognized by Indiana University Health and certain subsidiaries during 2013 were recorded in net patient service revenue in the accompanying consolidated statements of operations and changes in net assets for the year ended December 31, 2013.

Laws and regulations governing Medicare, Medicaid, and other governmental programs are extremely complex, subject to interpretation, and sometimes provide for retroactive adjustments. As a result, there is a reasonable possibility that recorded estimated settlements could change by a material amount in the near term. The Indiana University Health System believes it is in compliance with applicable laws and regulations governing Medicare, Medicaid, and other governmental programs and that adequate provisions have been recorded for any adjustments that may result from final settlements. However, any adjustments to the currently estimated settlements are recorded in future periods.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

**3. Summary of Significant Accounting Policies (continued)**

Patient service revenue, net of contractual allowances and discounts and before the provision for bad debts, recognized in the year from major payor sources is as follows:

	<b>Year Ended December 31</b>	
	<b>2014</b>	<b>2013</b>
Third-party payors	<b>\$ 5,416,315</b>	\$ 5,041,753
Self-pay patients	<b>141,357</b>	186,285
Total payors	<b>\$ 5,557,672</b>	\$ 5,228,038

**Member Premium Revenue and Health Claims**

The Indiana University Health System has agreements to provide medical services to subscribing participants or members that generally provide for predefined payments (on a per member or per month basis) regardless of services actually performed. The cost to provide health care services under these agreements, and for self-insured health benefits to employees, is accrued in the period in which the health care services are provided to a member or covered employee based, in part, on estimates, including an accrual for medical services provided but not yet reported. Expenses to providers are reported as health claims to providers in the accompanying consolidated statements of operations and changes in net assets. The accrual for medical services provided, but not yet reported, is reflected as accrued health claims in the accompanying consolidated balance sheets.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **3. Summary of Significant Accounting Policies (continued)**

##### **Meaningful Use Revenue**

The American Recovery and Reinvestment Act of 2009 established incentive payments under Medicare and Medicaid programs for certain eligible professionals, hospitals, and critical access hospitals (Providers). Providers can receive incentive payments by adopting, implementing, and upgrading electronic health records (EHR) technology. Providers can also receive incentive payments for demonstrating meaningful use of EHR technology. Upon satisfaction of the meaningful use criteria, using a grant accounting model, the Indiana University Health System recognized \$14,152 and \$22,215 of these incentive payments within other revenue in the accompanying consolidated statements of operations and changes in net assets for the years ended December 31, 2014 and 2013, respectively. If specified meaningful use criteria are met in future periods, the Indiana University Health System may qualify for additional incentive payments.

##### **Cash Equivalents**

Investments in highly liquid instruments with an original maturity of three months or less when purchased, excluding assets limited as to use, are considered by management to be cash equivalents.

The Indiana University Health System routinely invests in money market funds, including both treasury and agency money market funds and prime money market funds, that are considered by management to be cash equivalents. Such instruments, as well as bank deposits, are potentially subject to concentrations of credit risk. In order to mitigate such risk, the Indiana University Health System generally places its cash and cash equivalents with institutions of high credit quality.

##### **Patient Accounts Receivable and Allowance for Uncollectible Accounts**

The Indiana University Health System does not require collateral or other security for the delivery of health care services from its patients, substantially all of whom are residents of the state of Indiana. However, assignment of benefit payments payable under patients' health insurance programs and plans (e.g., Medicare, Medicaid, health maintenance organizations, and commercial insurance policies) is routinely obtained, consistent with industry practice.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**3. Summary of Significant Accounting Policies (continued)**

The provision for uncollectible accounts, for all payors, is recognized when services are provided based upon management's assessment of historical and expected net collections, taking into consideration business and economic conditions, changes and trends in health care coverage, and other collection indicators. Periodically, management assesses the adequacy of the allowance for uncollectible accounts based upon accounts receivable payor composition and aging, the significance of individual payors to outstanding accounts receivable balances, and historical write-off experience by payor category, as adjusted for collection indicators. The results of this review are then used to make any modifications to the provision for uncollectible accounts and the allowance for uncollectible accounts. In addition, the Indiana University Health System follows established guidelines for placing certain past due patient balances with collection agencies. Patient accounts that are uncollected, including those placed with collection agencies, are initially charged against the allowance for uncollectible accounts in accordance with collection policies of the Indiana University Health System and, in certain cases, are reclassified to charity care if deemed to otherwise meet financial assistance policies of the Indiana University Health System.

The composition of net patient accounts receivable is summarized as follows as of December 31:

	<u>2014</u>	<u>2013</u>
Managed care	53%	54%
Medicare	20	21
Medicaid	8	5
Other third-party payors	12	11
Patients	7	9
	<u>100%</u>	<u>100%</u>

A managed care payor represented 26% and 23% of net patient accounts receivables at December 31, 2014 and 2013, respectively.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **3. Summary of Significant Accounting Policies (continued)**

The allowance for uncollectible accounts for self-pay patients, including self-pay discounts and charity care, was 83% and 86% of self-pay accounts receivable as of December 31, 2014 and 2013, respectively. Overall, the net of self-pay discounts and write-offs has not changed significantly for the years ended December 31, 2014 and 2013. Effective July 1, 2014, the Indiana University Health System changed their financial assistance policy to remove both out-of-state patients and those above 400% of the federal poverty level from being eligible to participate.

#### **Inventories**

Inventories consist primarily of drugs and supplies, are stated at the lower of cost or market, and are generally valued using the average cost method.

#### **Assets Limited as to Use**

Assets limited as to use include the following: (i) cash and cash equivalents and designated investment assets, including those funds held by the consolidated foundations, set aside by the Board for future capital improvements and for other purposes, over which the Board retains control and may, in certain circumstances, use for other purposes; (ii) donor-restricted investment assets, the use of which has been specified by the donor; and (iii) assets held by trustees under bond or trust indenture agreements for construction and debt service. Substantially all assets limited as to use are invested and managed by professional investment managers and are held in custody by financial institutions. These funds are classified as trading securities. Accordingly, changes in unrealized gains and losses in the fair value of investments are included in nonoperating income within investment income in the accompanying consolidated statements of operations and changes in net assets. The Indiana University Health System is a limited partner in certain funds that employ hedged investment strategies and funds that employ investment strategies that require long holding periods to create value. These investments are accounted for using the equity method of accounting, based on the fund's financial information.

#### **Property and Equipment**

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets. Included in property and equipment are costs for software developed for internal use.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **3. Summary of Significant Accounting Policies (continued)**

Property and equipment under capital lease obligations are amortized on the straight-line method over the lease term or the estimated useful life of the equipment, whichever period is shorter. Such amortization is included with depreciation in the accompanying consolidated statements of operations and changes in net assets. Interest cost incurred on borrowed funds during the period of construction and other interest costs related to tax-exempt bonds are capitalized as a component of the cost of constructing the assets. In addition, interest earnings on unexpended borrowed funds related to tax-exempt financings offset capitalized tax-exempt interest. Repair and maintenance costs are expensed when incurred.

The Indiana University Health System evaluates when events or changes in circumstances have occurred that would indicate that the remaining estimated useful life of long-lived assets warrant revision or that the remaining balance of such assets may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group. If undiscounted cash flows are insufficient to recover the carrying value of the long-lived asset, such asset is written down to its fair value if its carrying value exceeds fair value.

#### **Equity Interest in Unconsolidated Subsidiaries**

Indiana University Health or its subsidiaries have also entered into certain limited liability company agreements with third parties that provide health care-related services. Where applicable, these arrangements are accounted for using the equity method of accounting. Indiana University Health's largest equity interest venture is a 50% membership interest in MDWise, Inc., which holds a health maintenance organization license and manages a network of health care providers serving Medicaid patients throughout the state of Indiana. The balance of this equity interest was \$15,566 and \$17,574 as of December 31, 2014 and 2013, respectively. Overall, equity interest in unconsolidated subsidiaries was \$49,202 and \$44,578 as of December 31, 2014 and 2013, respectively. The Indiana University Health System has recorded its equity in the income of its unconsolidated subsidiaries within other operating revenue, totaling \$1,066 and \$1,145 for the years ended December 31, 2014 and 2013, respectively.



## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **3. Summary of Significant Accounting Policies (continued)**

During 2014, Indiana University Health determined that the value of its investments in certain equity method investments was other-than-temporarily impaired and the investments were reduced to their estimated fair value, which is nominal, through the recording of \$2,073 impairment charges included in nonoperating income in the accompanying consolidated statements of operations and changes in net assets. During 2013, Indiana University Health recorded \$3,028 and \$7,106 of impairment charges included in other operating revenue and nonoperating income, respectively, in the accompanying consolidated statements of operations and changes in net assets.

#### **Unamortized Bond Issuance Costs and Bond Discount or Premium**

Costs incurred in connection with the issuance of long-term debt and bond discounts or premiums are amortized or accreted using the effective interest rate method. Amortization and accretion are included in interest expense in the accompanying consolidated statements of operations and changes in net assets (see Note 7).

#### **Contributions**

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is made. Conditional promises to give, including indications of an intention to give, are reported at fair value at the date the gift is made. If the gifts are made with donor stipulations that limit the use of the donated assets, the gifts are reported as either temporarily or permanently restricted. Donor-restricted contributions for which restrictions are met in the same year as made are reported as unrestricted contributions in the accompanying consolidated financial statements.

#### **Noncontrolling Interest in Subsidiaries**

The Indiana University Health System attributed income of \$90,175 and \$92,846 for the years ended December 31, 2014 and 2013, respectively, to the noncontrolling interests based on the ownership percentage of the noncontrolling interests in certain of the Indiana University Health System's consolidated subsidiaries. These amounts primarily relate to the seven joint venture surgery centers and are reflected in unrestricted net assets in the consolidated balance sheets. For the years ended December 31, 2014 and 2013, the seven joint venture surgery centers accounted for \$59,033 and \$59,419 of the income attributed to the noncontrolling interests. The seven joint venture surgery centers realized operating revenue of \$220,703 and \$220,696, and operating

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **3. Summary of Significant Accounting Policies (continued)**

income of \$121,287 and \$122,341 in 2014 and 2013, respectively. The operating revenue and operating income are reflected in total operating revenue and total operating income on the consolidated statements of operations and changes in net assets.

#### **Temporarily and Permanently Restricted Net Assets**

Temporarily and permanently restricted net assets are those assets whose use has been limited by donors to a specific time period or purpose. These net assets are generally restricted for medical education and research programs, medical supplies and equipment, and patient care services.

Interests in net assets of unconsolidated foundations are included in other assets in the accompanying consolidated balance sheets (see Note 14). The underlying assets of these interests in foundations consist primarily of cash and cash equivalents, money market and mutual funds, and marketable equity and debt securities.

#### **Business Combinations**

The Indiana University Health System allocates the purchase price of an acquisition to the various components of the acquisition based upon the fair value of each component, which may be derived from various observable or unobservable inputs and assumptions. Also, the Indiana University Health System may utilize third-party valuation specialists. These components typically include buildings, land, and equipment and may also include intangibles related to noncompete agreements or other specifically identified intangible assets. The excess of the fair value of assets acquired over liabilities assumed and the fair value of any noncontrolling interest is recorded as an inherent contribution within the performance indicator. Goodwill is recorded to the extent that liabilities assumed and noncontrolling interests exceed the fair value of assets acquired.

#### **Goodwill and Intangible Assets**

In connection with business combinations, the Indiana University Health System has recorded goodwill and definite-lived intangible assets on the accompanying consolidated balance sheets.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### 3. Summary of Significant Accounting Policies (continued)

The Indiana University Health System evaluates goodwill for impairment annually, or more frequently if events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. The goodwill impairment analysis, performed at the reporting unit level, generally includes estimating the fair value and comparing that to the carrying value. If fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired. These valuation methods require the Indiana University Health System to make estimates and assumptions regarding future operating results, cash flows, changes in working capital, capital expenditures, profitability, and the cost of capital.

The Indiana University Health System also reviews if events or changes in circumstances suggest impairment may have occurred related to the carrying value of the definite-lived intangible assets, which are amortized over periods of 5 to 35 years. It has been determined that there was no impairment to goodwill or definite-lived intangible assets during 2014 and 2013. Intangible assets included in other assets on the accompanying consolidated balance sheets as of December 31, 2014 and 2013, were \$180,776 and \$182,339, respectively, which include goodwill of \$166,552 and \$166,559, respectively.

#### Operating and Performance Indicators

The activities of the Indiana University Health System are primarily related to providing health care services, and accordingly, expense information by functional classification is not used as a basis for measuring performance. Furthermore, since substantially all resources are derived from providing health care services, similar to that if provided by a business enterprise, the following indicators are considered important in evaluating how well management has discharged its stewardship responsibilities:

**Operating Indicator (Operating Income)** – Includes all unrestricted revenue, gains, donor contributions to offset operating expenses, other support, equity income or loss of unconsolidated health care subsidiaries, and expenses directly related to the recurring and ongoing health care operations during the reporting period. The operating indicator excludes investment income or losses on assets limited as to use (including changes in unrealized gains and losses on investments), changes in the fair value of fixed-pay and basis swaps, gain or loss on the extinguishment of debt, inherent contribution of acquired entities, noncontrolling interest, and gains and losses deemed by management not to be directly related to providing health care services.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### 3. Summary of Significant Accounting Policies (continued)

**Performance Indicator (Excess of Revenues Over Expenses)** – Includes operating income and nonoperating income and losses. The performance indicator excludes certain changes in pension obligations and contributions for capital expenditures, distributions, and net assets released from restricted funds.

#### **Income Taxes**

The Internal Revenue Service (IRS) has determined that Indiana University Health and certain of its affiliated entities are tax-exempt organizations as defined in Section 501(c)(3) of the Internal Revenue Code (IRC).

Certain subsidiaries of Indiana University Health are taxable entities. The tax expense and liabilities of these subsidiaries are not material to the consolidated financial statements.

#### **Subsequent Events**

For the consolidated financial statements as of and for the year ended December 31, 2014, management has evaluated subsequent events through March 26, 2015, the date that these consolidated financial statements were issued.

#### **Reclassifications**

Certain amounts in the 2013 consolidated financial statements have been reclassified to conform to the 2014 presentation. Such reclassifications had no effect on previously reported excess of revenues over expenses, or net assets.

#### **New Accounting Guidance Not Yet Applicable**

In May 2014, the Financial Accounting Standards Board issued guidance related to recognizing revenue from contracts with customers. This new guidance dictates that the standard be applied either retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the revenue recognition standard recognized at the date of initial application. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2016. Indiana University Health is evaluating the effect this guidance will have on its consolidated financial statements.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **4. Significant Transactions**

##### **Indiana University Health Occupational Services**

Effective July 1, 2013, Indiana University Health Occupational Services, a wholly owned subsidiary of Indiana University Health, sold the operations and related fixed assets of eight freestanding clinics located in Fishers, Indianapolis, Lebanon, and Muncie, Indiana, to U.S. Healthworks of Indiana, Inc. for a purchase price of \$14,500, of which \$13,050 was received in July 2013, \$1,132 was received in December 2014 and the remainder was applied towards employee severance costs as allowed in the agreement. The gain related to this sale was \$12,771 and is recorded within other nonoperating income in 2013. Prior to this sale, on June 27, 2013, Indiana University Health, acting as Obligated Agent for Indiana University Health Obligated Group, effectuated the removal of Indiana University Health Occupational Services as an Obligated Group Affiliate under the Master Trust Indenture (as such terms are defined in the Master Trust Indenture). See Note 7 for further discussion on Indiana University Health Obligated Group.

##### **Indiana University Health La Porte and Subsidiaries**

Indiana University Health and La Porte are presently seeking a partnership with a new or additional healthcare organization for La Porte. Both organizations presently anticipate that, as part of this new partnership, Indiana University Health will likely cease to be the majority member of La Porte, which represented approximately 3.9% of the total operating revenues of the Indiana University Health System for the year-ended December 31, 2014.

#### **5. Assets Limited as to Use**

Board-designated and donor-restricted investment funds are invested in accordance with Board-approved policies. Trustee-held funds are generally invested in cash equivalents (including money market funds) and U.S. government and agency obligations, as defined by the debt agreements.

The estimated fair value of the assets limited as to use is determined using market information and other appropriate valuation methodologies. The methods and assumptions used to estimate the fair value of assets limited as to use are as follows: (i) cash and cash equivalents: the carrying amounts reported in the consolidated balance sheets approximate fair value; (ii) marketable securities: the fair values are based on quoted market prices or, if quoted market prices are not

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **5. Assets Limited as to Use (continued)**

available, quoted market prices of comparable instruments and other observable inputs; and (iii) other investments, including alternative investments (such as hedged strategies and long holding period strategies): accounted for using the equity method of accounting predominantly based upon the net asset values as determined by third-party administrators of each fund in consultation with and approval of the fund investment managers.

The Indiana University Health System is a limited partner in funds that employ hedged investment strategies and funds that employ investment strategies that require long holding periods to create value, both of which are designed to reduce overall portfolio volatility. In the case of hedged strategies, redemptions generally may be made quarterly with written notice ranging from 30 to 90 days; however, some funds employ lock-up periods that restrict redemptions or charge a redemption fee during the lock-up period. Lock-up periods range from one to three years with redemption charges of up to 5% of net asset value for redemptions made on or before the anniversary date of the initial investment or additional contribution. Upon complete redemption, many of the funds have “hold-back” provisions that allow the fund to retain up to 10% of the assets until the fund completes its audited financial statements for the redemption period. These investments are accounted for using the equity method of accounting, based on the fund’s financial information. In the case of long holding period strategies, capital is returned as monetization events occur, which may be infrequent in nature. Generally, capital is committed to a partnership for a period of five to ten years with the ability of the general partner to extend the life of the fund one to three additional years. Generally, during the first three to five years of a fund life, the general partner, in order to facilitate its funding of investments, will call capital from the limited partners up to the amount of its commitment. As of December 31, 2014, there was \$57,676 of unfunded commitments relating to long holding period strategies, which is expected to be funded over the next five years. As of December 31, 2013, there was \$25,259 of unfunded commitments relating to long holding period strategies.

Alternative investments include certain other risks that may not exist with other investments that are more widely traded. These include reliance on the skill of the fund managers, who often employ complex strategies utilizing various financial instruments, including futures contracts, foreign currency contracts, structured notes, interest rate, total return, and credit default swaps. Additionally, alternative investments may provide limited information on a fund’s underlying assets and have restrictive liquidity provisions. Management believes that the Indiana University Health System, in consultation with its investment consultants, has the capacity to analyze and

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**5. Assets Limited as to Use (continued)**

interpret the risks associated with alternative investments and, with this understanding, has determined that these investments represent a prudent approach for use in its portfolio management.

The largest fund allocation to any fund manager, which is an alternative fund of funds investment, is \$181,802 at December 31, 2014, and there are no investments in any individual fund greater than 23% of that fund's net assets. Changes in the value of these funds are included in nonoperating income in the accompanying consolidated statements of operations and changes in net assets.

The composition of assets limited as to use is set forth below.

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Board-designated investments and trustee-held funds:		
Cash and cash equivalents	\$ 73,745	\$ 64,048
Marketable securities:		
Fixed income securities	818,361	767,090
Global equities	113,069	132,906
Commingled funds	1,109,172	905,237
Total marketable securities	<u>2,040,602</u>	<u>1,805,233</u>
Other board-designated investments:		
Alternative investments:		
Hedged funds	989,096	715,322
Long holding period funds	87,249	44,641
Total other board-designated investments	<u>1,076,345</u>	<u>759,963</u>
Total assets limited to use	<u>3,190,692</u>	<u>2,629,244</u>
Less current portion	-	(114)
Total assets limited to use, less current portion	<u>\$ 3,190,692</u>	<u>\$ 2,629,130</u>

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**5. Assets Limited as to Use (continued)**

Assets limited as to use include funds held by the foundations whose fair values as of December 31, 2014, aggregated \$195,507, of which \$118,620 is considered board-designated investment funds and \$76,887 is considered donor-restricted investment funds.

The composition and presentation of investment income recognized in the accompanying consolidated statements of operations and changes in net assets are as follows:

	<b>Year Ended December 31</b>	
	<b>2014</b>	<b>2013</b>
Investment income:		
Interest and dividend income	\$ 45,371	\$ 35,352
Investment management and administration fees	(8,047)	(6,101)
Realized gains on sales of investments, net	41,863	89,002
Unrealized (losses) gains on investments	(24,778)	63,199
Equity (losses) gains on alternative investments	(15,654)	9,631
	<u>\$ 38,755</u>	<u>\$ 191,083</u>

**6. Property and Equipment**

The cost of property and equipment in service is summarized as follows:

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Land and improvements	\$ 264,097	\$ 264,622
Buildings and improvements	3,329,333	3,234,771
Equipment (including software developed for internal use of \$237,071 in 2014 and \$234,604 in 2013)	2,252,134	2,191,292
	<u>\$ 5,845,564</u>	<u>\$ 5,690,685</u>



Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

**6. Property and Equipment (continued)**

Useful lives of each category of assets are based on the estimated useful time frame that the particular assets are expected to be in service, generally in accordance with guidelines established by the American Hospital Association. Assets are depreciated on a straight-line basis beginning in the month when placed in service, with asset lives ranging as follows: 20–30 years for land improvements, 15–40 years for buildings and improvements, and 3–10 years for equipment, including software developed for internal use.

Construction-in-progress for assets currently under development is anticipated to extend through 2015 and includes commitments for the construction, refurbishment, and replacement of facilities and equipment. A summary of the construction-in-progress is as follows:

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Software developed for internal use	\$ –	\$ 79
Riley Simon Family Tower	–	70,941
Other facilities and equipment	<b>32,997</b>	44,033
	<b>\$ 32,997</b>	<b>\$ 115,053</b>

Firm commitments for construction-in-progress totaled \$38,600 at December 31, 2014.

Certain buildings, equipment, and software are accounted for as capital leases expiring in various years through 2037 and are included in property and equipment. Amortization of assets under capital leases is included in depreciation expense.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**6. Property and Equipment (continued)**

The following is a summary of property held under capital leases:

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Software	\$ 1,219	\$ 1,985
Equipment	4,905	37,251
Buildings	101,157	112,877
	107,281	152,113
Less accumulated amortization	(9,535)	(33,172)
	\$ 97,746	\$ 118,941

Interest rates are imputed based on the lower of the incremental borrowing rate at the inception of each lease or the lessor's implicit rate of return.

**7. Debt**

**Obligated Groups**

The Indiana University Health System operates under two separate Master Trust Indentures (MTIs). Each MTI provides for the issuance of long-term debt and sets forth the terms pursuant to which underlying debt is issued. These MTIs set forth the provisions governing membership for the respective obligated groups, which presently consist of the following specific separate entities: (1) the Indiana University Health Obligated Group includes the Downtown Hospitals of the Academic Health Center, La Porte, and Saxony (a division of Indiana University Health) as members; and (2) the Rehabilitation Hospital of Indiana Obligated Group includes RHI as the sole member. A third obligated group, the Ball Memorial Obligated Group, existed as of December 31, 2013, but made full provision to satisfy and legally defease all of its remaining obligations during 2014. Each obligated group is required to meet certain covenants, and its members are jointly and severally liable for the obligations under their respective MTIs. Each is subject to financial performance covenants that, among other compliance requirements, require the maintenance of debt service ratios and limit its ability to encumber certain of its respective assets. As of December 31, 2014, the Indiana University Health System was in compliance with all financial covenants.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **7. Debt (continued)**

##### **Issuance, Modification, and Extinguishment of Debt**

The Indiana University Health Obligated Group has executed direct-pay letter-of-credit agreements in support of all of its publicly remarketed variable-rate bond series, which require the credit provider to purchase bonds in the event the bonds are not remarketed. In addition, it has executed direct purchase agreements, whereby the credit provider purchases bonds for a predetermined period of time, after which the agreement must be extended or the bonds must be remarketed or reissued. In each of these two instances, the bonds have a longer nominal maturity than the agreement, but the existence and terms of these agreements allow for the long-term classification of the associated variable-rate bond series. Two such agreements expire during 2015. If not otherwise extended, these agreements would require the principal balance of the related bonds to be repaid over a shortened time frame. Accordingly, \$31,852 has been reclassified to current portion of long-term debt to reflect the associated amount for 2015.

On April 1, 2013, the Ball Memorial Obligated Group redeemed at par (\$5,495) all of the outstanding Hospital Authority of Delaware County Hospital Revenue Refunding Bonds, Series 1997. These bonds carried a fixed interest rate of 5.00%.

The Stonehenge Community Development VII, LLC, Fixed Rate, Unsecured New Market Tax Credit Notes A and B were called by the lender for a one-time payment of \$18,700 in March of 2014. This transaction resulted in a \$6,296 gain on extinguishment of debt included in gains on sales and acquisitions and other in the accompanying consolidated statements of operations and changes in net assets.

In June of 2014, a direct bank loan (the proceeds of which were used to redeem Series 2003F bonds in 2008) was amended to defer the maturity date to June 30, 2016, with an interest rate based on one-month London Interbank Offered Rate (LIBOR).

In August of 2014, Indiana University Health repaid the outstanding balance of \$11,936 and prepayment premium associated with a commercial bank loan, resulting in a \$239 loss on extinguishment of debt.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **7. Debt (continued)**

In August of 2014, through the Indiana Finance Authority, Indiana University Health reissued its Series 2011H and Series 2011I bonds. The transaction was accounted for as a modification of debt. As part of the reissuance, the rate calculation methodology for each was amended resulting in a reduction to the rate applicable to each; the principal payment schedule was amended; and the bank purchase period was extended to November of 2017.

On October 14, 2014, through the Indiana Finance Authority, Indiana University Health issued at par \$69,945 of Series 2014A tax-exempt fixed rate bonds at a premium of \$10,833. Proceeds were used to advance refund the Hospital Authority of Delaware County Hospital Revenue Bonds, Series 2006 (Ball Memorial Hospital, Inc. Obligated Group F/K/A Cardinal Health System Obligated Group) outstanding in the amount of \$67,095; to advance refund the Hospital Authority of Delaware County Hospital Revenue Refunding Bonds, Series 2009A (Ball Memorial Hospital, Inc. Obligated Group) outstanding in the amount of \$14,030; and to pay certain expenses related to the issuance. The refinancing was accounted for as a debt extinguishment, resulting in a loss of \$8,318 based upon the funds expended in excess of the carrying values associated with the refunded debt.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**7. Debt (continued)**

Long-term debt consists of the following:

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
<b>Indiana University Health Obligated Group</b>		
Indiana Finance Authority:		
Fixed Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2014A Serial Bonds, payable in varying principal installments through 2030, with interest rates ranging from 2.00% to 5.13% at December 31, 2014	\$ 69,945	\$ —
Fixed Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2011N Serial and Term Bonds, payable in varying principal installments through 2038, with interest rates ranging from 3.00% to 5.13% at December 31, 2014	169,920	184,215
Variable-Rate Demand Notes, Tax-Exempt Revenue Refunding Bonds, Series 2011A, B, C, D, E, H, I, L, and M, payable in varying installments through 2036, with variable interest rates ranging between 0.02% and 0.82% at December 31, 2014	441,270	449,820
Variable-Rate Demand Notes, Taxable Hospital Revenue Bonds, Series 2011J and K, payable in varying principal installments through 2033, with an interest rate of 0.09% at December 31, 2014	155,715	159,605
Indiana Health and Educational Facility Financing Authority:		
Fixed Rate, Tax-Exempt Hospital Revenue Bonds, Series 2006A and 2006B Serial and Term Bonds, payable in varying principal installments through 2040, with interest rates ranging from 4.75% to 5.25% at December 31, 2014	660,670	666,500
Variable-Rate Commercial Bank Loan, expiring in 2016 with nominal principal installments through 2033, with an interest rate of 0.48% at December 31, 2014	39,025	40,000
Fixed Rate Commercial Bank Loan, repaid in 2014	—	17,439

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

7. Debt (continued)

	December 31	
	2014	2013
<b>Ball Memorial Obligated Group</b>		
Hospital Authority of Delaware County, Indiana:		
Fixed Rate, Tax-Exempt Revenue Refunding Bonds, Series 2009A and 2006, defeased in 2014	\$	\$ 83,800
<b>Rehabilitation Hospital of Indiana Obligated Group</b>		
Indiana Finance Authority:		
Variable-Rate Demand Notes, Tax-Exempt Hospital Revenue Bonds, Series 2011A, payable in varying principal installments through 2031, with an interest rate of .03% at December 31, 2014	14,980	15,550
Variable-Rate, Subordinated Promissory Note, principal payable in full at maturity in 2017, with an interest rate of .01% at December 31, 2014	1,500	1,500
<b>Other Debt</b>		
Bloomington, Variable-Rate, repaid in 2014	–	2,299
Stonehenge Community Development VII, LLC, Fixed Rate, Unsecured New Market Tax Credit Notes A and B, extinguished in 2014	–	25,000
Mortgage obligations (interest rates ranging from 1.41% to 1.66%)	3,130	6,101
Capital lease obligations	96,104	108,484
Other	21,059	24,024
Total long-term debt	<u>1,673,318</u>	<u>1,784,337</u>
Unamortized premium, net of unamortized discount	24,251	14,461
Less current portion	<u>(78,757)</u>	<u>(116,149)</u>
Long-term debt, less current portion	<u>\$ 1,618,812</u>	<u>\$ 1,682,649</u>

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**7. Debt (continued)**

The scheduled maturities and mandatory redemptions of long-term debt, assuming remarketing of variable-rate bonds, are as follows:

	<b>Indiana University Health Obligated Group</b>	<b>RHI Obligated Group</b>	<b>Other</b>	<b>Total</b>
Year ending December 31:				
2015	\$ 73,092	\$ 615	\$ 5,050	\$ 78,757
2016	121,218	650	5,753	127,621
2017	124,248	2,195	4,507	130,950
2018	85,972	740	4,571	91,283
2019	46,485	785	4,730	52,000
Thereafter	1,085,530	11,495	95,682	1,192,707
	<u>\$ 1,536,545</u>	<u>\$ 16,480</u>	<u>\$ 120,293</u>	<u>\$ 1,673,318</u>

The estimated valuation of the revenue bonds is obtained from a third-party pricing service and is derived by utilizing well-priced, liquid bonds with similar characteristics such as currency, market type, industry, and credit rating. Pricing data for these reference bonds incorporates simple averages of indicative and executable price quotes obtained from various contributors, including brokers and other market makers, over a specified time window. These prices are used to construct a fair value curve, which in turn is used to discount the future cash flows of the revenue bonds. Based on the inputs used in determining the estimated fair value of these securities, this liability would be classified as Level 2 in the fair value hierarchy described in Note 9.

The estimated fair value of the revenue bonds at December 31, 2014 and 2013, amounted to \$1,564,659 (which includes RHI – \$14,980) and \$1,581,630 (which includes Ball Memorial - \$86,591 and RHI – \$15,550, respectively). The carrying value of the revenue bonds at December 31, 2014 and 2013, amounted to \$1,512,500 and \$1,559,490, respectively. The recorded value of all debt obligations not traded in the secondary credit markets approximated fair value at December 31, 2014 and 2013.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **7. Debt (continued)**

As of December 31, 2014 and 2013, the Indiana University Health System maintained several lines of credit totaling \$91,000. There was no balance drawn on the lines of credit as of December 31, 2014 or 2013.

Total interest paid on long-term debt for the years ended December 31, 2014 and 2013, aggregated \$77,403 and \$81,882, respectively. Total interest capitalized during the years ended December 31, 2014 and 2013, amounted to \$3,569 and \$4,773, respectively.

Indiana University Health is evaluating a refunding of all or a portion of its Indiana Health and Educational Facility Financing Authority Hospital Revenue Bonds, Series 2006A, all or a portion of the Indiana Finance Authority Taxable Hospital Revenue Bonds, Series 2011J and 2011K, and all or a portion of the direct bank loan, which was used to redeem the Series 2003F bonds in 2008. Each refunding is dependent on the issuance of one or more series of fixed and/or variable refunding bonds and market and other conditions, and there is no assurance that all or any outstanding debt will be refunded or redeemed or that refunding bonds will be issued. Management of Indiana University Health presently expects that, if one or more of these refunding transactions transpires, the transactions will close in the second quarter of 2015.



Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**8. Derivative Financial Instruments**

Long-term interest rate swap arrangements have been entered into with the primary objective being to mitigate interest rate risk. The following fixed-pay swaps, stated at current notional amounts, remain in place as of December 31, 2014:

	<b>Notional Amount</b>	<b>Effective Date</b>	<b>Maturity Date</b>	<b>Rate Received</b>	<b>Rate Paid</b>
\$	45,700	11/15/2005	2/16/2021	62.30% LIBOR plus 0.24%	3.19%
	60,195	6/23/2011	3/01/2036	62.30% LIBOR plus 0.24%	2.68%
	69,175	11/15/2005	2/15/2030	62.30% LIBOR plus 0.24%	3.35%
	69,475	6/20/2011	2/15/2030	62.30% LIBOR plus 0.24%	3.35%
	58,225	6/26/2003	3/01/2033	LIBOR	4.92%
	97,013	6/16/2011	3/01/2033	LIBOR	4.92%
	38,800	6/26/2003	3/01/2033	LIBOR	4.92%
				Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA)	
	8,800	1/27/2006	11/02/2020		3.98%
	1,294	6/01/2006	6/01/2026	LIBOR plus 1.25%	7.15%
	138	10/01/1999	10/01/2019	Prime minus 1.86%	7.72%

After giving effect to the above derivative transactions, the Indiana University Health System's variable-rate debt was approximately 11.9% and 11.4% of total debt outstanding as of December 31, 2014 and 2013, respectively.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**8. Derivative Financial Instruments (continued)**

In addition, long-term basis swap arrangements were entered into for the purpose of managing the effect of interest rates on cash flows and were in place as of December 31, 2014, as follows:

Notional Amount	Effective Date	Maturity Date	Swap Type	Rate Received	Rate Paid
\$ 140,446	3/10/2021	2/15/2033	Forward Starting	75.00% three-month LIBOR minus 0.05%	SIFMA
172,332	1/04/2008	2/15/2033	Basis	75.00% one-month LIBOR	SIFMA
172,332	2/15/2009	2/15/2021	Basis	72.00% three-month LIBOR minus 0.13%	SIFMA
309,200	3/10/2021	1/07/2033	Forward Starting	75.00% three-month LIBOR minus 0.04%	SIFMA
309,200	3/07/2009	3/07/2021	Basis	72.00% three-month LIBOR minus 0.12%	SIFMA
309,200	6/07/2011	1/07/2033	Basis	75.00% one-month LIBOR	SIFMA
250,000	3/01/2009	9/30/2038	Basis	77.00% three-month LIBOR minus 0.11%	SIFMA
250,000	3/01/2009	9/30/2038	Basis	77.00% three-month LIBOR minus 0.11%	SIFMA

Guidance on fair value accounting stipulates that a credit valuation adjustment (CVA) should be applied to the mark-to-market valuation position of interest rate swaps to more closely capture the fair value of such instruments that must incorporate the risk on nonperformance. Collateral arrangements reduce the credit exposure and are considered in determining the CVA. As of December 31, 2014, the fair value of interest rate swaps was a liability of \$145,339, which is net of CVA of \$9,837. As of December 31, 2013, the fair value of interest rate swaps was a liability of \$139,072, which is net of CVA of \$23,830. The fair values of the swaps have been included with noncurrent liabilities in the accompanying consolidated balance sheets.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### 8. Derivative Financial Instruments (continued)

As of December 31, 2014, interest rate swaps had a total notional amount of \$1,911,879, including \$448,815 of fixed-pay swaps and \$1,463,064 of basis swaps. Under agreements executed with counterparties, Indiana University Health is obligated to fund collateral amounts when the aggregate market value of swaps with a given counterparty exceeds a threshold set forth in the related agreement. The aggregate fair value of all derivative instruments, consisting of fixed-pay and basis swaps, with credit-risk-related contingent features that are in a liability position on December 31, 2014 and 2013, was \$132,509 and \$146,194, respectively. No collateral was posted as of December 31, 2014 and 2013.

The Indiana University Health System recorded the following (losses) gains, within nonoperating income, in the accompanying consolidated statements of operations and changes in net assets related to these derivative financial instruments:

	Year Ended December 31	
	2014	2013
(Losses) gains on interest rate swaps, net:		
Unrealized (losses) gains on interest rate swaps	\$ (6,267)	\$ 26,851
Realized losses on interest rate swaps	(15,672)	(15,472)
	<u>\$ (21,939)</u>	<u>\$ 11,379</u>

#### 9. Fair Value Measurements

The accounting guidance for the application of fair value provides, among other matters, for the following: defines fair value as 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 and establishes a framework for measuring fair value; establishes a three-level hierarchy for fair value measurements based upon the observability of inputs to the valuation of an asset or liability as of the measurement date; requires consideration of nonperformance risk when valuing liabilities; and expands disclosures about instruments measured at fair value. The three-level hierarchy is based upon the nature of valuation techniques and whether such techniques are based upon observable or unobservable inputs, as defined.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **9. Fair Value Measurements (continued)**

Observable inputs are intended to reflect market data obtained from independent sources, while unobservable inputs may reflect market assumptions made by management or measurements made by financial specialists generally associated with the financial asset or liability. These two types of inputs create the following fair value hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities as of the reporting date. Includes debt issued by US agencies.
- Level 2 – Pricing inputs other than quoted prices included in Level 1 that are either directly observable or that can be derived or supported from observable data as of the reporting date. Includes all collective trusts and off-shore mutual funds.
- Level 3 – Pricing inputs include those that are significant to the fair value of the financial asset or financial liability and are not observable from objective sources. In evaluating the significance of inputs, the Indiana University Health System generally classifies assets or liabilities as Level 3 when their fair value is determined using unobservable inputs that, individually or when aggregated with other unobservable inputs, represent more than 10% of the fair value of the assets or liabilities. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

The following tables set forth by level within the fair value hierarchy the Indiana University Health System's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2014 and 2013. The financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The assessment of the significance of a particular input to the fair value measurement requires judgment, could be subject to change or variation, and may affect the valuation of fair value assets and liabilities and their classification within the fair value hierarchy levels.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

9. Fair Value Measurements (continued)

	Level 1	Level 2	Level 3	Total
<b>December 31, 2014</b>				
<b>Assets</b>				
Cash and cash equivalents	\$ 501,438	\$ –	\$ –	\$ 501,438
Trading securities:				
Fixed income securities	346,690	469,071	2,600	818,361
Commingled funds	497,131	612,041	–	1,109,172
Global equities	108,663	4,406	–	113,069
Beneficial interests in charitable remainder and perpetual trusts	–	10,005	–	10,005
Total assets measured at fair value on a recurring basis	<u>\$ 1,453,922</u>	<u>\$ 1,095,523</u>	<u>\$ 2,600</u>	<u>\$ 2,552,045</u>
<b>Liabilities</b>				
Interest rate swaps	\$ –	\$ 145,339	\$ –	\$ 145,339
Total liabilities measured at fair value on a recurring basis	<u>\$ –</u>	<u>\$ 145,339</u>	<u>\$ –</u>	<u>\$ 145,339</u>
<b>December 31, 2013</b>				
<b>Assets</b>				
Cash and cash equivalents	\$ 395,188	\$ –	\$ –	\$ 395,188
Trading securities:				
Fixed income securities	274,969	492,121	–	767,090
Commingled funds	639,327	265,910	–	905,237
Global equities	79,427	53,479	–	132,906
Beneficial interests in charitable remainder and perpetual trusts	–	10,107	–	10,107
Total assets measured at fair value on a recurring basis	<u>\$ 1,388,911</u>	<u>\$ 821,617</u>	<u>\$ –</u>	<u>\$ 2,210,528</u>
<b>Liabilities</b>				
Interest rate swaps	\$ –	\$ –	\$ 139,072	\$ 139,072
Total liabilities measured at fair value on a recurring basis	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 139,072</u>	<u>\$ 139,072</u>

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **9. Fair Value Measurements (continued)**

The fair value of cash and cash equivalents, which consist mainly of funds invested in money market funds, is based on quoted market prices and classified as Level 1. The fair value of Level 1 trading securities is based on quoted market prices from an active exchange or deemed to have similar liquidity characteristics. The fair value of Level 2 trading securities is based on third-party market quotes in an inactive market or similar securities in an active market and other observable inputs. The fair value of interest rate swaps is based upon forward interest rate curves, as adjusted for CVA (see Note 8).

Cash and cash equivalents not held in money market funds aggregated \$99,989 and \$111,532 as of December 31, 2014 and 2013, respectively, and are not included in the tables. The Indiana University Health System's \$1,076,345 and \$759,963 of alternative investments as of December 31, 2014 and 2013, respectively, are not included in the tables because they are accounted for using the equity method of accounting (see Note 5). The beneficial interests in charitable remainder and perpetual trusts are shown within other long-term assets on the accompanying consolidated balance sheets.

In 2014, the Indiana University Health System modified its fair value hierarchy to provide consistency in the level-determination of certain types of financial instruments. Some asset types were classified differently in the prior year. The following detail outlines changes implemented in 2014.

All collective trusts, off-shore mutual funds, and corporate fixed income securities were not historically classified consistently as Level 2. Historically, some of these instruments had been presented as Level 1. The classification change resulted in reporting consistency as all collective trusts, off-shore mutual funds, and corporate fixed income securities are now Level 2. Balances reported as collective trusts, off-shore mutual funds, and corporate fixed income securities within Level 1 at December 31, 2013 amounted to \$217,705, \$7,451 and \$1,962, respectively.

Additionally, the prior year classifications resulted in some publicly traded securities to be classified as Level 2 based upon limited trading volume. The revised classification results in consistency within Level 1 instruments. Certain government agency obligations were also previously considered Level 2, but to provide consistency in reporting like instruments, the new methodology results in government agency obligations reported as Level 1. The balance of these publicly traded securities and government agency obligations at December 31, 2013 amounted to \$51,177 and \$40,948, respectively.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**9. Fair Value Measurements (continued)**

Some debt securities, previously classified as Level 2, are currently classified as Level 3. This change is to reflect lack of an active market. The balance of these debt securities at December 31, 2013 amounted to \$2,939.

The following table is a rollforward of the amounts included in the consolidated balance sheets for derivative financial instruments classified within Level 3 of the valuation hierarchy defined above:

	<b>Financial Liabilities for Derivative Financial Instruments</b>
Fair value at January 1, 2014	\$ 139,072
Unrealized losses	6,267
Transfer to Level 2	(145,339)
Fair value at December 31, 2014	<u>\$ -</u>

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **9. Fair Value Measurements (continued)**

The Indiana University Health System engages a third party to assist in valuing the CVA. The third party uses the income approach to present value the cash flows using the relevant rate of return for the corresponding swap contracts. Where observable, this return would be the observed market rate(s) of return associated with the swap counterparty in a liability position. Collateral amounts posted, if any, are also taken into consideration. The CVA depicts the difference in the mark-to-market absent any credit risk, and the fair value of the swap that incorporates the credit risk of the party holding the swap in a liability position at that point in time. For swaps for which Indiana University Health is in a liability position, this credit risk is measured by comparing the mark-to-market value derived using the LIBOR swap curve to the fair value derived using the AA-rated Municipal Healthcare curve (or the AA+ rated Muni GO curve for the swaps insured by Assured Guaranty Municipal Corporation) adjusted to a taxable basis using the relevant SIFMA/LIBOR ratio.

The value of the CVA may vary depending upon the following factors:

- whether the Indiana University Health System is required to post collateral under the swap agreements,
- to the extent that the credit rating of the Indiana University Health System increases or decreases, in which case the CVA would decrease or increase, respectively (assuming the swaps are in a liability position), or
- to the extent that the spread between the swap curves discussed above expands or compresses.

Generally, swaps are transferred between Level 2 and Level 3 when the CVA exceeds 10% of the gross valuation of the swap. Transfers are generally recorded at the end of the reporting period.



Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

(Thousands of Dollars)

**10. Commitments and Contingencies**

The Indiana University Health System is from time to time subject to various legal proceedings and claims arising in the ordinary course of business. The Indiana University Health System's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any other claims, individually or collectively, will have a material adverse effect on the Indiana University Health System's financial condition, results of operations, or cash flow.

**Leases**

Buildings and medical and office equipment are leased under noncancelable operating and capital leases. Future minimum lease payments as of December 31, 2014, are as follows:

	<b>Operating Leases</b>	<b>Capital Leases</b>
Year ending December 31:		
2015	\$ 39,182	\$ 9,135
2016	32,703	8,634
2017	26,169	8,362
2018	20,268	8,226
2019	15,397	8,192
Thereafter	33,391	172,039
Total minimum lease payments	<u>\$ 167,110</u>	214,588
Less amount representing interest		118,484
Present value of net minimum lease payments		<u>\$ 96,104</u>

Rent and lease expense, included in supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, amounted to \$80,576 and \$74,376 for the years ended December 31, 2014 and 2013, respectively.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **11. Medical Malpractice**

The Indiana University Health System's medical malpractice coverage is provided through the Indiana University Health Risk Retention Group, Inc. (IUHRRG), a wholly owned subsidiary. The program of medical malpractice coverage considers limitations in claims and damages prescribed by the Indiana Medical Malpractice Act (the Act), which limits the amount of individual claims to \$1,250 and annual aggregate claims to \$7,500, of which up to \$1,000 would be paid by the State of Indiana Patient Compensation Fund (the Fund) and \$250 by the Indiana University Health System for each occurrence of malpractice. The Act also requires that health care providers meet certain requirements, including making funding payments to the Fund and maintaining certain insurance levels. The Indiana University Health System has met these requirements and is a qualified provider under the Act, retaining risk of \$250 per occurrence and \$7,500 in the annual aggregate.

The Indiana University Health System's medical malpractice program includes coverage offered by IUHRRG and reinsured by Indiana University Health Assurance SPC (IUHASPC), a wholly owned subsidiary. This reinsurance also serves as excess insurance for general liability, automobile liability, employers liability, managed care errors and omissions, and professional liability. This coverage is provided on a claims-made basis (aggregating \$70,000 as of July 1, 2014, and \$100,000 prior).

Contributions for coverage provided by the captive insurance companies are expensed as incurred, and loss reserves are established for incurred but not yet reported claims. Laws in the jurisdictions in which the captive insurance companies are domiciled require, among other matters, that certain capital and funding requirements be met. The actuarially determined amount of accrued medical malpractice claims is included in noncurrent liabilities in the accompanying consolidated balance sheets.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **12. Retirement Plans**

##### **Defined-Contribution Plans**

Retirement benefits are provided to substantially all employees of the Indiana University Health System, primarily through defined-contribution plans. Contributions, which are included in benefits expense, to the defined-contribution plans are based on compensation of qualified employees and amounted to \$70,819 in 2014 and \$89,279 in 2013 (net of forfeitures of \$2,277 and \$3,202 in 2014 and 2013, respectively).

##### **Defined-Benefit Plans**

Defined-benefit pension plans sponsored by Indiana University Health, La Porte, Ball Memorial, and Bloomington have been curtailed, with benefits frozen and no new participants allowed. The defined-benefit pension plans applicable to Indiana University Health were principally limited to current and former employees who elected not to participate in the defined-contribution plan established at the time of Indiana University Health's formation.

Pension benefits are based on years of service and compensation of employees (as defined) and are actuarially determined. Where applicable, the funding policy is to annually contribute the amount required to comply with applicable legislation and IRS regulations.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**12. Retirement Plans (continued)**

Adjustments to pension liabilities to reflect funded status are charged or credited to unrestricted net assets. An increase to the pension liability of \$72,149 has been recorded in 2014 due to lower discount rates assumed for net periodic pension costs and a change in mortality assumptions due to revised IRS guidelines. A decrease to the pension liability of \$130,488 was recorded in 2013 mainly due to contributions of \$61,862 and higher discount rates.

The following table sets forth the funded status of the defined-benefit pension plans and amounts recognized in the consolidated financial statements. The discount rates used vary with each plan based on plan characteristics such as the average age of participants.

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Changes in benefit obligation of the plans:		
Benefit obligation at beginning of year	\$ 446,753	\$ 498,114
Service cost and other	144	1,872
Interest cost	21,214	19,991
Actuarial gain (loss)	86,693	(46,819)
Benefits paid	(23,123)	(26,405)
Benefit obligation at end of year	<u>\$ 531,681</u>	<u>\$ 446,753</u>
Changes in assets of the plans:		
Fair value of assets at beginning of year	\$ 422,760	\$ 343,634
Actual return on assets	35,362	43,669
Employer contributions	471	61,862
Benefits paid	(23,123)	(26,405)
Fair value of assets at end of year	<u>\$ 435,470</u>	<u>\$ 422,760</u>
Funded deficiency at December 31	<u>\$ (96,211)</u>	<u>\$ (23,993)</u>
Items not yet recognized as a component of net periodic pension cost:		
Net actuarial loss	\$ 151,996	\$ 79,847
	<u>\$ 151,996</u>	<u>\$ 79,847</u>

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**12. Retirement Plans (continued)**

	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Components of net pension benefit cost:		
Service cost	\$ 374	\$ 1,957
Interest cost	21,214	19,991
Expected return on assets	(26,719)	(23,512)
Amortization of unrecognized prior service cost	–	(314)
Amortization of unrecognized net loss	4,532	19,327
Termination benefit and settlement expense (income)	1,123	(85)
Net periodic pension cost	<u>\$ 524</u>	<u>\$ 17,364</u>
Weighted-average actuarial assumptions to determine benefit cost:		
Discount rate for net periodic pension cost	4.98%	4.04%
Discount rate for benefit obligations	4.11	4.90
Expected rate of return on plan assets	6.44	6.47
Rate of compensation increase	0.00	2.00
Accumulated benefit obligation	\$ 531,681	\$ 446,525
Fair value of assets at end of year	<u>435,470</u>	<u>422,760</u>
Accumulated benefit obligation exceeding fair value of plan assets	<u>\$ 96,211</u>	<u>\$ 23,765</u>
Expected future benefit payments:		
2015		\$ 25,138
2016		27,085
2017		28,106
2018		29,747
2019		30,318
2020–2024		158,211

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
*(Thousands of Dollars)*

**12. Retirement Plans (continued)**

Accumulated adjustments to unrestricted net assets at December 31, 2014, include amounts related to net actuarial loss and prior service costs that have not yet been recognized in net pension benefit cost. Expected amortization of amounts in unrestricted net assets is expected to increase net periodic pension costs by \$4,050 during the year ending December 31, 2015. Required contributions are expected to aggregate \$587 to the defined-benefit pension plans during 2015.

The plans' assets are held in a group trust. The principal long-term determinant of a plan's investment return is the asset allocation of the group trust. The group trust's allocations are weighted toward growth-oriented assets versus duration-oriented investments. The expected long-term rate of return assumption is based on the mix of assets in the plans and the long-term earnings expected to be associated with each asset class. These assumptions are periodically benchmarked against peer plans.

The weighted-average asset allocations of the plans, by asset category, are as follows:

<b>Asset category</b>	<b>December 31</b>	
	<b>2014</b>	<b>2013</b>
Commingled funds	<b>79%</b>	77%
Hedged funds	<b>20</b>	20
Cash and cash equivalents	<b>1</b>	3
	<b>100%</b>	100%

The allocation strategy for the group trust in which the plans participate is currently composed of approximately 60% to 70% of growth-oriented investments and 30% to 40% of duration-oriented investments. The largest component of these growth-oriented assets is public equity securities that are diversified and invested in U.S. and international companies.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**12. Retirement Plans (continued)**

The following tables present the plans' financial instruments as of December 31, 2014 and 2013, measured at fair value on a recurring basis within the fair value hierarchy as disclosed in Note 9:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>December 31, 2014</b>				
<b>Assets</b>				
Cash and cash equivalents	\$ 4,633	\$ –	\$ –	\$ 4,633
Commingled funds	228,988	115,451	–	344,439
Hedged funds	–	86,398	–	86,398
Total assets measured at fair value on a recurring basis	<u>\$ 233,621</u>	<u>\$ 201,849</u>	<u>\$ –</u>	<u>\$ 435,470</u>

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>December 31, 2013</b>				
<b>Assets</b>				
Cash and cash equivalents	\$ 14,440	\$ –	\$ –	\$ 14,440
Fixed income	–	7	–	7
Commingled funds	276,257	48,813	–	325,070
Hedged funds	–	83,243	–	83,243
Total assets measured at fair value on a recurring basis	<u>\$ 290,697</u>	<u>\$ 132,063</u>	<u>\$ –</u>	<u>\$ 422,760</u>

The fair value of cash equivalents, which consist mainly of funds invested in money market funds, is based on quoted market prices and classified as Level 1. The fair value of Level 1 investments is based on quoted market prices from an active exchange. The fair value of Level 2 investments is based on third-party quotes in an inactive market or similar securities in an active market and other observable inputs.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

**12. Retirement Plans (continued)**

The plans invest in hedged funds for which the net asset value per share represents the fair value of the investment held. Risks and redemption restrictions for these investments are similar to the alternative investments described in Note 5.

In 2014, the Indiana University Health System modified its fair value hierarchy to provide consistency in the level-determination of certain types of financial instruments. Some asset types were classified differently in the prior year. The following detail outlines changes implemented in 2014.

All collective trusts were not historically classified consistently as Level 2. Historically, some of these instruments had been presented as Level 1 because they were actively traded on public exchanges. The methodology change was in order to provide consistency in reporting all collective trusts consistently as Level 2. Balances reported as collective trusts within Level 1 at December 31, 2013 amounted to \$78,809.



## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **13. Endowments**

Endowment funds of Methodist Health Foundation and BMH Foundation consist of donor-restricted endowment funds held for various specific purposes. As required by GAAP, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The Board of Directors of both foundations have interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring 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, the foundations classify as permanently restricted net assets the following: (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 fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the foundations in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the foundations consider the various factors in making a determination to appropriate or accumulate donor-restricted endowment funds, such as the duration and preservation of the fund, the purposes of the foundations and the donor-restricted endowment fund, general economic conditions, the possible effect of inflation and deflation, the expected total return from income and the appreciation of investments, other resources of the organization, and the investment policies of the foundations.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements (continued)  
(Thousands of Dollars)

**13. Endowments (continued)**

Changes in and composition of donor-restricted endowment net assets for both foundations for the years ended December 31, 2014 and 2013, were as follows:

	<b>Temporarily Restricted</b>	<b>Permanently Restricted</b>	<b>Total</b>
Endowment net assets at			
January 1, 2013	\$ 10,940	\$ 44,906	\$ 55,846
Investment return	5,477	244	5,721
Appropriation of endowment assets for expenditures	(1,782)	–	(1,782)
Endowment net assets at			
December 31, 2013	14,635	45,150	59,785
Investment return	<b>2,133</b>	<b>204</b>	<b>2,337</b>
Appropriation of endowment assets for expenditures	<b>(2,691)</b>	–	<b>(2,691)</b>
Endowment net assets at			
December 31, 2014	<b>\$ 14,077</b>	<b>\$ 45,354</b>	<b>\$ 59,431</b>

Methodist Health Foundation and BMH Foundation have adopted separate investment and spending policies for endowment assets. Policies for both foundations attempt to preserve capital, maximize the return within reasonable and prudent levels of risk, and provide a return to the restricted funds. Endowment assets are invested in a manner that is intended to produce results that exceed the initial recorded value of the investment and yield a targeted long-term rate while assuming a moderate level of investment risk. Disbursements are made for the purposes of supporting various Indiana University Health and Ball Memorial program services. Each foundation has set a threshold for the amount available to distribute each year.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued) (Thousands of Dollars)

#### **14. Related-Party Transactions**

##### **Indiana University School of Medicine**

The Consolidation Agreement requires that Indiana University Health fund salaries and related employee benefit costs for medical doctor interns and residents of the School of Medicine who provide services at the Indiana University Health System's facilities. These costs totaled \$46,472 and \$43,862 in 2014 and 2013, respectively, and have been reported with salaries, wages, and benefits expense in the accompanying consolidated statements of operations and changes in net assets.

The Indiana University Health System purchases certain services from the School of Medicine. These expenses, principally for certain physician and staff salaries, medical directors, medical care case management services, utilities, laboratory services, and other services, totaled \$52,730 and \$39,262 for the years ended December 31, 2014 and 2013, respectively, and have been reported within salaries, wages, and benefits, supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets.

The Indiana University Health System also provides additional support to the School of Medicine to assist with medical education and research. During 2014 and 2013, Indiana University Health expensed \$43,728 and \$73,115, respectively, within educational and research support to Indiana University and supplies, drugs, purchased services and other expenses in the accompanying consolidated statements of operations and changes in net assets. As of December 31, 2013, \$40,000 of this support was recorded within accounts payable and accrued expenses in accompanying consolidated balance sheets and paid to the School of Medicine during the first quarter of 2014. No such amount is accrued as of December 31, 2014.

Additionally, in 2012, Indiana University Health committed to support ratably for a five-year period ending December 31, 2016, certain basic, clinical, and translational research programs of the School of Medicine. The total commitment aggregates \$75,000, subject to Board approval annually, and will be used to reimburse expenses incurred by the School of Medicine. For the years ended December 31, 2014 and 2013, the Indiana University Health System expensed \$15,000 under this agreement within supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, of which \$28,066 and \$22,138 was accrued within accounts payable and accrued expenses at December 31, 2014 and 2013, respectively.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **14. Related-Party Transactions (continued)**

The School of Medicine rents space at Indiana University Health's Fairbanks Hall, an educational and resource center, under a 34-year lease agreement with Indiana University Health. In 2008, the School of Medicine prepaid the rent, totaling \$4,887 under the agreement, and the income is being recognized over the term of the lease.

#### **Other Foundations**

Bloomington Hospital Foundation, Tipton County Foundation, Indiana University Health White Memorial Hospital Foundation, and White County Community Foundation are tax-exempt organizations under Section 501(c)(3) of the IRC; these foundations hold funds solely on behalf of Bloomington, Tipton, and White, respectively.

The financial statements of these foundations are not included in the consolidated financial statements. The interests in net assets of these other foundations, which totaled \$13,976 and \$13,849 at December 31, 2014 and 2013, respectively, are included with other assets and net assets in the accompanying consolidated balance sheets and principally represent donor-restricted funds. These foundations also hold other net assets that are subject to the direction of their respective Boards of Directors. Other changes in the net assets of these foundations are generally reflected within temporarily and permanently restricted net assets.

## Indiana University Health, Inc. and subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Thousands of Dollars)*

#### **15. Health Care Legislation and Regulation**

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, participation requirements, reimbursement for patient services, Medicare and Medicaid fraud and abuse, and security, privacy, and standards of health information. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and noncompliance with regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs together with the imposition of significant fines and penalties, significant repayments for patient services previously billed, and disruptions or delays in processing administrative transactions, including the adjudication of claims and payment.

In the opinion of management, there are no known regulatory inquiries that are expected to have a material adverse effect on the consolidated financial statements of the Indiana University Health System; however, compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

The Affordable Care Act and the Health Care and Education Reconciliation Act legislation, among other matters, is designed to expand access to coverage to substantively all citizens by 2019 through a combination of public program expansion and private industry health insurance. Changes to existing Medicare and Medicaid coverage and payments are also expected to occur as a result of this legislation which has also included the creation of a Health Insurance Marketplace. In addition, in January 2015 CMS approved Medicaid expansion for Indiana as part of its Healthy Indiana Plan. Implementing regulations are generally required for these legislative acts, which are to be adopted over a period of years.

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