

CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Beacon Health System, Inc. and Affiliated Corporations
Years Ended December 31, 2016 and 2015
With Reports of Independent Auditors

Ernst & Young LLP



Beacon Health System, Inc. and Affiliated Corporations

Consolidated Financial Statements
and Supplementary Information

Years Ended December 31, 2016 and 2015

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Report of Independent Auditors

The Board of Directors
Beacon Health System, Inc. and Affiliated Corporations

We have audited the accompanying consolidated financial statements of Beacon Health System, Inc. and Affiliated Corporations (the Corporation), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, 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 Beacon Health System, Inc. and Affiliated Corporations at December 31, 2016 and 2015, and the 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 9, 2017

Beacon Health System, Inc. and Affiliated Corporations

Consolidated Balance Sheets
(In Thousands)

	December 31	
	2016	2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 43,032	\$ 63,838
Short-term investments	53,501	42,564
Patient accounts receivable, less allowances for doubtful accounts (2016 – \$30,657; 2015 – \$33,633)	160,873	163,256
Due from third-party payors	40,376	12,487
Other receivables	9,072	9,949
Inventories	25,437	24,111
Prepaid expenses	15,757	9,416
Total current assets	<u>348,048</u>	<u>325,621</u>
Assets limited as to use:		
Internally designated investments	590,890	547,515
Restricted cash	4,526	3,012
Externally designated investments – insurance trust	2,680	2,656
Designated cash	19,769	18,948
Board-designated endowment	24,961	19,477
Endowment and temporarily restricted investments	6,514	6,217
	<u>649,340</u>	<u>597,825</u>
Property and equipment:		
Land	44,897	45,749
Buildings and improvements	730,503	633,254
Furniture and equipment	466,023	447,712
Construction-in-progress	55,372	105,257
	<u>1,296,795</u>	<u>1,231,972</u>
Less allowances for depreciation and amortization	<u>641,882</u>	<u>605,738</u>
	<u>654,913</u>	<u>626,234</u>
Deferred charges and other assets	32,938	31,564
Interest rate swap	–	598
Total assets	<u><u>\$ 1,685,239</u></u>	<u><u>\$ 1,581,842</u></u>

	December 31	
	2016	2015
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 46,991	\$ 49,184
Accrued salaries and benefits	35,928	35,096
Accrued expenses	4,809	4,522
Due to third-party payors	4,452	11,265
Current maturities of long-term debt	8,824	8,231
Total current liabilities	<u>101,004</u>	<u>108,298</u>
Non-current liabilities:		
Long-term debt, less current maturities	279,909	239,808
Pension and other liabilities	92,159	100,437
Interest rate and basis swaps	22,779	20,523
	<u>394,847</u>	<u>360,768</u>
Total liabilities	<u>495,851</u>	<u>469,066</u>
Net assets:		
Unrestricted:		
Undesignated	1,154,359	1,080,002
Board-designated endowment	19,621	19,477
Total unrestricted	<u>1,173,980</u>	<u>1,099,479</u>
Temporarily restricted	14,742	12,706
Permanently restricted	666	591
Total net assets	<u>1,189,388</u>	<u>1,112,776</u>
Total liabilities and net assets	<u><u>\$ 1,685,239</u></u>	<u><u>\$ 1,581,842</u></u>

See accompanying notes.

Beacon Health System, Inc. and Affiliated Corporations

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

	Year Ended December 31	
	2016	2015
Unrestricted revenue, gains, and other support		
Net patient service revenue	\$ 945,600	\$ 934,934
Provision for bad debts	(59,658)	(73,035)
Net patient service revenue less provision for bad debts	885,942	861,899
Other revenue	36,274	40,567
Net assets released from restrictions used for operations	980	332
	923,196	902,798
Expenses		
Salaries and wages	391,882	379,739
Employee benefits	102,234	93,500
Supplies and other	222,224	223,052
Professional fees and purchased services	119,129	115,892
Depreciation and amortization	55,987	52,517
Interest	6,637	4,985
	898,093	869,685
Income from operations	25,103	33,113
Non-operating		
Investment income, net	42,741	(20,496)
Unrealized gains (losses) on swap transactions, net	(1,246)	7,827
Gain on swap termination	158	–
Loss on sale of assets	(1,362)	–
Fair value of net assets combined	5,157	–
Revenue and gains in excess of expenses	70,551	20,444

Beacon Health System, Inc. and Affiliated Corporations

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

	Year Ended December 31	
	2016	2015
Unrestricted net assets		
Revenue and gains in excess of expenses	\$ 70,551	\$ 20,444
Net assets released from restrictions used for capital purposes	1,664	5,456
Net assets released from board-designated endowment	–	(815)
Other	–	(142)
Postretirement benefit adjustments other than periodic costs	2,286	(5,702)
Increase in unrestricted net assets	<u>74,501</u>	19,241
Temporarily restricted net assets		
Contributions temporarily restricted for use	3,857	3,594
Investment income	308	(438)
Fair value of net assets combined	515	–
Net assets released from restrictions used for operating and capital purposes	(2,644)	(5,788)
Increase in temporarily restricted net assets	<u>2,036</u>	(2,632)
Permanently restricted net assets		
Fair value of net assets combined	75	–
	<u>75</u>	–
Change in net assets	76,612	16,609
Net assets at beginning of year	1,112,776	1,096,167
Net assets at end of year	<u>\$ 1,189,388</u>	<u>\$ 1,112,776</u>

See accompanying notes.

Beacon Health System, Inc. and Affiliated Corporations

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended December 31	
	2016	2015
Operating activities		
Change in net assets	\$ 76,612	\$ 16,609
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:		
Depreciation and amortization	55,987	52,517
Provision for bad debts	59,658	73,035
Unrealized gains (losses) on swap transactions, net	1,246	(7,827)
Gain on swap termination	(158)	-
Loss on sale of assets	1,362	-
Postretirement benefit adjustments other than periodic costs	(2,286)	5,702
Realized gains on investments	(23,501)	(3,168)
Restricted contributions and investment income	(4,165)	(3,156)
Changes in operating assets and liabilities:		
Patient accounts receivable	(57,275)	(96,032)
Other receivables, inventories, and prepaid expenses	(6,790)	3,364
Other assets	(20,036)	(2,566)
Restricted cash	(1,514)	3,132
Designated cash	(821)	-
Investments – trading	(36,616)	51,938
Accounts payable, accrued salaries and benefits, and accrued expenses	(1,074)	(24,609)
Due to/from third-party payors, net	(34,702)	7,294
Other long-term liabilities	(6,654)	(2,276)
Net cash (used in) provided by operating activities	(727)	73,957
Investing activities		
Net additions to property and equipment	(64,823)	(101,433)
Net cash used in investing activities	(64,823)	(101,433)
Financing activities		
Principal payments on long-term debt and other debt obligations	(9,139)	(8,374)
Net proceeds from issuance of long-term debt and other debt obligations	50,000	-
Payment of bond issue costs	(282)	-
Restricted contributions and investment income	4,165	3,156
Net cash provided by (used in) financing activities	44,744	(5,218)
Decrease in cash and cash equivalents	(20,806)	(32,694)
Cash and cash equivalents at beginning of year	63,838	96,532
Cash and cash equivalents at end of year	\$ 43,032	\$ 63,838
Supplemental disclosure of cash flow information		
Interest paid	\$ 6,671	\$ 5,022

See accompanying notes.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements

(In Thousands)

December 31, 2016

1. Organization and Basis of Consolidation

The accompanying consolidated financial statements represent the accounts of Beacon Health System, Inc. (the Corporation) and its various affiliated corporations under the control of the Corporation (collectively, BHS). The Corporation is an Indiana not-for-profit corporation exempt from federal income tax under Internal Revenue Code (the Code) Section 501(a) as an organization described in Section 501(c)(3) and a public charity as described in Section 509(a)(3). The Corporation is the sole corporate member of the following entities:

- Elkhart General Hospital, Inc. (EGH)
- Memorial Hospital of South Bend, Inc. (MHSB)
- Beacon Health Foundation, Inc. (BHF), formerly Memorial Health Foundation, Inc.
- Beacon Medical Group, Inc. (BMG), formerly Memorial Health System, Inc.
- Beacon Health Ventures, Inc. (BHV)
- Community Occupational Medicine, Inc. (COM)
- CHA ACO, LLC (CHA ACO)

EGH, MHSB, BMG, and BHF are also exempt from federal income tax under Section 501(a) as organizations described in Section 501(c)(3) and as public charities described in Sections 509(a)(1) and 509(a)(2). BHV and COM are Indiana for-profit corporations. EGH is a 365-licensed-bed (254 available) acute care community hospital located in Elkhart, Indiana. MHSB is a 657-licensed-bed (409 available) acute care trauma center located in South Bend, Indiana. EGH and MHSB (collectively, the Hospitals) provide inpatient, outpatient, and 24-hour emergency care services for residents of Elkhart and South Bend, Indiana, and the surrounding communities.

In October 2016, Elkhart General Hospital Foundation (EGHF), a third party, was combined into the Memorial Hospital Foundation, Inc. (MHF) The combined operations were renamed Beacon Health Foundation, Inc. (“BHF”) All assets and liabilities of EGHF were assumed by BHF.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

1. Organization and Basis of Consolidation (continued)

Aggregate financial information of EGHF merged into BHF was as follows:

	<u>2016</u>
Assets	\$ 5,821
Liabilities	74
Net Assets	5,747

BHF is organized primarily to promote and encourage philanthropic activities for the support of the Corporation and its affiliates. EGHF was organized primarily to support EGH. EGHF combined with MHF as it had a common purpose and alignment with MHF. MHF and EGHF combined into BHF with no impact to income from operations.

BHV manages the taxable operations of the Corporation, including home care and other non-acute health care services.

COM primarily promotes population health management.

CHA ACO coordinates high-quality care for Medicare beneficiaries participating in the Medicare Shared Savings Programs.

BMG operates the physician enterprise of the Corporation.

All significant intercompany accounts and transactions have been eliminated in consolidation.

The Corporation owns a less than majority ownership or controlling interest in the following:

- 50% interest in Community Health Alliance LLC, an Indiana physician hospital organization
- 50% interest in Memorial Spine and Neuroscience Center, LLC, an outpatient surgery center specializing in neurologic, spine, and pain control procedures
- 42% interest in LaPorte Medical Group Surgery Center, LLP, an outpatient surgery center

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

1. Organization and Basis of Consolidation (continued)

- 50% interest in Valparaiso Medical Development, LLC, a professional medical building venture
- 25% interest in Magnetic Resonance Imaging, LLC, an imaging and radiology center
- 33% interest in Michiana Information Health Network, Inc., a health information exchange
- 40% interest in Elkhart Health, Fitness & Aquatics, Inc., a health fitness and aquatics center
- 42% interest in Wakarusa Medical Clinic, LLC, a medical clinic
- 50% interest in Wa Nee Walk-in Clinic, LLC, a medical clinic
- 40% interest in Northern Indiana Ambulatory Surgery Center, LLC, an ambulatory surgery center, on October 1, 2016 the Corporation sold its interest.

Aggregate financial information relating to these investments is as follows:

	<u>2016</u>		<u>2015</u>
Assets	\$ 34,391	\$	37,999
Liabilities	15,164		17,003
Net income	4,064		5,950

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Although estimates are considered to be fairly stated at the time the estimates are made, actual results could differ from those estimates.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Cash Equivalents

All investments that are not limited as to use with a maturity of three months or less at the time of acquisition are reflected as cash equivalents. Cash equivalents include checking accounts, money market accounts, corporate credit card accounts, and petty cash. The carrying value of cash equivalents approximates fair value.

Short-Term Investments

Short-term investments include cash reinvested on a daily basis, accrued interest on investments, and money expected to be used in less than a year as part of BHS' community benefit. Also included in short-term investments are restricted and unrestricted investment donations that are in the process of being liquidated.

Accounts Receivable

The Corporation evaluates the collectibility of its accounts receivable based on the length of time the receivable is outstanding, payor class, and the anticipated future uncollectible amounts based on historical experience. Accounts receivable are charged to the allowance for doubtful accounts when they are deemed uncollectible.

Assets Limited as to Use

Assets limited as to use include assets set aside by the Board of Directors (the Board) for future capital improvements and community health enhancement initiatives that the Board, at its discretion, may subsequently use for other purposes. In addition, assets limited as to use also include assets held by trustees under self-funded insurance agreements, and investments externally designated under indenture or donor restriction.

Investments

The Corporation classifies its investments as trading. Under a trading classification, all unrestricted realized and unrealized gains and losses are included in revenue and gains in excess of expenses.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices for those or similar investments. Dividend and interest income, realized gains and losses, and changes to fair values of investments are reported as non-operating investment income in the consolidated statements of operations and changes in net assets.

Investments in alternative investments, primarily hedge fund of funds, that invest in marketable securities and derivative products are reported using the equity method. The estimated fair values are provided by the respective fund managers and are based on historical costs, appraisals, and other estimates that require varying degrees of judgment. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and may differ from the value that would have been used had a ready market for such investments existed. Resulting differences could be material. The financial statements of the hedge funds are audited annually. Equity earnings related to these alternative investments are included in non-operating investment income. The Corporation's holding reflects net contributions to the hedge fund and an allocated share of realized and unrealized investment income and expense.

Inventories

Inventories are stated at the lower of cost (average cost method) or market.

Unamortized Bond Issuance Costs

Costs incurred in connection with the issuance of long-term debt are deferred and amortized over the term of the related financing, which approximates the effective interest method.

Fair Value of Financial Instruments

The Corporation's carrying amount for its financial instruments, which include cash and cash equivalents, investments and assets limited as to use, and accounts receivable, at December 31, 2016 and 2015, approximates fair value. The estimated fair value amounts have been determined by the Corporation using available market information and appropriate valuation methodologies.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment are carried at cost, except for donated assets, which are recorded at fair value at the date of donation. Allowances for depreciation and amortization are computed primarily utilizing the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years.

Asset Impairment

The Corporation considers whether indicators of impairment are present and performs the necessary tests to determine whether the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating expenses at the time the impairment is identified. There was \$681 and \$0 of impairment of long-lived assets in 2016 and 2015, respectively.

The carrying value of goodwill amounted to approximately \$10,409 at December 31, 2016 and 2015, respectively, and is included in deferred charges and other assets in the consolidated balance sheets. Goodwill is assessed for impairment on an annual basis at the reporting unit level. If the fair value of the reporting unit is less than the carrying value, an impairment loss equal to the difference between the implied fair value of the reporting unit goodwill and the carrying value of the reporting unit goodwill is recognized. There was no impairment of goodwill in 2016 or 2015.

Deferred Charges and Other Assets

Included in deferred charges and other assets are intangible assets, goodwill, and investments in unconsolidated affiliates.

The acquisition of a business entity can result in the recording of intangible assets. Acquired definite-lived intangible assets (excluding goodwill) are amortized over the useful life of the assets. Goodwill is carried at acquisition value, less any impairment reductions.

The Corporation accounts for its investments in less than majority owned and controlled affiliates using either the equity method of accounting. Income from these investments is reflected in other revenue in the consolidated statements of operations and changes in net assets.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Endowment Investments

Income is received directly by BHF from BHF board-designated endowment investments and is included in investment income within temporarily restricted net assets. EGH receives a portion of the income from investments in endowments directly as they are released from restriction. These endowment investments have perpetual existence.

Contributions

Unconditional pledges to give cash and other assets are reported at fair value at the date the pledge is received to the extent estimated to be collectible by the Corporation. Pledges received with donor restrictions that limit the use of the donated assets are reported as either temporarily or permanently restricted support. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions.

Temporarily Restricted Net Assets

Temporarily restricted net assets are used to differentiate resources, the use of which is restricted by donors or grantors to a specific time period or purpose, from resources on which no restrictions have been placed or that arise from the general operations of the Corporation. Temporarily restricted gifts and bequests are recorded as an addition to temporarily restricted net assets in the period received. Assets released from restrictions that are used for the purchase of property and equipment or capital purposes are reported in the consolidated statements of operations and changes in net assets as additions to unrestricted net assets. Resources restricted by donors for specific operating purposes are reported in unrestricted revenue, gains, and other support to the extent expended within the period.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Permanently Restricted Net Assets

Permanently restricted net assets have been restricted by donors to be maintained by the Corporation in perpetuity. In accordance with the restriction, a majority of the investment income and investment gains or losses from permanently restricted net assets are restricted by the donor for a specific purpose and are therefore temporarily restricted. A specified portion of income earned by the temporarily restricted net assets is released from restriction and used for operations each year and, therefore, is included in the consolidated statements of operations and changes in net assets as other revenue.

Net Patient Service Revenue

Net patient service revenue is recorded in the period in which services are rendered, based upon estimated amounts due from patients and third-party payors. Third parties include Medicare, Medicaid, managed health care plans, and other commercial plans. BHS has agreements with various third-party payors that provide for payments to BHS at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts received or due from patients, third-party payors, and others for services rendered. These amounts include estimated adjustments under certain reimbursement agreements with third-party payors, which are subject to audit by the applicable administering agency. These adjustments are accrued on an estimated basis and are adjusted in future periods as final settlements are determined (see Note 3). The Hospitals provide care to all patients regardless of their ability to pay. Charity care provided is excluded from net patient service revenue (see Note 4).

Performance Indicator

The consolidated statements of operations and changes in net assets include a performance indicator, revenue and gains in excess of expenses. Changes in unrestricted net assets, which are excluded from revenue and gains in excess of expenses, consistent with industry practice, include contributions of long-lived assets, including assets acquired using contributions, which, by donor restrictions, were to be used for the purpose of acquiring such assets, and pension-related changes other than net periodic costs.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Allocation of Costs

The Corporation's ability to exercise control over consolidated entities could result in the entities having a financial position or operating results that are significantly different from those that would have been obtained if the entities were autonomous. The manner of allocating certain shared and centralized costs, such as accounts payable processing, information technology support, and other Corporation-managed administration costs, is determined by the Corporation utilizing Internal Revenue Service transfer pricing guidance. Alternate methods of accounting for these cost allocations may produce significantly different operating results for each of the consolidated entities.

Interest Rate and Basis Swaps

All interest rate and basis swaps are measured at fair value based on techniques consistent with the market approach. None of the swaps are designated as hedging instruments; therefore, the unrealized gains or losses on the fair value of the swaps are included in revenue and gains in excess of expenses in the consolidated statements of operations and changes in net assets.

Asset Retirement Obligations

The Corporation accounts for the fair value of legal obligations associated with long-lived asset retirements by recognizing an expense and accreting a liability over the life of the asset to cover potential legal obligations at the end of the asset's useful life. The asset retirement obligation primarily relates to future asbestos remediation related to buildings on MHSB's campus, as well as ground/soil remediation associated with the removal of underground fuel tanks. The carrying value of the obligation amounted to approximately \$4,444 and \$4,302 at December 31, 2016 and 2015, respectively, and is reflected in pension and other liabilities on the consolidated balance sheets.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*. The amendments in this update require not-for-profit entities that are conduit bond obligors to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This will result in BHS making additional judgments, such as estimates of the collectability of revenue. In March 2016, the FASB issued ASU 2016-08 clarifying the implementation guidance on principal versus agent considerations. During third quarter of 2016, the FASB issued ASU 2016-10 and 2016-12. The amendments in these updates further clarify key guidance related to revenue recognition. BHS is required to adopt the new guidance in conjunction with ASU 2014-09. This new guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2017, with early adoption not permitted. BHS is required to adopt the new guidance for the fiscal year beginning on January 1, 2018, and is currently evaluating the impact this guidance will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. The amendments in this update replace the three classes of net assets (unrestricted, temporary, and permanent) with two classes (with and without donor restrictions). The ASU also requires additional disclosures relating to net assets and expenses. BHS is required to adopt the new guidance for the fiscal year beginning on January 1, 2018, and is currently evaluating the impact this guidance will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. The amendments in this update clarify the classification of eight types of transactions, including proceeds from the settlement of insurance claims and distributions received from equity method investees, in the statement of cash flows to reduce diversity in practices. BHS is required to adopt the new guidance for the fiscal year beginning on January 1, 2018, and is currently evaluating the impact this guidance will have on its consolidated financial statements.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

In February 2016, the FASB issued ASU 2016-02, *Leases*. Under the new guidance lessees are required to capitalize leases with greater than 12 months term on the balance sheet. Leases will be classified as operating or financing. Both types of leases will be recorded on the balance sheet. Operating leases will reflect lease expense on a straight line basis whereas financing leases will accelerate lease expense in the early period of the lease term and decline with passage of time similar to current accounting for capital leases. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. BHS is required to adopt the new guidance for the fiscal year beginning on January 1, 2019, and is currently evaluating the impact this guidance will have on its consolidated financial statements.

Reclassifications

Certain reclassifications were made to the 2015 consolidated financial statements to conform with classifications made in 2016. The reclassifications had no effect on the changes in net assets or on net assets previously reported. The bond issuance costs in 2015 of \$2,077 were reclassified from deferred costs and other assets to long-term debt, less current portion on the consolidated balance sheets.

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts

The Medicare and Medicaid programs reimburse the Corporation for inpatient and outpatient services at predetermined rates based on diagnosis and treatment. Changes in the Medicare and Medicaid programs or reduction in funding of the programs could have an adverse effect on future amounts recognized as net patient service revenue.

The laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

Managed care reimbursement agreements provide for payment of patient services at a fixed percentage of covered charges. The Corporation has also entered into contractual arrangements with various health maintenance and preferred provider organizations, the terms of which call for the Corporation to be paid for covered services at predetermined rates, including percentage of charges, per diem, and case rate.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

**3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts
(continued)**

Estimated amounts due are calculated from contractually obligated terms of payment for each payor, as well as uninsured discounts applied for patients with no insurance coverage. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the years ended December 31 from these major payor sources is as follows (in thousands):

Payor	2016	2015
Anthem	\$ 195,495	\$ 195,920
Commercial	289,665	285,132
Medicare	267,045	267,108
Medicaid	131,663	133,904
Self-pay	61,732	52,870
Net patient service revenue	945,600	934,934
Provision for bad debt	(59,658)	(73,035)
Net patient service revenue less provision for bad debt	\$ 885,942	\$ 861,899

Net patient service revenues related to the Medicare program are 28% and 29% for the years ended December 31, 2016 and 2015, respectively. Net patient service revenues related to the Medicaid program are 14% for the years ended December 31, 2016 and 2015. Amounts reported under the Anthem payor contract account for 21% of net patient service revenue for the years ended December 31, 2016 and 2015. Credit is granted without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Major components of net patient accounts receivable include 32% from Medicare and 23% from Anthem at December 31, 2016, and 29% from Medicare and 19% from Anthem at December 31, 2015.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

**3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts
(continued)**

The provision for bad debts is based upon management's assessment of historical and expected net collections taking into consideration the trends in health care coverage, historical economic trends, and other collection indicators. Management assesses the adequacy of the allowances periodically throughout the year based upon historical write-off experience by major payor category. The results of the review are then utilized to make modifications, as necessary, to the provision for bad debts to provide for an appropriate allowance for uncollectible accounts. A significant portion of the Corporation's uninsured patients will be unwilling to pay for the services provided. Thus, the Corporation records a significant provision for bad debts related to uninsured patients in the period the services are provided. The allowance for doubtful accounts recognized at December 31 by major payor source is as follows:

Payor	2016	2015
Third-party payors	\$ 18,341	\$ 18,699
Self-pay	12,316	14,934
	<u>\$ 30,657</u>	<u>\$ 33,633</u>

Adjustments arising from reimbursement arrangements with third-party payors are accrued for on an estimated basis in the period in which the services are rendered, with the exception of Indiana Medicaid Disproportionate Share (DSH) reimbursement. DSH payments by the state of Indiana, if eligible, are paid according to the fiscal year of the state, which ends on June 30 of each year, and are based on the cost of uncompensated care provided by the DSH providers during their respective fiscal year ended during the state fiscal year. DSH payments are recorded after eligibility is determined, and payments are probable and reasonably estimable. In 2016, MHSB qualified for the State DSH program for State Fiscal Years (SFY) 2017 and 2018. In 2015, MHSB qualified for the State DSH program for SFYs 2015 and 2016. MHSB recorded net patient service revenue of \$22,923 for the year ended December 31, 2016, related to SFY 2016 and 2015 DSH payments. MHSB recorded net patient service revenue of \$19,920 for the year ended December 31, 2015, related to SFY 2015 and 2014 DSH payments.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

**3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts
(continued)**

In April 2014, the Indiana Hospital Assessment Fee program (HAF) was approved by the Centers for Medicare & Medicaid Services (CMS) retroactively for the period July 1, 2013 to June 30, 2017. Under HAF, Indiana hospitals receive additional federal Medicaid funds for the state's health care system, administered by the Indiana Family and Social Services Administration. HAF includes both a payment to the Hospitals from the state (included in net patient service revenue) and an assessment (included in supplies and other expenses) against the Hospitals, which is paid to the state the same year. BHS recognized revenues and assessments as follows:

	Year Recognized		
	2016	2015	Total
Year ended December 31, 2016 HAF Revenue	\$ 47,799	\$ –	\$ 47,799
Year ended December 31, 2016 HAF Assessments	(25,153)	–	(25,153)
Year ended December 31, 2015 HAF Revenue	–	44,796	44,796
Year ended December 31, 2015 HAF Assessments	(138)	(23,880)	(24,018)
Year ended December 31, 2014 HAF Assessments	–	(160)	(160)
	\$ 22,508	\$ 20,756	\$ 43,264

HAF revenue is included in net patient service revenue and HAF assessments are included in supplies and other expenses in the consolidated statements of operations and changes in net assets.

Estimates for DSH, cost report settlements, and contractual allowances can differ from actual reimbursement based on the results of subsequent reviews, government regulatory changes, and cost report audits. For the years ended December 31, 2016 and 2015, net patient service revenue has been increased by approximately \$9,618 and decreased by \$303, respectively, for changes in estimates of third-party payor settlements related to prior years.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

4. Charity Care

Charity care represents unreimbursed costs for services rendered at a reduced fee, or no fee, due to the inability of the patient to pay for services. The amount of the charity care provided was approximately \$5,908 and \$7,602 for the years ended December 31, 2016 and 2015, respectively, at estimated cost. The Corporation utilized a cost to charge ratio methodology for the cost analysis. The only reimbursement for financial assistance care received by the Corporation is determined through a settlement process in the Hospitals' annual Medicare cost report filing. Financial assistance care reimbursement was approximately \$827 and \$981 for the years ended December 31, 2016 and 2015, respectively.

5. Retirement Plans

The Corporation maintains a defined-contribution employee retirement and savings plan for all employees who have attained 21 years of age and have completed 12 months of continuous service. The Corporation's contributions are based on 100% of the employee's contributions, up to 4% of the employee's salary. Both employee and corporation contributions are subject to certain limitations. Included in employee benefits on the statement of operations are contributions of approximately \$11,487 and \$10,585 for the years ended December 31, 2016 and 2015, respectively.

The Corporation also has a noncontributory, defined-benefit pension plan (the MEM Plan), which includes MHSB, BMG, BHF, and BHV with a final average pay plan and a cash balance plan. The cash balance plan was frozen for new participants and accrual of benefits as of December 31, 2007, and the much smaller grandfathered final average pay plan, with fewer participants, remains frozen and has not been altered. The assets in the cash balance plan will continue to earn interest, but service credits are frozen.

The Corporation also has a noncontributory, defined-benefit pension plan (the EGH Plan) for EGH. As of December 31, 2007, the EGH Plan was frozen for all participants who had not attained the age of 50 and accumulated 15 years of vesting service as of December 31, 2007. No new participants are allowed into the plan as of December 31, 2007. Participants who were at least 50 years old and had accumulated 15 years of service at December 31, 2007, continued to accrue benefits under the terms of the EGH Plan until it was frozen effective January 1, 2013. Additionally, a lump-sum payout option was effective for all participants on July 1, 2012.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

5. Retirement Plans (continued)

The Corporation's defined-benefit plan expense was as follows:

	EGH	MEM	Total
December 31, 2016	\$ 4,136	\$ 3,814	\$ 7,950
December 31, 2015	3,015	2,662	5,677

The Corporation's expected plan expense for the year ending December 31, 2017 is as follows:

	EGH	MEM	Total
Plan expense	\$ 4,589	\$ 3,317	\$ 7,906

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The measurement date of December 31 is utilized for both plans. The summary of the changes in the benefit obligation and plan assets and the resulting funded status of the plans are as follows:

	December 31, 2016		
	EGH	MEM	Total
Accumulated benefit obligation	\$ 151,129	\$ 138,800	\$ 289,929
Change in projected benefit obligation:			
Projected benefit obligation at beginning of year	\$ 150,727	\$ 139,494	\$ 290,221
Service cost	910	1,662	2,572
Interest cost	5,661	5,271	10,932
Actuarial loss	4,862	530	5,392
Benefits and administrative expenses paid	(6,742)	(5,369)	(12,111)
Lump-sum benefits paid	(4,289)	(2,788)	(7,077)
Projected benefit obligation at end of year	\$ 151,129	\$ 138,800	\$ 289,929
Change in plan assets:			
Fair value of plan assets at beginning of year	\$ 105,371	\$ 95,992	\$ 201,363
Actual return on plan assets	7,302	5,932	13,234
Employer contributions	7,500	7,500	15,000
Benefits and administrative fees paid	(6,742)	(5,369)	(12,111)
Lump-sum benefits paid	(4,289)	(2,788)	(7,077)
Fair value of plan assets at end of year	\$ 109,142	\$ 101,267	\$ 210,409
Funded status:			
Funded status of the plan and amounts recognized as pension and other liabilities in the consolidated balance sheets	\$ (41,987)	\$ (37,533)	\$ (79,520)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

5. Retirement Plans (continued)

	December 31, 2015		
	EGH	MEM	Total
Accumulated benefit obligation	\$ 150,727	\$ 139,494	\$ 290,221
Change in projected benefit obligation:			
Projected benefit obligation at beginning of year	\$ 158,120	\$ 144,094	\$ 302,214
Service cost	620	1,406	2,026
Interest cost	5,510	5,034	10,544
Actuarial gain	(5,653)	(2,066)	(7,719)
Benefits and administrative expenses paid	(6,183)	(4,725)	(10,908)
Lump-sum benefits paid	(1,687)	(4,249)	(5,936)
Projected benefit obligation at end of year	\$ 150,727	\$ 139,494	\$ 290,221
Change in plan assets:			
Fair value of plan assets at beginning of year	\$ 112,907	\$ 103,828	\$ 216,735
Actual return on plan assets	(3,666)	(2,862)	(6,528)
Employer contributions	4,000	4,000	8,000
Benefits and administrative fees paid	(6,183)	(4,725)	(10,908)
Lump-sum benefits paid	(1,687)	(4,249)	(5,936)
Fair value of plan assets at end of year	\$ 105,371	\$ 95,992	\$ 201,363
Funded status:			
Funded status of the plan and amounts recognized as pension and other liabilities in the consolidated balance sheets	\$ (45,356)	\$ (43,502)	\$ (88,858)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

Included in unrestricted net assets are the following amounts that have not been recognized in net periodic pension cost:

	At December 31, 2016		
	EGH	MEM	Total
Prior service cost	\$ –	\$ 5	\$ 5
Actuarial net loss	<u>62,672</u>	<u>46,687</u>	<u>109,359</u>
	<u>\$ 62,672</u>	<u>\$ 46,692</u>	<u>\$ 109,364</u>

	At December 31, 2015		
	EGH	MEM	Total
Prior service cost	\$ –	\$ 7	\$ 7
Actuarial net loss	<u>62,677</u>	<u>48,965</u>	<u>111,642</u>
	<u>\$ 62,677</u>	<u>\$ 48,972</u>	<u>\$ 111,649</u>

The estimated prior service cost and actuarial net losses that will be amortized into expense over the next fiscal year are as follows:

	At December 31, 2016		
	EGH	MEM	Total
Prior service cost	\$ –	\$ (2)	\$ (2)
Actuarial net loss	<u>(5,284)</u>	<u>(3,281)</u>	<u>(8,565)</u>
Estimated benefit cost amortizations in the next fiscal year	<u>\$ (5,284)</u>	<u>\$ (3,283)</u>	<u>\$ (8,567)</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

Changes in the plan's assets and benefit obligations recognized in unrestricted net assets include the following:

	Year Ended December 31, 2016		
	EGH	MEM	Total
Current year actuarial gain	\$ (5)	\$ (2,281)	\$ (2,286)
Current year amortization prior service cost	–	5	5
	<u>\$ (5)</u>	<u>\$ (2,276)</u>	<u>\$ (2,281)</u>

	Year Ended December 31, 2015		
	EGH	MEM	Total
Current year actuarial loss	\$ 1,128	\$ 4,574	\$ 5,702
Current year amortization prior service cost	–	7	7
	<u>\$ 1,128</u>	<u>\$ 4,581</u>	<u>\$ 5,709</u>

The components of net periodic benefit cost for the defined-benefit pension plans were as follows:

	Year Ended December 31, 2016		
	EGH	MEM	Total
Service cost	\$ 910	\$ 1,662	\$ 2,572
Interest cost	5,661	5,271	10,932
Expected return on plan assets	(7,196)	(6,626)	(13,822)
Prior service credit recognized	–	2	2
Amortization of recognized losses	4,760	3,502	8,262
Benefit cost	<u>\$ 4,135</u>	<u>\$ 3,811</u>	<u>\$ 7,946</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

	Year Ended December 31, 2015		
	EGH	MEM	Total
Service cost	\$ 620	\$ 1,406	\$ 2,026
Interest cost	5,510	5,034	10,544
Expected return on plan assets	(7,689)	(7,111)	(14,800)
Prior service credit recognized	–	2	2
Amortization of recognized losses	4,574	3,331	7,905
Benefit cost	<u>\$ 3,015</u>	<u>\$ 2,662</u>	<u>\$ 5,677</u>

Assumptions used to determine benefit obligations at the measurement date are as follows:

	December 31, 2016	
	EGH	MEM
Discount rates	3.75%	3.75%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00

	December 31, 2015	
	EGH	MEM
Discount rates	3.90%	3.90%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00

In 2016, mortality assumptions for the plans' utilizing the RP-2014 mortality tables were updated with the 2016 projection scale.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

Assumptions used to determine net pension expense for the fiscal years are as follows:

	December 31, 2016	
	EGH	MEM
Discount rates	3.90%	3.90%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00
	December 31, 2015	
	EGH	MEM
Discount rates	3.60%	3.60%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00

The following is a summary of the pension plan asset actual allocations:

Asset Category	EGH/MEM	2016		2015	
	Target	EGH	MEM	EGH	MEM
Equity securities	38%	39%	39%	36%	36%
Debt securities	33	23	21	25	23
Other	29	38	40	39	41
Total	100%	100%	100%	100%	100%

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The following table sets forth by level, within the fair value hierarchy (see Note 11), the combined MEM and EGH plan assets carried at fair value as of December 31, 2016:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Fair Value</u>
Short-term investment funds ^(a)	\$ 7,546	\$ —	\$ —	\$ 7,546
Mutual funds ^(a)				
Large cap equity	24,543	—	—	24,543
International equity	35,642	—	—	35,642
Blended fund	21,537	—	—	21,537
Total mutual funds	<u>81,722</u>	—	—	<u>81,722</u>
Total assets measured on a recurring basis at fair value	<u>\$ 89,268</u>	<u>\$ —</u>	<u>\$ —</u>	<u>89,268</u>
Investments recorded at fair value based on NAV				<u>121,141</u>
Total assets measured at fair value				<u>\$ 210,409</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The following table sets forth by level, within the fair value hierarchy (see Note 11), the combined MEM and EGH plan assets carried at fair value as of December 31, 2015:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Fair Value</u>
Short-term investment funds ^(a)	\$ 7,760	\$ —	\$ —	\$ 7,760
Mutual funds ^(a)				
Large cap equity	5,829	—	—	5,829
International equity	55,992	—	—	55,992
Blended fund	18,021	—	—	18,021
Total mutual funds	79,842	—	—	79,842
Common stocks ^(a)	8,600	—	—	8,600
Total assets measured on a recurring basis at fair value	<u>\$ 96,202</u>	<u>\$ —</u>	<u>\$ —</u>	96,202
Investments recorded at fair value based on NAV				<u>105,161</u>
Total assets measured at fair value				<u>\$ 201,363</u>

^(a) Pricing for common stocks, mutual funds, and short-term investments is based on the open market and is valued on a daily basis.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

In addition to understanding fair value methodologies, long/short funds, MLP, REIT, fund of funds, hedge funds, and other funds may be subject to redemption and/or liquidity restrictions. Those funds that have restrictions are summarized below, as follows:

Type of Fund	Fair Value at December 31		Redemption Restrictions	Liquidity Time Frame
	2016	2015		
Mutual funds				
International equities	\$ 1,948	\$ 2,167	None	Under 95 days
Long/short funds				
Commingled	3,133	2,941	None	Under 95 days
Master limited partnership	11,745	11,333	1 year lock redemption fee	Under 95 days
REIT	11,926	10,917	None	Under 95 days
Hedge funds				
Multi-strategy hedge funds	13,511	14,597	1 year lock varying redemption fees	Under 95 days
Multi-strategy hedge funds	1,027	1,716	None	Under 95 days
Long/short hedge funds	4,087	3,504	None	Under 95 days
Long/short hedge funds	4,571	5,064	1 year lock redemption fee	Under 95 days
International	2,765	474	1 year lock redemption fee	Under 95 days
International	1,958	5,079	None	Under 95 days
Other hedge funds	5,102	5,049	None	Under 95 days
Other hedge funds	3,124	2,897	1 year lock redemption fee	Under 95 days
Other hedge funds	2,467	2,237	18 month year lock redemption fee	Under 95 days
Fund of funds				
Fund of funds	450	—	1 year redemption restriction	Under 95 days
Fund of funds	1,864	2,240	None	Under 95 days

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The Corporation employs a total return investment approach, whereby a mix of equities and fixed-income investments is used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. The investment portfolio contains a diversified blend of equity, fixed-income, and alternative investments. Equity investments are diversified across U.S. and non-U.S. corporate stocks, as well as growth, value, and small and large capitalizations.

Other assets, such as hedge funds, are used to enhance long-term returns while improving portfolio diversification. The Corporation's external investment managers may use derivatives to gain market exposure in an efficient and timely manner. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements, and periodic asset/liability studies.

The following pension benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years ending December 31:

	EGH	MEM	Total
2017	\$ 11,501	\$ 9,061	\$ 20,562
2018	11,211	9,076	20,287
2019	11,291	9,678	20,969
2020	10,427	8,921	19,348
2021	11,064	9,811	20,875
2022–2025	47,737	45,461	93,198

The Corporation anticipates contributing the following to the plan assets from employer assets in 2017:

	EGH	MEM	Total
Anticipated 2017 total contributions	\$ 6,000	\$ 6,000	\$ 12,000

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

6. Lease Obligations

The Corporation leases certain office space and equipment under non-cancelable operating leases. At December 31, 2016, the minimum future rental payments under these leases are as follows:

2017	\$	5,377
2018		3,088
2019		2,047
2020		1,567
2021		1,342
Thereafter		4,016
	\$	<u>17,437</u>

Rental expense for the years ended December 31, 2016 and 2015, was approximately \$7,622 and \$7,369, respectively, which is included in supplies and other expense.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

7. Long-Term Debt

Long-term debt consists of the following at December 31:

	<u>2016</u>	<u>2015</u>
Tax-exempt bonds issued on behalf of BHS by the Indiana Finance Authority:		
BHS Revenue Bonds, Series 2013A, bearing interest at fixed rates between 2.00% and 5.00%, due in varying annual installments on August 15 of each year through 2034	\$ 95,830	\$ 100,830
BHS Revenue Note, Series 2013B, bearing interest at a fixed rate of 1.17%, at December 31, 2016, due in monthly installments through 2020	3,644	4,710
Tax-exempt bonds issued on behalf of BHS by the Hospital Authority of St. Joseph County:		
BHS Revenue Bonds, Series 2016, bearing interest at fixed rate of 1.39%, due in varying annual installments through 2046	50,000	—
BHS Revenue Bonds, Series 2013C, bearing interest at fixed rates between 3.75% and 5.00%, due in varying annual installments on August 15 of each year through 2044	46,130	46,130
Tax-exempt bonds issued on behalf of MHSB by the Hospital Authority of St. Joseph County:		
MHSB Revenue Bonds, Series 2008A, bearing interest at variable rates retaining the hedge from Series 2006 with a floating fixed interest rate swap of 3.52% at December 31, 2016 and 2015, due in varying annual installments on August 15 of each year through 2033	37,450	37,660

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

7. Long-Term Debt (continued)

	<u>2016</u>	<u>2015</u>
Tax-exempt bonds issued on behalf of EGH by the Hospital Authority of Elkhart County:		
EGH Revenue Bonds, Series 2008, bearing interest at variable rates of 0.74% and 0.01% at December 31, 2016 and 2015, respectively, due annually on May 1 of each year through 2033	\$ 41,180	\$ 42,100
Mortgage – bearing interest at variable rates of 2.22% and 1.86% at December 31, 2016 and 2015, respectively, London Interbank Offered Rate (LIBOR) plus 1.50%, due in varying annual installments on the last day of every month through 2016	671	858
Capital leases	1,727	2,645
	<u>276,632</u>	234,933
Bond issuance costs	(2,247)	(2,077)
Unamortized premium	14,348	15,183
	<u>288,733</u>	248,039
Less current portion	8,824	8,231
	<u>\$ 279,909</u>	<u>\$ 239,808</u>

In August 2016, The Hospital Authority of St. Joseph County issued Hospital Revenue Bonds, Series 2016 (Series 2016 Bonds), on behalf of the Obligated Group. The Series 2016 Bonds are \$50,000,000 private placement bonds bearing interest at a fixed rate of 1.39%, due in varying annual installments through 2046. Proceeds from the bonds were utilized to fund existing and future capital projects.

In May 2013, the Indiana Finance Authority, on behalf of BHS, issued revenue refunding bonds Series 2013A (2013A) in the principal amount of \$116,705. The interest rate for 2013A is a fixed rate varying between 2.00% and 5.00%. The proceeds from 2013A were utilized to refund the MHSB Revenue Bonds, Series 2008B; MHSB Revenue Bonds, Series 1998A; and the EGH Revenue Bonds, Series 1998.

In May 2013, the Indiana Finance Authority, on behalf of BHS, issued a revenue note Series 2013B (2013B) in the principal amount of \$7,492. The interest rate for 2013B is a fixed rate of 1.17%. Proceeds from the bond were utilized for the purchase of a helicopter.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

7. Long-Term Debt (continued)

In May 2013, the Hospital Authority of St. Joseph County, on behalf of BHS, issued revenue bonds Series 2013C (2013C) in the principal amount of \$46,130. The interest rate for 2013C is a fixed rate varying between 3.75% and 5.00%. The proceeds from 2013C were utilized to refund the MHSB Revenue Bonds, Series 2007. The remaining proceeds are set aside in externally designated investments for future projects.

In August 2008, the Hospital Authority of St. Joseph County, on behalf of MHSB, issued revenue refunding bonds in the principal amount of \$78,495. The interest rate for the Series 2008A is a weekly interest rate determined by the remarketing agent. The 2008 bond issue is secured by an irrevocable direct-pay letter of credit issued by JPMorgan Chase Bank (JPMorgan). The JPMorgan letters of credit expire on July 31, 2018. As long as no default has occurred, draws on the direct-pay letter of credit made for failed remarketing will be required to be repaid in 12 equal quarterly installments commencing 12 months after the date of draw.

The Series 2008A Bonds are subject to mandatory redemption through the operation of a sinking fund on each August 15 commencing with the year 2011 up to and including the year 2033 in amounts sufficient to redeem the principal amounts.

The Hospital Authority of Elkhart County issued \$47,800 of Series 2008 Hospital Revenue Bonds (the Series 2008 Bonds). EGH borrowed the proceeds of the sale of the Series 2008 Bonds and evidenced this loan with a loan agreement, issued under a Trust Indenture dated December 1, 2008.

The proceeds of the Series 2008 Bonds were issued to retire interest and principal payments of previously outstanding bonds. The Series 2008 Bonds require EGH to hold a letter of credit with JPMorgan. The letter of credit expires on July 31, 2018, and decreases by the principal payments made by EGH on the Series 2008 Bonds. The Series 2008 Bonds mature in May 2033.

As long as no default has occurred, draws on the direct-pay letter of credit made for failed remarketing will be required to be repaid in eight equal quarterly installments commencing on the last business day of the fourth calendar quarter after the stated expiration date of the letter of credit (July 31, 2018).

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

7. Long-Term Debt (continued)

The Corporation is the Obligated Group Agent for the Obligated Group under the Master Trust Indentures. The Obligated Group includes the Corporation, MHSB, EGH, and BMG. MHF and BHV constitute designated affiliates under the terms of the Master Trust Indentures. The bonds are secured by pledged revenues of the Obligated Group and contain various covenants, including achievement of specified financial ratios and limitations on additional debt.

The loan agreements require maintenance of certain debt service coverage ratios, limit additional borrowings, and require compliance with various other restrictive covenants. The Corporation was in compliance with all covenants during 2016 and 2015.

Interest capitalized for the years ended December 31, 2016 and 2015, was approximately \$1,311 and \$1,550.

Maturities of long-term debt and capital lease obligations for each of the next five years are as follows:

2017	\$	8,824
2018		8,809
2019		8,932
2020		8,078
2021		8,925

8. Lines of Credit

The Corporation has a \$2,000 revolving line of credit with 1st Source Bank. The line of credit was renewed and extended through May 31, 2017. Of the \$2,000 revolving line of credit, \$50 for the years ended December 31, 2016 and 2015, was segregated for the beneficiary of a self-insurance trust. Conversely, \$1,950 was available to be drawn upon at December 31, 2016 and 2015. No draws were taken by MHSB in either 2016 or 2015. The interest rate on the line of credit is the prime rate minus 0.5%. No amounts were outstanding on the line of credit as of December 31, 2016 or 2015.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

8. Lines of Credit (continued)

The Corporation has a \$7,000 revolving line of credit with Merrill Lynch. The line of credit is due on demand and can be terminated by either party with notice. Advances on the line can be made with a variable rate of LIBOR plus 1.25%, at a fixed rate as agreed upon by the parties for a 12-month period or at an agreed-upon term rate for periods greater than 12 months. At any time MHSB may request that variable rate advances be converted into fixed or term rates. No draws were taken by MHSB in either 2016 or 2015. No amounts were outstanding on the line of credit as of December 31, 2016 or 2015.

9. Interest Rate and Basis Swaps

MHSB has various derivative instruments related to long-term debt obligations to manage the exposure on interest rates and MHSB's interest expense. Through the use of derivative financial instruments, MHSB is exposed to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of the derivative contract is positive, the counterparty owes MHSB, which creates credit risk to MHSB. When the fair value of the derivative contract is negative, MHSB owes the counterparty, and there is no credit risk to MHSB at that point in time. MHSB minimizes the credit risk in derivative instruments by entering into transactions that require the counterparty to post collateral for the benefit of the fair value of the derivative contract. Market risk is the adverse effect on the value of the financial instrument that results from a change in interest rates. The management of market risk associated with interest rate changes is defined in MHSB's Swap Management Policy (the Policy). The Policy includes continuous monitoring of market conditions, emergent opportunities, and risks. Swap management is meant to be long term in nature, and any modifications to the program are reviewed for the long-term costs and benefits. Management also mitigates risk through periodic reviews of its derivative position in the context of its total blended cost of capital.

In February 2016, MHSB terminated one Deutsche bank swap with a notional amount of \$54,000. MHSB realized a net gain of \$158, which is included in the nonoperating income on the consolidated statements of operations and changes in net assets.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

9. Interest Rate and Basis Swaps (continued)

The derivative instruments require adherence to collateral posting thresholds. For the years ended December 31, 2016 and 2015, the mark-to-market valuation on the swap portfolio was below the required collateral posting threshold of \$30,000 with PNC Bank, \$25,000 with Morgan Stanley, \$25,000 with Wells Fargo, and \$25,000 with Deutsche Bank.

The following is a summary of the outstanding fixed payer rate swaps as of December 31, 2016:

Origination Date	Notional Amounts	MHSB Receives	MHSB Pays	Maturity Date
March 2006	\$ 37,450	61.9% of 30-day LIBOR plus 0.31%	3.5150%	August 2033
March 2003	7,850	65% of 30-day LIBOR plus 0.45%	3.8100	August 2034

The following is a summary of the outstanding fixed payer rate swaps as of December 31, 2015:

Origination Date	Notional Amounts	MHSB Receives	MHSB Pays	Maturity Date
March 2006	\$ 37,660	61.9% of 30-day LIBOR plus 0.31%	3.5150%	August 2033
March 2003	8,100	65% of 30-day LIBOR plus 0.45%	3.8100	August 2034

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

9. Interest Rate and Basis Swaps (continued)

The following is a summary of the outstanding basis rate swaps as of December 31, 2016:

Origination Date	Notional Amounts	MHSB Receives	MHSB Pays	Maturity Date
January 2007	\$ 42,000	74.6% of 1M LIBOR	SIFMA tax-exempt index + 0.0715%	January 2041
March 2001	140,000	75.125% of 3M LIBOR	SIFMA tax-exempt index	March 2031
July 2009	63,000	74.6% of 1M LIBOR	SIFMA tax-exempt index + 0.17%	January 2041
August 2009	81,000	61.7% of 1M LIBOR + 0.76%	SIFMA tax-exempt index + 0.17%	August 2041

The following swap agreement was terminated in February, 2016 and is not included in the table above:

Origination Date	Notional Amounts	Corporation Receives	Corporation Pays	Maturity Date
August 2007	\$ 54,000	61.7% of 1M LIBOR + 0.76%	SIFMA tax-exempt index +.0715%	August 2041

Net interest paid or received under the above swap agreements is included in interest expense. The net differential for MHSB as a result of the swap agreements amounted to payments of approximately \$1,318 and \$218 for the years ended December 31, 2016 and 2015, respectively, and is reflected as an increase to interest expense. The swap agreements do not qualify for hedge accounting; therefore, the change in the fair value of the swap agreements is recorded as an unrealized non-operating gain of approximately \$1,246 and loss of approximately \$7,827 for the years ended December 31, 2016 and 2015, respectively.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

9. Interest Rate and Basis Swaps (continued)

The fair value of derivative instruments at December 31 is as follows:

	Balance Sheet		
	Location	2016	2015
Derivatives not designated as hedging instruments:			
Interest rate contracts	Interest rate and basis swap receivable	\$ —	\$ 598
	Interest rate and basis swaps payable	<u>(22,779)</u>	<u>(20,523)</u>
		<u>\$ (22,779)</u>	<u>\$ (19,925)</u>

10. Investments

Total investment return for the years ended December 31 is summarized as follows:

	2016	2015
Investment return:		
Net unrealized gains on investments	\$ 4,370	\$ (23,170)
Net realized gains on investments	35,916	13,177
Net equity earnings on alternative investments	2,763	(10,941)
	<u>\$ 43,049</u>	<u>\$ (20,934)</u>
Reported as:		
Investment income, net (non-operating)	\$ 42,741	\$ (20,496)
Investment income (temporarily restricted net assets)	308	(438)
	<u>\$ 43,049</u>	<u>\$ (20,934)</u>

The Corporation's investments are exposed to various kinds and levels of risk. Equity mutual funds expose the Corporation to market risk, performance risk, and liquidity risk. Market risk is the risk associated with major movements of the equity markets. Performance risk is the risk associated with a company's operating performance. Fixed-income securities expose the Corporation to interest rate risk, credit risk, and liquidity risk. As interest rates change, the value of many fixed-income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

10. Investments (continued)

of market participants to buy and sell given securities. Liquidity risk tends to be higher for equities related to small capitalization companies. Due to the volatility of the capital markets, there is a reasonable possibility of changes in fair value, resulting in additional gains and losses in the near term.

11. Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable and accrued expenses are reasonable estimates of their fair values due to the short-term nature of these financial instruments.

The fair value of the Corporation's long-term debt, excluding capital leases and the mortgage, is approximately \$284,707 and \$246,304 at December 31, 2016 and 2015, respectively. The valuation for the estimated fair value of long-term debt is completed by a third-party service and takes into account a number of factors, including, but not limited to, any one or more of the following: (i) general interest rate and market conditions; (ii) macroeconomic and/or deal-specific credit fundamentals; (iii) valuations of other financial instruments that may be comparable in terms of rating, structure, maturity, and/or covenant protection; (iv) investor opinions about the respective deal parties; (v) size of the transaction; (vi) cash flow projections, which, in turn, are based on assumptions about certain parameters that include, but are not limited to, default, recovery, prepayment, and reinvestment rates; (vii) administrator reports, asset manager estimates, broker quotations, and/or trustee reports; and (viii) comparable trades, where observable. Based on the inputs in determining the estimated fair value of debt, this fair value measurement would be considered Level 2.

Accounting Standards Codification Topic (ASC) 820-10-50-2 establishes a three-level valuation hierarchy. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in an active market and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables present the financial instruments carried as of December 31, 2016 and 2015, by caption, on the consolidated balance sheets by the valuation hierarchy defined above for those instruments carried at fair value, as well as the alternative investments that are reported on the equity method of accounting. Deferred compensation investments are included in other assets on the consolidated balance sheets.

	December 31, 2016					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets						
Short-term investments ^(a)	\$ 53,501	\$ –	\$ –	\$ 53,501	\$ –	\$ 53,501
Internally designated investments:						
Mutual funds ^(a)						
Blended fund	330,982	–	–	330,982	–	330,982
Total mutual funds	330,982	–	–	330,982	–	330,982
Common stock ^(a)	5,742	–	–	5,742	–	5,742
Alternatives:						
Fund of hedge funds	–	–	–	–	2,654	2,654
International equity	–	–	–	–	3,818	3,818
MLP	–	–	–	–	41,577	41,577
Private equity	–	–	–	–	21,710	21,710
REIT	–	–	–	–	29,054	29,054
International	–	–	–	–	16,321	16,321
Commingled funds	–	–	–	–	83,565	83,565
Other	–	–	–	–	15,075	15,075
Long/short hedge	–	–	–	–	12,089	12,089
Global	–	–	–	–	4,212	4,212
Multi-strategy	–	–	–	–	24,091	24,091
Total alternatives	–	–	–	–	254,166	254,166
Total internally designated investments	336,724	–	–	336,724	254,166	590,890

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

11. Fair Value of Financial Instruments (continued)

	December 31, 2016					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets (continued)						
Restricted cash ^(a)	\$ 4,526	\$ –	\$ –	\$ 4,526	\$ –	\$ 4,526
Ext. designated investment – insurance trust:						
Fixed income ^(a)	2,680	–	–	2,680	–	2,680
Designated cash ^(a)	19,769	–	–	19,769	–	19,769
Board-designated endowment:						
Mutual funds: ^(a)						
Equities	2,733	–	–	2,733	–	2,733
Blended fund	9,168	417	–	9,585	–	9,585
Fixed income ^{(a), (b)}	371	277	–	648	–	648
Equities ^(a)	953	–	–	953	–	953
Common collective trust funds ^(d)	–	2,904	–	2,904	–	2,904
Alternatives	–	–	–	–	8,138	8,138
Total board-designated endowment	13,225	3,598	–	16,823	8,138	24,961
Endowment:						
Mutual funds: ^(a)						
Fixed income	379	–	–	379	–	379
Equities	1,071	–	–	1,071	–	1,071
Blended fund	1,317	–	–	1,317	–	1,317
Money market ^(a)	200	–	–	200	–	200
Hedge funds	–	–	–	–	414	414
Common collective trust funds ^(d)	–	3,133	–	3,133	–	3,133
Total endowment	2,967	3,133	–	6,100	414	6,514
Total	\$ 433,392	\$ 6,731	\$ –	\$ 440,123	\$ 262,718	\$ 702,841
Liabilities						
Swaps ^(c)	\$ –	\$ –	\$ (22,779)	\$ (22,779)	\$ –	\$ (22,779)
Total	\$ –	\$ –	\$ (22,779)	\$ (22,779)	\$ –	\$ (22,779)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

	December 31, 2015					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets						
Short-term investments ^(a)	\$ 42,564	\$ —	\$ —	\$ 42,564	\$ —	\$ 42,564
Internally designated investments:						
Blended fund	276,907	—	—	276,907	—	276,907
Total mutual funds	276,907	—	—	276,907	—	276,907
Common stock ^(a)	28,771	—	—	28,771	—	28,771
Alternatives:						
Fund of hedge funds	—	—	—	—	6,492	6,492
International equity	—	—	—	—	88,363	88,363
Blended fund	—	—	—	—	73,042	73,042
Private equity	—	—	—	—	14,483	14,483
Real estate	—	—	—	—	6,417	6,417
Other	—	—	—	—	15,647	15,647
Long/short hedge	—	—	—	—	9,655	9,655
Global	—	—	—	—	4,312	4,312
Multi-strategy	—	—	—	—	23,426	23,426
Total alternatives	—	—	—	—	241,837	241,837
Total internally designated investments	305,678	—	—	305,678	241,837	547,515

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

11. Fair Value of Financial Instruments (continued)

	December 31, 2015					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets (continued)						
Restricted cash ^(a)	\$ 3,012	\$ –	\$ –	\$ 3,012	\$ –	\$ 3,012
Ext. designated investment – insurance trust:						
Fixed income ^(a)	2,656	–	–	2,656	–	2,656
Designated cash ^(a)	18,948	–	–	18,948	–	18,948
Board-designated endowment:						
Mutual funds: ^(a)						
Equities	1,089	–	–	1,089	–	1,089
Blended fund	9,225	–	–	9,225	–	9,225
Fixed income ^{(a), (b)}	133	285	–	418	–	418
Equities ^(a)	924	–	–	924	–	924
Alternatives	–	–	–	–	7,821	7,821
Total board-designated endowment	11,371	285	–	11,656	7,821	19,477
Endowment:						
Mutual funds: ^(a)						
Fixed income	351	–	–	351	–	351
Equities	1,112	–	–	1,112	–	1,112
Blended fund	485	–	–	485	–	485
Money market ^(a)	131	–	–	131	–	131
Hedge Fund	–	–	–	–	396	396
Common collective trust funds ^(d)	–	3,742	–	3,742	–	3,742
Total endowment	2,079	3,742	–	5,821	396	6,217
Swaps ^(c)	–	–	598	598	–	598
Total	\$ 386,308	\$ 4,027	\$ 598	\$ 390,933	\$ 250,054	\$ 640,987
Liabilities						
Swaps ^(c)	\$ –	\$ –	\$ (20,523)	\$ (20,523)	\$ –	\$ (20,523)
Total	\$ –	\$ –	\$ (20,523)	\$ (20,523)	\$ –	\$ (20,523)

^(a) Pricing for mutual funds, short-term investments, equities, and government obligations is based on the open market and is valued on a daily basis.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

- (b) Pricing is based on the fair value of the securities and is valued on a monthly basis. Information used to value this account is provided by International Data Corp. (IDC). In the event that a security is not actively traded in the open market, the characteristics are matched to a comparable issue from the IDC data to appropriately value the holding.
- (c) Pricing is based on discounted cash flows to reflect a credit spread adjustment to the LIBOR discount curve in order to reflect “nonperformance” risk. The credit spread adjustment is derived from how other comparable entities’ bonds price and trade in the market. As the credit spread adjustment is a significant component of the swap valuation and is an unobservable input, the swaps have been classified as Level 3.
- (d) Pricing is based on the market value of the securities and is valued on a monthly basis.

The table below sets forth a summary of changes in the fair value of the Corporation’s Level 3 swaps for the years ended December 31:

	<u>2016</u>	<u>2015</u>
Balance, beginning of the year	\$ (19,925)	\$ (27,752)
Unrealized gains, net	(1,246)	7,827
Realized gains, net	158	–
Sales of swaps	(1,766)	–
Balance, end of the year	<u>\$ (22,779)</u>	<u>\$ (19,925)</u>

For the year ended December 31, 2016, the Corporation recorded approximately \$1,246 in non-operating losses, which relates to losses of \$2,325 due to the change in the swaps’ value and loss of \$528 to reflect the fair value of the uncollateralized portion of the swap balance. For the year ended December 31, 2015, the Corporation recorded approximately \$7,827 in non-operating gains, which relates to gains of \$8,507 due to the change in the swaps’ value and loss of \$680 to reflect the fair value of the uncollateralized portion of the swap balance.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

12. Functional Expenses

The Corporation provides general health care services to residents within its geographic location. Expenses related to this and general and administrative functions for the years ended December 31 are as follows:

	<u>2016</u>	<u>2015</u>
Health care services	\$ 564,601	\$ 544,677
Affiliated health services	178,321	168,767
General and administrative	155,171	156,241
	<u>\$ 898,093</u>	<u>\$ 869,685</u>

13. Commitments

BMG is a guarantor for a portion of a loan of an unconsolidated joint venture, Valparaiso Medical Development, LLC, in which BMG records an equity interest. The portion of debt guaranteed by BMG is a maximum of \$5,052 and \$5,280 at December 31, 2016 and 2015, respectively. No amounts have been paid or accrued pursuant to this guarantee as of December 31, 2016 or 2015. The loan is collateralized by the assets, including the facility and land, held by Valparaiso Medical Development, LLC.

The Corporation has committed to investing \$100,300 in certain hedge funds and alternative investments. During the years ended December 31, 2016 and 2015, the Corporation invested approximately \$11,210 and \$2,072, respectively. The Corporation had a remaining unfunded commitment of approximately \$52,423 at December 31, 2016.

The Corporation has entered into various construction projects, including related commitments to construction managers, architects, and other vendors. The commitments under these agreements were approximately \$61,281, of which approximately \$36,045 was paid at December 31, 2016.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

14. Professional Liability Insurance

The Corporation is a defendant in certain litigation arising in the ordinary course of business. MHSB and EGH have obtained separate professional liability insurance coverage under claims-made policies. MHSB terminated self-funding of its professional and general liability coverage on November 30, 2009. EGH terminated self-funding of its professional and general liability coverage on April 1, 2012. The Indiana Medical Malpractice Act has provided recovery up to \$1,250, per occurrence, with the first \$250 covered by the respective entity. MHSB maintains a trust fund for its self-insurance program, which it will continue to maintain until all claims have been settled. The fair value of the trust fund at December 31, 2016 and 2015, was approximately \$2,680 and \$2,656, respectively. The amount of malpractice and general liability claims, including a component for incurred but not reported claims, was approximately \$5,400 and \$5,496, gross of an insurance recoverable at December 31, 2016 and 2015, respectively, which is included in pension and other liabilities. The interest rate used to discount these claims was 3.0% at December 31, 2016 and 2015. In addition, at December 31, 2016 and 2015, the Corporation recognized a recoverable insurance asset of approximately \$4,287 and \$4,120, respectively, which is included in deferred charges and other assets.

15. Income Taxes

The Corporation and its related affiliates, except for BHV, have been determined to qualify as exempt from federal income tax under Section 501(a) as organizations described in Section 501(c)(3) of the Code.

Most of the income received by the Corporation and its related affiliates, except for BHV, is exempt from taxation, as the income is related to the mission of the organization. Accordingly, there is no material provision for income tax for these entities. However, some of the income received by exempt entities is subject to taxation as unrelated business income. The Corporation and its subsidiaries file federal and various state income tax returns in the United States.

ASC 740, Income Taxes, requires that realization of an uncertain income tax position is more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it is recognized in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. This interpretation also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. No amount was recorded for the years ended December 31, 2016 or 2015.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

16. Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2016</u>	<u>2015</u>
Net assets currently available for:		
General – health care	\$ 10,012	\$ 7,605
Capital	3,210	3,545
Programs	178	209
Education	285	302
Other	1,057	1,045
	<u>\$ 14,742</u>	<u>\$ 12,706</u>

Permanently restricted net assets generate investment income, which is used to benefit the following purposes at December 31:

	<u>2016</u>	<u>2015</u>
Endowment investments providing income for health care educational purposes	\$ 266	\$ 191
Endowment for charity care at EGH	400	400
	<u>\$ 666</u>	<u>\$ 591</u>

17. Subsequent Events

The Corporation evaluated events and transactions occurring subsequent to December 31, 2016 through March 9, 2017, the date of issuance of the accompanying consolidated financial statements. During this period, there were no subsequent events requiring recognition or disclosure in the consolidated financial statements, other than those previously disclosed.

Supplementary Information



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Report of Independent Auditors on Supplementary Information

The Board of Directors
Beacon Health System, Inc. and Affiliated Corporations

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The following financial information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Ernst & Young LLP

March 9, 2017

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet

(In Thousands)

December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Assets								
Current assets:								
Cash and cash equivalents	\$ 43,032		\$ 25,091	\$ 4,451	\$ 451	\$ 1,709	\$ 11,458	\$ (128)
Short-term investments	53,501	–	34,652	–	1,057	–	–	17,792
Patient accounts receivable, net	160,873	(4,615)	89,958	14,453	–	4,351	55,354	1,372
Due from third-party payors	40,376	–	37,855	–	–	–	2,521	–
Other receivables	9,072	–	4,353	998	1,267	300	1,770	384
Inventories	25,437	–	17,028	–	–	443	7,966	–
Prepaid expenses	15,757	–	1,016	398	–	128	1,528	12,687
Due from affiliates	–	(1)	1	–	–	–	–	–
Total current assets	348,048	(4,616)	209,954	20,300	2,775	6,931	80,597	32,107
Assets limited as to use:								
Internally designated investments	590,890	–	–	–	–	–	–	590,890
Restricted cash	4,526	–	–	–	4,526	–	–	–
Externally designated investments – insurance trust	2,680	–	2,650	20	–	10	–	–
Designated cash	19,769	–	–	–	–	–	–	19,769
Board-designated endowment	24,961	–	–	–	24,961	–	–	–
Endowment and temporarily restricted investments	6,514	–	–	–	–	–	6,514	–
	649,340	–	2,650	20	29,487	10	6,514	610,659
Property and equipment:								
Land	44,897	–	21,318	3,883	–	–	3,943	15,753
Buildings and improvements	730,503	–	434,250	43,559	19	1,448	246,861	4,366
Furniture and equipment	466,023	–	284,146	32,456	159	8,059	101,998	39,205
Construction-in-progress	55,372	–	43,438	308	–	–	6,459	5,167
	1,296,795	–	783,152	80,206	178	9,507	359,261	64,491
Less allowances for depreciation and amortization	641,882	–	417,901	30,825	141	5,850	160,503	26,662
	654,913	–	365,251	49,381	37	3,657	198,758	37,829
Deferred charges and other assets	32,938	(12,367)	4,583	16,728	1,607	7,046	4,181	11,160
Interest in net assets of recipient organization	–	(8,628)	8,628	–	–	–	–	–
Total assets	\$ 1,685,239	\$ (25,611)	\$ 591,066	\$ 86,429	\$ 33,906	\$ 17,644	\$ 290,050	\$ 691,755

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet (continued) (In Thousands)

December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Liabilities and net assets								
Current liabilities:								
Accounts payable	\$ 46,991		\$ 23,193	\$ 8,585	\$ 3	\$ 664	\$ 10,924	\$ 3,622
Accrued salaries and benefits	35,928	(4,615)	16,946	6,801	-	2,022	8,514	6,260
Accrued expenses	4,809	-	2,454	-	-	123	937	1,295
Due to third-party payors	4,452	-	3,582	-	-	-	870	-
Due to affiliates	-	(1)	-	-	-	-	-	1
Current maturities of long-term debt	8,824	-	5,757	66	-	-	2,801	200
Total current liabilities	<u>101,004</u>	<u>(4,616)</u>	<u>51,932</u>	<u>15,452</u>	<u>3</u>	<u>2,809</u>	<u>24,046</u>	<u>11,378</u>
Non-current liabilities:								
Long-term debt, less current maturities	279,909	-	155,995	131	-	-	74,264	49,519
Pension and other liabilities	92,159	-	8,467	37,558	-	14	43,980	2,140
Interest rate and basis swaps	22,779	-	22,779	-	-	-	-	-
Total liabilities	<u>495,851</u>	<u>(4,616)</u>	<u>239,173</u>	<u>53,141</u>	<u>3</u>	<u>2,823</u>	<u>142,290</u>	<u>63,037</u>
Net assets:								
Unrestricted:								
Undesignated	1,154,359	(12,367)	343,265	33,288	5,388	14,821	141,246	628,718
Board-designated endowment	19,621	-	-	-	19,621	-	-	-
Total unrestricted	<u>1,173,980</u>	<u>(12,367)</u>	<u>343,265</u>	<u>33,288</u>	<u>25,009</u>	<u>14,821</u>	<u>141,246</u>	<u>628,718</u>
Temporarily restricted	14,742	(8,628)	8,628	-	8,628	-	6,114	-
Permanently restricted	666	-	-	-	266	-	400	-
Total net assets	<u>1,189,388</u>	<u>(20,995)</u>	<u>351,893</u>	<u>33,288</u>	<u>33,903</u>	<u>14,821</u>	<u>147,760</u>	<u>628,718</u>
Total liabilities and net assets	<u>\$ 1,685,239</u>	<u>\$ (25,611)</u>	<u>\$ 591,066</u>	<u>\$ 86,429</u>	<u>\$ 33,906</u>	<u>\$ 17,644</u>	<u>\$ 290,050</u>	<u>\$ 691,755</u>

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet

(In Thousands)

December 31, 2015

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Memorial Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Assets								
Current assets:								
Cash and cash equivalents	\$ 63,838	\$ –	\$ 45,400	\$ 4,020	\$ 446	\$ 1,223	\$ 12,245	\$ 504
Short-term investments	42,564	–	21,775	–	1,045	–	–	19,744
Patient accounts receivable, net	163,256	(3,870)	101,236	13,633	–	6,035	45,300	922
Due from third-party payors	12,487	–	11,180	–	–	–	1,307	–
Other receivables	9,949	–	4,270	1,023	838	256	3,306	256
Inventories	24,111	–	15,145	–	–	1,066	7,900	–
Prepaid expenses	9,416	–	1,133	399	–	190	1,335	6,359
Due from affiliates	–	(1,676)	504	632	–	–	–	540
Total current assets	325,621	(5,546)	200,643	19,707	2,329	8,770	71,393	28,325
Assets limited as to use:								
Internally designated investments	547,515	–	–	–	–	–	–	547,515
Restricted cash	3,012	–	–	–	3,012	–	–	–
Externally designated investments – insurance trust	2,656	–	2,626	20	–	10	–	–
Designated cash	18,948	–	–	–	–	–	–	18,948
Board-designated endowment	19,477	–	–	–	19,477	–	–	–
Endowment and temporarily restricted investments	6,217	–	–	–	–	–	6,217	–
	597,825	–	2,626	20	22,489	10	6,217	566,463
Property and equipment:								
Land	45,749	–	22,038	3,883	–	–	3,825	16,003
Buildings and improvements	633,254	–	408,979	36,253	–	9,060	174,699	4,263
Furniture and equipment	447,712	–	285,458	29,988	429	8,546	87,082	36,209
Construction-in-progress	105,257	–	19,307	3,687	–	–	79,677	2,586
	1,231,972	–	735,782	73,811	429	17,606	345,283	59,061
Less allowances for depreciation and amortization	605,738	–	396,771	26,374	412	11,863	145,889	24,429
	626,234	–	339,011	47,437	17	5,743	199,394	34,632
Deferred charges and other assets								
Interest rate swap	31,564	(12,367)	4,727	16,958	2,125	7,308	4,187	8,626
Interest in net assets of recipient organization	598	–	598	–	–	–	–	–
	–	(6,889)	6,889	–	–	–	–	–
Total assets	\$ 1,581,842	\$ (24,802)	\$ 554,494	\$ 84,122	\$ 26,960	\$ 21,831	\$ 281,191	\$ 638,046

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet (continued)

(In Thousands)

December 31, 2015

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Memorial Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Liabilities and net assets								
Current liabilities:								
Accounts payable	\$ 49,184	\$ –	\$ 20,872	\$ 6,932	\$ 23	\$ 712	\$ 14,005	\$ 6,640
Accrued salaries and benefits	35,096	(3,870)	17,097	6,539	–	1,826	8,667	4,837
Accrued expenses	4,522	–	2,161	–	–	12	953	1,396
Due to third-party payors	11,265	–	7,916	–	–	–	3,349	–
Due to affiliates	–	(1,676)	–	–	83	1,520	73	–
Current maturities of long-term debt	8,231	–	5,525	64	–	–	2,642	–
Total current liabilities	108,298	(5,546)	53,571	13,535	106	4,070	29,689	12,873
Non-current liabilities:								
Long-term debt, less current maturities	239,808	–	162,307	203	–	–	77,298	–
Pension and other liabilities	100,437	–	7,759	43,529	–	14	47,354	1,781
Interest rate and basis swaps	20,523	–	20,523	–	–	–	–	–
Total liabilities	469,066	(5,546)	244,160	57,267	106	4,084	154,341	14,654
Net assets:								
Unrestricted:								
Undesignated	1,080,002	(12,367)	303,445	26,855	297	17,747	120,633	623,392
Board-designated endowment	19,477	–	–	–	19,477	–	–	–
Total unrestricted	1,099,479	(12,367)	303,445	26,855	19,774	17,747	120,633	623,392
Temporarily restricted	12,706	(6,889)	6,889	–	6,889	–	5,817	–
Permanently restricted	591	–	–	–	191	–	400	–
Total net assets	1,112,776	(19,256)	310,334	26,855	26,854	17,747	126,850	623,392
Total liabilities and net assets	\$ 1,581,842	\$ (24,802)	\$ 554,494	\$ 84,122	\$ 26,960	\$ 21,831	\$ 281,191	\$ 638,046

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (In Thousands)

Year Ended December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted revenue, gains, and other support								
Net patient service revenue	\$ 945,600	\$ –	\$ 505,241	\$ 111,648	\$ –	\$ 31,438	\$ 290,795	\$ 6,478
Provision for bad debts	(59,658)	–	(29,577)	(5,814)	–	(2,280)	(21,983)	(4)
Net patient service revenue less provision for bad debts	885,942	–	475,664	105,834	–	29,158	268,812	6,474
Other revenue	36,274	(10,606)	16,647	8,411	864	2,562	12,821	5,575
Net assets released from restrictions used for operations	980	–	338	12	–	(1)	11	620
	<u>923,196</u>	<u>(10,606)</u>	<u>492,649</u>	<u>114,257</u>	<u>864</u>	<u>31,719</u>	<u>281,644</u>	<u>12,669</u>
Expenses								
Salaries and wages	391,882	–	143,776	118,031	–	22,102	78,875	29,098
Employee benefits	102,234	–	39,695	21,660	–	4,968	25,010	10,901
Supplies and other	222,224	(10,150)	119,883	20,402	545	7,374	72,059	12,111
Management fees	–	–	30,071	10,880	200	2,750	19,325	(63,226)
Professional fees and purchased services	119,129	(456)	47,275	4,287	830	1,272	41,312	24,609
Depreciation and amortization	55,987	–	29,522	5,239	10	1,258	16,086	3,872
Interest	6,637	–	5,322	6	–	1	1,308	–
	<u>898,093</u>	<u>(10,606)</u>	<u>415,544</u>	<u>180,505</u>	<u>1,585</u>	<u>39,725</u>	<u>253,975</u>	<u>17,365</u>
Income (loss) from operations	25,103	–	77,105	(66,248)	(721)	(8,006)	27,669	(4,696)
Non-operating								
Investment income, net	42,741	–	674	53	382	4	16	41,612
Unrealized losses on swap transactions, net	(1,246)	–	(1,246)	–	–	–	–	–
Gain on swap termination	158	–	158	–	–	–	–	–
Loss on sale of assets	(1,362)	–	(1,362)	–	–	–	–	–
Fair value of net assets combined	5,157	–	–	–	5,157	–	–	–
Revenue and gains in excess of (less than) expenses	<u>70,551</u>	<u>–</u>	<u>75,329</u>	<u>(66,195)</u>	<u>4,818</u>	<u>(8,002)</u>	<u>27,685</u>	<u>36,916</u>

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (continued) (In Thousands)

Year Ended December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted net assets								
Revenue and gains in excess of (less than) expenses	\$ 70,551	\$ -	\$ 75,329	\$ (66,195)	\$ 4,818	\$ (8,002)	\$ 27,685	\$ 36,916
Net assets released from restrictions used for capital purposes	1,664	-	1,557	50	-	-	57	-
Other	-	-	(37,066)	70,297	417	5,076	(7,134)	(31,590)
Postretirement benefit adjustments other than periodic costs	2,286	-	-	2,281	-	-	5	-
Increase (decrease) in unrestricted net assets	<u>74,501</u>	<u>-</u>	<u>39,820</u>	<u>6,433</u>	<u>5,235</u>	<u>(2,926)</u>	<u>20,613</u>	<u>5,326</u>
Temporarily restricted net assets								
Contributions temporarily restricted for use	3,857	-	-	-	3,857	-	-	-
Investment income	308	-	-	-	11	-	297	-
Contributions of net assets from Elkhart General Hospital Foundation	515	-	-	-	515	-	-	-
Net assets released from restrictions used for operating and capital purposes	(2,644)	-	-	-	(2,644)	-	-	-
Change in interest in recipient organization	-	(1,739)	1,739	-	-	-	-	-
Increase in temporarily restricted net assets	<u>2,036</u>	<u>(1,739)</u>	<u>1,739</u>	<u>-</u>	<u>1,739</u>	<u>-</u>	<u>297</u>	<u>-</u>
Permanently restricted net assets								
Contributions of net assets from Elkhart General Hospital Foundation	75	-	-	-	75	-	-	-
Increase in permanently restricted net assets	<u>75</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>75</u>	<u>-</u>	<u>-</u>	<u>-</u>
Increase (decrease) in net assets	76,612	(1,739)	41,559	6,433	7,049	(2,926)	20,910	5,326
Net assets at beginning of year	1,112,776	(19,256)	310,334	26,855	26,854	17,747	126,850	623,392
Net assets at end of year	<u>\$ 1,189,388</u>	<u>\$ (20,995)</u>	<u>\$ 351,893</u>	<u>\$ 33,288</u>	<u>\$ 33,903</u>	<u>\$ 14,821</u>	<u>\$ 147,760</u>	<u>\$ 628,718</u>

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (In Thousands)

Year Ended December 31, 2015

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Memorial Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted revenue, gains, and other support								
Net patient service revenue	\$ 934,934	\$	\$ 500,889	\$ 103,230	\$	\$ 34,864	\$ 290,363	\$ 5,588
Provision for bad debts	(73,035)	-	(36,369)	(5,818)	-	(1,471)	(29,377)	-
Net patient service revenue less provision for bad debts	861,899	-	464,520	97,412	-	33,393	260,986	5,588
Other revenue	40,567	(9,054)	21,919	9,340	854	2,884	13,089	1,535
Net assets released from restrictions used for operations	332	-	289	-	-	-	-	43
	902,798	(9,054)	486,728	106,752	854	36,277	274,075	7,166
Expenses								
Salaries and wages	379,739	-	140,824	113,888	-	22,420	79,854	22,753
Employee benefits	93,500	-	37,736	19,821	-	4,866	23,161	7,916
Supplies and other	223,052	(8,595)	122,377	19,449	302	6,943	72,146	10,430
Management fees	-	-	25,686	10,474	238	2,432	16,847	(55,677)
Professional fees and purchased services	115,892	(459)	46,722	4,569	705	1,263	39,505	23,587
Depreciation and amortization	52,517	-	28,913	4,059	10	1,284	14,959	3,292
Interest	4,985	-	4,770	8	-	-	207	-
	869,685	(9,054)	407,028	172,268	1,255	39,208	246,679	12,301
Income (loss) from operations	33,113	-	79,700	(65,516)	(401)	(2,931)	27,396	(5,135)
Non-operating								
Investment income, net	(20,496)	-	(37)	30	(449)	3	4	(20,047)
Gains on swap termination	7,827	-	7,827	-	-	-	-	-
Loss on bond refunding	-	-	-	-	-	-	-	-
Revenue and gains in excess of (less than) expenses	20,444	-	87,490	(65,486)	(850)	(2,928)	27,400	(25,182)

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (continued) (In Thousands)

Year Ended December 31, 2015

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Memorial Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted net assets								
Revenue and gains in excess of (less than) expenses	\$ 20,444	\$ –	\$ 87,490	\$ (65,486)	\$ (850)	\$ (2,928)	\$ 27,400	\$ (25,182)
Net assets released from restrictions used for capital purposes	5,456	–	5,453	–	–	–	–	3
Net assets released from board-designated endowment	(815)	–	–	–	(815)	–	–	–
Other	(142)	–	(66,113)	69,032	257	13,485	(14,943)	(1,860)
Postretirement benefit adjustments other than periodic costs	(5,702)	–	–	(4,574)	–	–	(1,128)	–
Increase (decrease) in unrestricted net assets	19,241	–	26,830	(1,028)	(1,408)	10,557	11,329	(27,039)
Temporarily restricted net assets								
Contributions temporarily restricted for use	3,594	–	–	–	3,594	–	–	–
Investment income	(438)	–	–	–	(43)	–	(395)	–
Net assets released from restrictions used for operating and capital purposes	(5,788)	–	–	–	(5,788)	–	–	–
Change in interest in recipient organization	–	2,239	(2,239)	–	–	–	–	–
Increase (decrease) in temporarily restricted net assets	(2,632)	2,239	(2,239)	–	(2,237)	–	(395)	–
Increase (decrease) in net assets	16,609	2,239	24,591	(1,028)	(3,645)	10,557	10,934	(27,039)
Net assets at beginning of year	1,096,167	(21,495)	285,743	27,883	30,499	7,190	115,916	650,431
Net assets at end of year	\$ 1,112,776	\$ (19,256)	\$ 310,334	\$ 26,855	\$ 26,854	\$ 17,747	\$ 126,850	\$ 623,392

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