

CONSOLIDATED FINANCIAL STATEMENTS

Indiana University Health, Inc. and Subsidiaries  
Years Ended December 31, 2017 and 2016  
With Report of Independent Auditors

Ernst & Young LLP



Indiana University Health, Inc. and Subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2017 and 2016

**Contents**

Report of Independent Auditors.....	1
Consolidated Financial Statements	
Consolidated Balance Sheets .....	3
Consolidated Statements of Operations and Changes in Net Assets .....	5
Consolidated Statements of Cash Flows.....	7
Notes to Consolidated Financial Statements.....	9



Ernst & Young LLP  
Suite 4000  
111 Monument Circle  
Indianapolis, IN 46204

Tel: +1 317 681 7000  
Fax: +1 317 681 7216  
ey.com

## Report of Independent Auditors

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

We have audited the accompanying consolidated financial statements of Indiana University Health, Inc. and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, 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 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 financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the 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 financial statements.

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



## Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Indiana University Health, Inc. and Subsidiaries at December 31, 2017 and 2016, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

*Ernst + Young LLP*

February 22, 2018

Indiana University Health, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in Thousands)

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 414,674	\$ 415,860
Short-term investments	5,081	15,502
Current portion of assets limited as to use	143,611	56,958
Patient accounts receivable, less allowance for uncollectible accounts of \$221,832 and \$187,876 at 2017 and 2016, respectively	870,252	776,180
Other receivables	156,281	157,207
Prepaid expenses	46,026	25,658
Inventories	85,856	77,975
Total current assets	<u>1,721,781</u>	<u>1,525,340</u>
Assets limited as to use:		
Board-designated investment funds and other investments	4,791,654	4,142,004
Donor-restricted investment funds	88,239	69,927
Total assets limited as to use, less current portion	<u>4,879,893</u>	<u>4,211,931</u>
Property and equipment:		
Cost of property and equipment in service	5,536,733	5,531,399
Less accumulated depreciation	<u>(3,267,111)</u>	<u>(3,190,606)</u>
	2,269,622	2,340,793
Construction-in-progress	69,775	40,593
Total property and equipment, net	<u>2,339,397</u>	<u>2,381,386</u>
Other assets:		
Equity interest in unconsolidated subsidiaries	44,103	102,175
Interest in net assets of foundations	22,038	13,775
Goodwill, intangibles, and other assets	341,810	310,066
Total other assets	<u>407,951</u>	<u>426,016</u>
Total assets	<u><u>\$ 9,349,022</u></u>	<u><u>\$ 8,544,673</u></u>

Indiana University Health, Inc. and Subsidiaries

Consolidated Balance Sheets (continued)

(Dollars in Thousands)

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 525,199	\$ 567,486
Accrued salaries, wages, and related liabilities	296,053	241,516
Accrued health claims	95,844	94,793
Estimated third-party payer allowances	87,215	61,219
Current portion of long-term debt	100,105	144,389
Total current liabilities	<u>1,104,416</u>	<u>1,109,403</u>
Noncurrent liabilities:		
Long-term debt, less current portion	1,351,115	1,402,807
Interest rate swaps	75,813	92,240
Accrued pension obligations	10,134	100,122
Accrued medical malpractice claims	63,626	61,436
Other	33,876	95,861
Total noncurrent liabilities	<u>1,534,564</u>	<u>1,752,466</u>
Total liabilities	<u>2,638,980</u>	<u>2,861,869</u>
Net assets:		
Indiana University Health	6,368,314	5,384,110
Noncontrolling interest in subsidiaries	225,806	209,457
Total unrestricted	<u>6,594,120</u>	<u>5,593,567</u>
Temporarily restricted	42,004	22,191
Permanently restricted	73,918	67,046
Total net assets	<u>6,710,042</u>	<u>5,682,804</u>
Total liabilities and net assets	<u><u>\$ 9,349,022</u></u>	<u><u>\$ 8,544,673</u></u>

See accompanying notes.

Indiana University Health, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets

(Dollars in Thousands)

	<b>Year Ended December 31</b>	
	<b>2017</b>	<b>2016</b>
Revenues:		
Patient service revenue (net of contractually and discounts)	<b>\$ 5,662,459</b>	\$ 5,736,999
Provision for uncollectible accounts	<b>(280,802)</b>	(254,669)
Net patient service revenue	<b>5,381,657</b>	5,482,330
Member premium revenue	<b>584,927</b>	598,041
Other revenue	<b>321,080</b>	153,207
Total operating revenues	<b>6,287,664</b>	6,233,578
Expenses:		
Salaries, wages, and benefits	<b>2,918,188</b>	2,844,228
Supplies, drugs, purchased services, and other	<b>1,896,100</b>	1,938,424
Hospital assessment fee	<b>132,069</b>	111,763
Health claims to providers	<b>474,623</b>	478,102
Depreciation and amortization	<b>231,601</b>	255,204
Interest	<b>34,476</b>	40,334
Total operating expenses	<b>5,687,057</b>	5,668,055
Operating income before educational and research support	<b>600,607</b>	565,523
Educational and research support to Indiana University	<b>(17,500)</b>	(17,500)
Total operating income	<b>583,107</b>	548,023
Nonoperating income (loss):		
Investment income, net	<b>504,915</b>	261,900
Gains on interest rate swaps, net	<b>5,720</b>	3,060
Loss on deconsolidation of subsidiaries, net	<b>–</b>	(452,119)
Debt extinguishment and other	<b>6,990</b>	9,768
Total nonoperating income (loss)	<b>517,625</b>	(177,391)
Consolidated excess of revenues over expenses	<b>1,100,732</b>	370,632
Less amounts attributable to noncontrolling interest in subsidiaries	<b>111,483</b>	110,537
Excess of revenues over expenses attributable to Indiana University Health and subsidiaries	<b>989,249</b>	260,095

See accompanying notes.

Indiana University Health, Inc. and Subsidiaries

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

	December 31, 2017			December 31, 2016		
	Total	Controlling	Noncontrolling	Total	Controlling	Noncontrolling
Unrestricted net assets:						
Consolidated excess of revenues over expenses	\$ 1,100,732	\$ 989,249	\$ 111,483	\$ 370,632	\$ 260,095	\$ 110,537
Change in pension obligations	(1,098)	(1,098)	-	25,430	25,430	-
Contributions for capital expenditures	8,084	8,084	-	6,735	6,735	-
Distributions to noncontrolling interests	(133,231)	-	(133,231)	(116,384)	-	(116,384)
Contributions from noncontrolling interest	38,097	-	38,097	2,940	-	2,940
Other	(12,031)	(12,031)	-	1,514	934	580
	<b>1,000,553</b>	<b>984,204</b>	<b>16,349</b>	<b>290,867</b>	<b>293,194</b>	<b>(2,327)</b>
Temporarily restricted net assets:						
Change in beneficial interest in net assets of foundations	3,383	3,383	-	(419)	(419)	-
Contributions	2,211	2,211	-	1,619	1,619	-
Investment return	3,919	3,919	-	775	775	-
Net assets released from restrictions	(3,437)	(3,437)	-	(3,331)	(3,331)	-
Other	13,737	13,737	-	(345)	(345)	-
Beneficial interest reclassification	-	-	-	799	799	-
	<b>19,813</b>	<b>19,813</b>	<b>-</b>	<b>(902)</b>	<b>(902)</b>	<b>-</b>
Permanently restricted net assets:						
Change in beneficial interest in net assets of foundations	4,880	4,880	-	56	56	-
Contributions and other	1,292	1,292	-	422	422	-
Other	700	700	-	-	-	-
Beneficial interest reclassification	-	-	-	(799)	(799)	-
	<b>6,872</b>	<b>6,872</b>	<b>-</b>	<b>(321)</b>	<b>(321)</b>	<b>-</b>
Increase (decrease) in net assets	<b>1,027,238</b>	<b>1,010,889</b>	<b>16,349</b>	<b>289,644</b>	<b>291,971</b>	<b>(2,327)</b>
Net assets at beginning of year	<b>5,682,804</b>	<b>5,473,347</b>	<b>209,457</b>	<b>5,393,160</b>	<b>5,181,376</b>	<b>211,784</b>
Net assets at end of year	<b>\$ 6,710,042</b>	<b>\$ 6,484,236</b>	<b>\$ 225,806</b>	<b>\$ 5,682,804</b>	<b>\$ 5,473,347</b>	<b>\$ 209,457</b>

See accompanying notes.

Indiana University Health, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Dollars in Thousands)

	<b>Year Ended December 31</b>	
	<b>2017</b>	<b>2016</b>
<b>Operating activities</b>		
Increase in net assets	\$ 1,027,238	\$ 289,644
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Change in fair value of interest rate swaps	(16,427)	(20,435)
Change in pension liability	1,098	(25,430)
(Income) loss in unconsolidated subsidiaries	(266)	39,480
Loss on deconsolidation of subsidiaries, net	–	452,119
Gain on sale of membership interests	(68,152)	–
Gain on sale of a business unit	(25,285)	–
Provision for uncollectible accounts	280,802	254,669
Contributions from noncontrolling interests	(38,097)	(2,940)
Depreciation and amortization	231,601	255,204
Amortization of deferred gain on sale of medical office buildings	(842)	(1,071)
Gain on extinguishment of debt	(17)	(5,532)
Restricted contributions and investment return	(15,686)	(1,654)
Distributions to noncontrolling interests	133,231	116,384
Assets limited as to use	(744,194)	(742,318)
Net changes in operating assets and liabilities:		
Patient accounts receivable, net	(374,874)	(295,974)
Other assets	(11,251)	(155,806)
Accounts payable, accrued liabilities, and other liabilities	(137,950)	175,799
Accrued salaries, wages, and related liabilities	54,537	1,897
Estimated third-party payer allowances	25,996	(45,306)
Net cash provided by operating activities	<u>321,462</u>	<u>288,730</u>

Indiana University Health, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (continued)

(Dollars in Thousands)

	<b>Year Ended December 31</b>	
	<b>2017</b>	<b>2016</b>
<b>Investing activities</b>		
Purchase of property and equipment, net of disposals	\$ (188,702)	\$ (205,350)
Deconsolidation of subsidiaries, net	–	(7,154)
Proceeds from sale of a business unit	25,763	–
Proceeds from sale of membership interests	49,108	–
Acquisition of subsidiaries, net of cash received	(33,410)	–
Net cash used in investing activities	<u>(147,241)</u>	(212,504)
<b>Financing activities</b>		
Increase in restricted net assets	15,686	1,654
Repayments on long-term debt	(314,961)	(351,180)
Proceeds from issuance of long-term debt	219,002	267,902
Contributions from noncontrolling interests	38,097	2,940
Distributions to noncontrolling interests	(133,231)	(116,384)
Deconsolidation of subsidiary contingent receivable	–	18,000
Net cash used in financing activities	<u>(175,407)</u>	(177,068)
Decrease in cash and cash equivalents	(1,186)	(100,842)
Cash and cash equivalents at beginning of year	415,860	516,702
Cash and cash equivalents at end of year	<u>\$ 414,674</u>	<u>\$ 415,860</u>

See accompanying notes.

# Indiana University Health, Inc. and Subsidiaries

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

December 31, 2017 and 2016

### **Mission Statement**

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

### **Value Statement**

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

*Total patient care, including mind, body, and spirit*

*Excellence in education for health care providers*

*Quality of care and respect for life*

*Charity, equality and justice in health care*

*Leadership in health promotion and wellness*

*Excellence in research*

*An internal community of mutual trust and respect*

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

### **History and Organization**

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

Indiana University Health was formed as an Indiana nonprofit corporation through a consolidation, as of January 1, 1997, under the terms of a Definitive Health Care Resources Consolidation Agreement, as amended (the Consolidation Agreement), and certain other related agreements by and between the Trustees of Indiana University and Methodist Health Group, Inc. (formerly known as Methodist Hospital of Indiana, Inc.). The facilities and operations of Indiana University Health University Hospital (University Hospital), Riley Hospital for Children at Indiana University Health (Riley Hospital), and Indiana University Health Methodist Hospital (Methodist Hospital) (collectively, the Downtown Hospitals of the Academic Health Center) were

# Indiana University Health, Inc. and Subsidiaries

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

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

merged and consolidated to form a single corporate entity, which was then licensed as a single acute care hospital and operates as an academic health center. Members of the Board of Directors (the Board) of Indiana University Health are selected by its two classes of members: the Methodist Class (members of which are members of Methodist Health Group, Inc.) and the University Class (members of which are the individuals who are the Trustees of Indiana University).

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

#### Nature of Operations

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

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

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

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

**Ambulatory Care** – Consists of personal and home health care services, occupational health services, outpatient oncology services, outpatient surgery centers, and urgent care centers that are located throughout the State of Indiana. Principal divisions or subsidiaries include Indiana University Health Home Care, Indiana University Occupational Health Centers, Workplace Health Services, Indiana University Health Central Indiana Cancer Centers, Indiana University Health Morgan, several surgery center joint ventures, and an urgent care center joint venture.

## Indiana University Health, Inc. and Subsidiaries

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

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

**Medical Risk** – Consists of the medical management of health care services of members whose health care coverage is provided by the managed care networks of the Indiana University Health System. Includes health maintenance organizations and other insurance related organizations that provide health plan services to fully-insured and self-insured members residing in Indiana. Insurance offerings include commercial group products (fully-insured and self-insured), products on the Health Insurance Marketplace (Exchange), Medicare Advantage products and Medicaid management services. Indiana University Health System also participates in the medical management of Medicare fee-for-service members through a NextGen Accountable Care Organization contract with the Centers for Medicare and Medicaid (CMS). The Indiana University Health System will no longer provide products on the Exchange as of January 1, 2018.

**Foundations** – Indiana University Health is the sole corporate member of Indiana University Health Foundation, Inc., formerly known as Methodist Health Foundation, Inc. (Indiana University Health Foundation), which aids and supports Methodist Hospital and other programs and areas of Indiana University Health. Prior to December 31, 2017, Tipton was the sole corporate member of Tipton County Health Care Foundation, Inc. (Tipton Foundation), which aids in carrying out the mission of Tipton; Arnett was the sole corporate member of Indiana University Health Arnett Hospital Foundation, Inc. (Arnett Foundation), which aids and supports Arnett; and the corporate members of Indiana University Health Paoli Hospital Foundation, Inc. (Paoli Foundation), which aids and supports Paoli, were Paoli, Bloomington, and the Board of Commissioners of Orange County, Indiana. On December 31, 2017, Tipton Foundation, Arnett Foundation and Paoli Foundation were merged into the Indiana University Health Foundation. Those foundations will continue to serve the same purposes as prior to the mergers. Ball Memorial is the sole corporate member of Indiana University Health Ball Memorial Hospital Foundation, Inc. (BMH Foundation), which aids in carrying out the mission of Ball Memorial and Blackford. RHI is the sole corporate member of RHI Foundation, Inc. (RHI Foundation), which aids and supports RHI.

#### 2. Community Benefit and Charity Care

The Indiana University Health System provides health care services and other financial support through various programs that are designed, among other matters, to enhance the health of the community, improve the health of low-income patients, and foster medical education and research through its affiliation with the School of Medicine. In addition, the Indiana University Health

## Indiana University Health, Inc. and Subsidiaries

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

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

System provides services intended to benefit the poor and underserved, including those persons who cannot afford health insurance because of inadequate resources or those who are uninsured or underinsured. Health care services to patients under government programs, such as Medicare and Medicaid, are also considered part of the Indiana University Health System's benefit provided to the community since a substantial portion of such services is reimbursed at amounts less than cost.

The Indiana University Health System's financial assistance policy is designed to provide care to all patients regardless of their ability to pay, and all uninsured patients who fail to qualify for coverage are eligible for discounted care. The financial assistance policy affords charitable discounts only for uninsured patients equivalent to the amounts generally billed, and it provides eligibility for full charity for emergent encounters for uninsured patients who earn less than 200% of the federal poverty level and who meet application criteria. Patients whose liability is deemed catastrophic relative to their annual household income are also eligible for reduced charges.

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

Eligibility for full charity is determined based on the qualifying criteria, as defined in the financial assistance policy, and through information provided on applications completed by patients and their families or beneficiaries. Eligibility is also based on analysis of patients without third-party insurance coverage who did not apply for charity but for whom all collection efforts have been exhausted and who meet other criteria, including those who are deceased and are found to have no estate. The cost to provide charity care using the consolidated cost to charge ratio was \$84,895 and \$77,407 for 2017 and 2016, respectively.

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

## Indiana University Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Dollars in Thousands)*

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

The Patient Protection and Affordable Care Act (the Affordable Care Act) required, among other things, that hospital organizations establish a financial assistance policy and a policy relating to emergency medical care. The hospital organizations of the Indiana University Health System have adopted a financial assistance policy that includes financial assistance eligibility criteria, the basis for calculating amounts charged to patients, the method for applying for financial assistance, billing and collections policies with regard to actions that may be taken in the case of nonpayment, as well as measures to widely publicize the policy within the communities served. Additionally, the Indiana University Health System's hospital organizations have adopted policies requiring the organizations to provide, without discrimination, care for emergency medical conditions to individuals regardless of their eligibility under the financial assistance policy. These hospital organizations have also adopted policies to limit the amount charged for emergency or other medically necessary care that is provided to individuals eligible for assistance under the organizations' financial assistance policy to not more than the amounts generally billed to individuals who have insurance covering such care.

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

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

Through the statewide facility-by-facility community health needs assessments Indiana University Health conducted, the following community health needs were identified and selected as priority areas in which Indiana University Health will focus on community benefit efforts: access to affordable health care, behavioral health, and obesity prevention. The costs of providing these

## Indiana University Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Dollars in Thousands)*

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

programs and services are included in total operating expenses in the accompanying consolidated statements of operations and changes in net assets.

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

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

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

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

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

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

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

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

The Indiana University Health System has entered into certain interest rate swap transactions (fixed-pay swaps and basis swaps). As of and for the years ended December 31, 2017 and 2016, the Indiana University Health System's fixed-pay swap and basis swap agreements did not qualify for hedge accounting. Therefore, the changes in fair value of these interest rate swaps during these years are reported in nonoperating loss in the consolidated statements of operations and changes in net assets.

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

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

For the year ended December 31, 2017, the percentage of patient service revenue (net of contractuels and discounts) derived under Medicare, Medicaid, and managed care programs approximated 24%, 9%, and 57%, respectively (24%, 9%, and 59%, respectively, for the year ended December 31, 2016). One managed care payer represented 30% and 31% of patient service revenue (net of contractuels and discounts) for 2017 and 2016, respectively. Provision has been made, by a charge to contractual allowances as an offset to patient service revenue, for the differences between gross charges for patient services and estimated reimbursement from these government and insurance programs.

During 2012, the Indiana General Assembly approved a hospital assessment fee program (Medicaid Assessment Fee). Under this program, the Office of Medicaid Policy and Planning (OMPP) collects a fee from eligible hospitals. The fee is used in part to increase reimbursement to eligible hospitals for services provided in both fee-for-service and managed care programs and as the state share of DSH payments. The program was effective retroactively from July 1, 2011 through June 30, 2013, and was subsequently extended through June 30, 2019. The 2017 budget bill extending the program through June 30, 2019, was signed into law on April 27, 2017.

## Indiana University Health, Inc. and Subsidiaries

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

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

For the years ended December 31, 2017 and 2016, reimbursement related to the Medicaid Assessment Fee program was recorded within net patient revenue in the consolidated statements of operations and changes in net assets totaling \$286,856 and \$253,368, respectively. During the years ended December 31, 2017 and 2016, an assessment fee was recognized of \$132,069 and \$111,763, respectively. This fee was recorded within the hospital assessment fee on the consolidated statements of operations and changes in net assets.

Indiana University Health is a Medicaid DSH provider under Indiana law (IC 12-15-16(1-3)) and, as such, is eligible to receive state DSH payments. The amount of these additional state DSH funds depends on regulatory approval by agencies of the federal and state governments and is determined by the level, extent, and cost of uncompensated care (as defined) and various other factors. For the years ended December 31, 2017 and 2016, state DSH payments have been made by the State of Indiana, and amounts were recorded as revenue based on data acceptable to the State of Indiana, less any amounts management believes may be subject to adjustment. State DSH payments by the State of Indiana are based on the fiscal year of the state, which ends June 30 of each year. State DSH reimbursement is recognized as revenue after eligibility is determined by the state and payments are probable and reasonably estimable. Due to the recording of reserves on DSH payments for state fiscal years 2016 and 2017, as a result of a final ruling for those fiscal years from CMS, state DSH of (\$3,198) was recognized by Indiana University Health and certain subsidiaries recorded in net patient service revenue in the accompanying consolidated statement of operations and changes in net assets for the year ended December 31, 2017. For state fiscal years 2015 and 2016, state DSH of \$27,165 was recognized by Indiana University Health and certain subsidiaries, which was recorded in net patient service revenue in the accompanying consolidated statement of operations and changes in net assets for the year ended December 31, 2016.

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

	Year Ended December 31	
	2017	2016
Third-party payers	\$ 5,558,927	\$ 5,584,323
Self-pay patients	103,532	152,676
Total payers	<u>\$ 5,662,459</u>	<u>\$ 5,736,999</u>

#### Member Premium Revenue and Health Claims

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

#### Cash Equivalents

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

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

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

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

	<u>2017</u>	<u>2016</u>
Managed care	52%	58%
Medicare	16	16
Medicaid	16	9
Other third-party payers	7	9
Patients	9	8
	<u>100%</u>	<u>100%</u>

One managed care payer represented 19% and 21% of net patient accounts receivable at December 31, 2017 and 2016, respectively.

The allowance for uncollectible accounts for self-pay patients, including self-pay discounts and charity care, was 80% and 81% of self-pay accounts receivable as of December 31, 2017 and 2016, respectively. The Indiana University Health System has not experienced significant changes in write-off trends and has not changed its financial assistance policy for the year ended December 31, 2017.

#### **Inventories**

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

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

Assets limited as to use include the following: (i) cash and cash equivalents and designated investment assets, including those funds held by the consolidated foundations, set aside by the Board for future capital improvements, over which the Board retains control and may, in certain circumstances, use for other purposes and (ii) donor-restricted investment assets, the use of which has been specified by the donor. Substantially all assets limited as to use are invested and managed by professional investment managers and are held in custody by financial institutions. These funds

## Indiana University Health, Inc. and Subsidiaries

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

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

are classified as trading securities. Accordingly, changes in unrealized gains and losses in the fair value of investments are included in nonoperating income (loss) within investment income in the accompanying consolidated statements of operations and changes in net assets. The Indiana University Health System is a limited partner in certain funds that employ hedged investment strategies and funds that employ investment strategies that require long holding periods to create value. These investments are accounted for using the equity method of accounting, based on the fund's financial information. Management has utilized the best available information for reported alternative investment values, which in some instances are valuations as of an interim date.

#### **Property and Equipment**

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets.

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

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

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

Indiana University Health or its subsidiaries have also entered into certain limited liability company agreements with third parties that provide health care-related services. Where applicable, these arrangements are accounted for using the equity method of accounting.

## Indiana University Health, Inc. and Subsidiaries

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

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

Indiana University Health had a 50% membership interest in MDwise, Inc., which holds a health maintenance organization license and manages a network of health care providers serving Medicaid patients throughout the state of Indiana, and a 50% membership interest in MDwise Medicaid Network, which assumes risk for Medicaid products. On December 29, 2017 Indiana University Health transferred its membership interests in MDwise, Inc. and MDwise Medicaid Network, Inc. to a third-party (see Note 4). Indiana University Health reported \$4,297 and (\$42,850) as its share of income (loss) related to MDwise, Inc. and MDwise Medicaid Network, Inc. as of and for the years ended December 31, 2017 and 2016, respectively.

The Indiana University Health System also has joint venture arrangements for the operation of urgent care facilities and other health care-related service providers.

Total equity interest in unconsolidated subsidiaries was \$44,103 and \$102,175 as of December 31, 2017 and 2016, respectively. As of December 31, 2016, Indiana University Health had a liability of \$52,895 related to its interest in MDwise Medicaid Network, Inc. recorded in other noncurrent liabilities in the consolidated balance sheet (see Note 4). The Indiana University Health System has recorded its interest in the income of its unconsolidated subsidiaries, including MDwise, Inc. and MDwise Medicaid Network, Inc., within other operating revenue, totaling \$266 and (\$39,480) for the years ended December 31, 2017 and 2016, respectively.

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

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

#### **Contributions**

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

The Indiana University Health System recorded \$111,483 and \$110,537 for the years ended December 31, 2017 and 2016, respectively, of excess of revenues over expenses attributable to noncontrolling interest in subsidiaries based on the ownership percentage of the noncontrolling interests in certain of the Indiana University Health System's consolidated subsidiaries. These amounts primarily relate to the surgery center joint ventures. For the years ended December 31, 2017 and 2016, the surgery center joint ventures accounted for \$129,808 and \$117,243, respectively, of the excess of revenues over expenses attributable to noncontrolling interest in subsidiaries. The surgery center joint ventures realized operating revenue of \$308,261 and \$280,614 and operating income of \$175,119 and \$158,297 in 2017 and 2016, respectively. The operating revenue and operating income are reflected in total operating revenue and total operating income, respectively, on the consolidated statement of operations and changes in net assets.

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

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

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

##### **Business Combinations**

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

## Indiana University Health, Inc. and Subsidiaries

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

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

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

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

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

The Indiana University Health System also reviews whether events or changes in circumstances suggest impairment may have occurred related to the carrying value of the definite-lived intangible assets, which are amortized over periods of 5 to 35 years. It has been determined that there was no impairment to goodwill or definite-lived intangible assets during 2017 or 2016. Intangible assets included in other assets in the accompanying consolidated balance sheets as of December 31, 2017 and 2016, were \$219,632 and \$189,361, respectively, which include goodwill of \$196,581 and \$176,036, respectively.

##### **Reclassification**

The accompanying consolidated statement of cash flows for the year ended December 31, 2016, has been adjusted to present the deconsolidation of subsidiaries consistent with current year presentation resulting in an increase in net cash provided by operations of \$388,182, a decrease to net cash used in investing activities of \$406,182, and a decrease in net cash used in financing activities of \$18,000 for the year ended December 31, 2016. This change had no impact on the consolidated balance sheet as of December 31, 2016 or consolidated statement of operations and changes in net assets for the year ended December 31, 2016.

## Indiana University Health, Inc. and Subsidiaries

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

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

##### Operating and Performance Indicators

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

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

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

##### Income Taxes

The Internal Revenue Service (IRS) has determined that Indiana University Health and certain of its affiliated entities are tax-exempt organizations as defined in Section 501(c)(3) of the Internal Revenue Code (IRC). Indiana University Health and its tax-exempt affiliates are, however, subject to federal and state income taxes on unrelated business income under the provision of Section IRC 511.

## Indiana University Health, Inc. and Subsidiaries

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

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

Deferred income taxes, which as of December 31, 2017 and 2016, have no net carrying value, reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. As of December 31, 2017 and 2016, the Indiana University Health System had gross deferred tax assets of \$93,794 and \$116,490, respectively, primarily relating to net operating loss carryovers. Management determined that a full valuation allowance at both December 31, 2017 and 2016, was necessary to reduce the deferred tax assets to the amount that would more likely than not be realized. Accounting Standards Codification (ASC) 740, *Income Taxes*, requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The change in the valuation allowance for the current year is \$22,696, which reflects a change in the federal corporate tax rate to 21% effective for years beginning after December 31, 2017, pursuant to the Tax Cuts and Jobs Act enacted December 22, 2017. At December 31, 2017, the Indiana University Health System has available net operating loss carryforwards of \$377,123. These net operating losses will expire between 2018 and 2037.

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

#### **Subsequent Events**

For the consolidated financial statements as of and for the year ended December 31, 2017, management has evaluated subsequent events through February 22, 2018, the date that these consolidated financial statements were issued.

#### **Recent Accounting Pronouncements Adopted**

In May 2015, the Financial Accounting Standards Board (FASB) issued guidance on disclosures for investments in certain entities that calculate net asset value (NAV) per share. The provisions of this guidance affect fair value measurement disclosures only. Investments for which fair value is measured at net asset value per share (or its equivalent) using the practical expedient provisions, are no longer required to be included within the fair value hierarchy leveling tables. Indiana University Health adopted this guidance as of December 31, 2017.

## Indiana University Health, Inc. and Subsidiaries

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

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

In January 2016, the FASB issued guidance on financial instruments, and the recognition and measurement of financial assets and financial liabilities, to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The pronouncement provides additional guidance on classifying and measuring financial instruments. For entities other than public business entities, which includes not-for-profit organizations, the pronouncement eliminates the requirement to disclose the fair values of financial instruments measured at amortized cost on the balance sheet. The guidance is effective for Indiana University Health for fiscal years beginning after December 15, 2018, and interim periods beginning after December 15, 2019. However, the pronouncement allows for entities other than public business entities to early adopt the provision that eliminates the fair value disclosures for financial instruments not recognized at fair value. Indiana University Health elected to adopt the provision that allows for the elimination of disclosure of the fair values of financial instruments measured at amortized cost on the balance sheet early and has made the relevant changes in the consolidated financial statements.

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

In March 2017, the FASB issued guidance to require bifurcation of net periodic pension and postretirement benefit cost which requires that only service cost be reported within operating income, once adopted. Early adoption is permitted. Indiana University Health will adopt this guidance effective January 1, 2018. Upon adoption, it will not have an effect on consolidated excess of revenues over expenses on the consolidated statements of operations and changes in net assets.

In August 2016, the FASB issued guidance to clarify the classification of eight types of transactions in the statement of cash flows to reduce diversity in practices. Indiana University Health is required to adopt this new guidance for fiscal year 2019. Upon adoption, changes reflected in the consolidated financial statements will be presentation only.

In August 2016, the FASB issued guidance for not-for-profit entities related to improving the usefulness of information provided to donors, grantors, creditors, and other users of the financial statements by eliminating the distinction between resources with permanent restrictions and temporary restrictions from the face of the financial statements, as well as enhancing or providing additional information in the financial statements and notes related to liquidity, expense classifications, allocation methodology, underwater endowment funds, and investment returns.

## Indiana University Health, Inc. and Subsidiaries

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

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

The amendments in this update are effective for fiscal years beginning after December 15, 2017, and should be applied retrospectively. Early adoption of these amendments is permitted. As of December 31, 2017, Indiana University Health has not adopted these amendments. Upon adoption, changes reflected in the consolidated financial statements will be presentation only.

In February 2016, the FASB issued guidance related to leases. One of the primary changes brought about by the new standard is the reporting of operating leases on the balance sheet. This new guidance dictates that the implementation of the new standard would recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2018. Indiana University Health is evaluating the effect this guidance will have on its consolidated financial statements.

In May 2014, the FASB issued guidance related to recognizing revenue from contracts with customers. This new guidance dictates that the standard be applied either full retrospective to each prior reporting period presented or modified retrospective with the cumulative effect of initially applying the revenue recognition standard recognized at the date of initial application. Subsequently, the FASB issued updates to this guidance to provide clarification to the aspects of collectibility criterion, identifying performance obligations and the licensing implementation guidance and recognizing revenue when another party is involved in providing goods or services to a customer. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2017. The most significant impact will be to the presentation of the consolidated statement of operations and changes in net assets where the provision for doubtful accounts will be recorded as a direct reduction to revenues and will not be presented as a separate line item. Indiana University Health adopted the new standard on January 1, 2018 using the full retrospective application and has concluded that the adoption will not have a material effect on the consolidated statements of operations and changes in net assets.

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

##### **MDwise**

Indiana University Health held 50% membership interests in both MDwise, Inc. and MDwise Medicaid Network, Inc., with Health and Hospital Corporation of Marion County (HCC) holding the other 50% membership interest (see Note 3). On October 31, 2017, a sponsorship transfer

## Indiana University Health, Inc. and Subsidiaries

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

#### **4. Significant Transactions (continued)**

agreement was entered into with Michigan-based McLaren Health Care (McLaren), whereby Indiana University Health and HCC would transfer their membership interests in MDwise, Inc. and MDwise Medicaid Network, Inc. to McLaren. The transaction closed on December 29, 2017, and resulted in the recognition of a gain of \$68,152 in other revenue on the consolidated statement of operations and changes in net assets.

#### **Jay County**

On November 20, 2017, Indiana University Health entered into an Affiliation and Asset Purchase Agreement with Jay County Hospital, a 25-bed critical access hospital located in Portland, Indiana. Effective March 1, 2018, Jay County Hospital will transfer all of its assets and liabilities to Indiana University Health Jay Hospital, a newly created nonprofit organization, and Indiana University Health will become the sole corporate member of the hospital.

#### **Dialysis Business**

On June 1, 2017, Indiana University Health sold two outpatient hemodialysis in-center units in downtown Indianapolis and a home dialysis program to ISD Renal, Inc. a subsidiary of DaVita, Inc. Through the sale transaction, Indiana University Health sold substantially all of the assets owned and used by the dialysis business for \$25,763. Indiana University Health recognized a gain of \$25,285 related to the transaction. The gain is reflected in other revenue on the consolidated statement of operations and changes in net assets.

#### **Frankfort**

On November 10, 2016, Indiana University Health entered into a lease agreement with Clinton County to lease the hospital building and other related property and equipment and to assume the operations of Frankfort Hospital, the Clinton County-owned hospital, effective June 1, 2017. As of the effective date, Indiana University Health began a five-year lease with renewal options for the 25-bed county-owned critical access hospital and affiliated medical offices. The annual minimum rental rate is \$1,000. Additional rent can be triggered if the hospital reaches certain net income targets, which did not occur in 2017.

## Indiana University Health, Inc. and Subsidiaries

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

#### 4. Significant Transactions (continued)

##### Goshen

On December 6, 2016, a Separation Agreement was executed, effective December 31, 2016, between Indiana University Health and Goshen Hospital (Goshen). As of the effective date, Indiana University Health withdrew as the sole corporate member of Goshen. Under the agreement, Goshen agreed to pay Indiana University Health a separation payment of \$20,000 payable over a ten-year period, with the first installment of \$2,000 due at closing. The Indiana University Health System recognized a nonoperating loss of \$295,214, net of the separation payment of \$20,000, related to the transaction for the year ended December 31, 2016. Just prior to the closing of this transaction, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of Goshen from the Obligated Group and Affiliates (see Note 7).

For the year ended December 31, 2016, Goshen represented approximately 4.3% of the total operating revenues of the Indiana University Health System.

##### La Porte

On December 24, 2015, a Contribution and Sale Agreement was executed by and among Indiana University Health, Indiana University Health La Porte (La Porte), Frankfort Health Partner, Inc. and Community Health Systems, Inc. (CHS) and other affiliated entities. In anticipation of the agreement, Indiana University Health and La Porte formed a limited liability company with Indiana University Health holding a 20% interest and La Porte holding 80%. The agreement includes a put option for Indiana University Health to put its interest in the limited liability company to CHS at its sole discretion. Upon closing of the agreement, La Porte and certain of its affiliated entities contributed assets to the limited liability company and certain of its affiliated entities. Also upon the closing, Frankfort Health Partner, Inc., a subsidiary of CHS, purchased La Porte's 80% interest in the limited liability company for \$96,489, plus the net working capital minus any long-term debt or capital leases. Pursuant to the limited liability company agreement, 20% of the assets contributed to the limited liability company are deemed to have been contributed on behalf of Indiana University Health, the value of which has been credited to Indiana University Health's capital account. The proceeds of the sale, net of the settlement of La Porte's liabilities existing on the date of sale and a portion to be retained by Indiana University Health under the agreement, were contributed to a foundation in support of the La Porte community. This transaction closed on March 1, 2016. The Indiana University Health System recognized a nonoperating loss, net of the value of Indiana University Health's investment in the new limited

## Indiana University Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued) *(Dollars in Thousands)*

#### **4. Significant Transactions (continued)**

liability company, of \$156,809 related to the transaction in the first quarter of 2016. In anticipation of the closing of this transaction, during 2015, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of La Porte from the Obligated Group (see Note 7). During 2016, Indiana University Health approved the termination of the La Porte defined benefit pension plan, effective December 31, 2016. Accordingly, the outstanding net actuarial loss of \$17,933 was accelerated in 2016 and was reflected in the consolidated statement of operations and changes in net assets as part of the nonoperating loss on deconsolidation of subsidiaries, net and change in pension obligation. The plan assets were liquidated and annuitized as of December 31, 2017.

For the year ended December 31, 2016, La Porte represented approximately 0.6% of the total operating revenues of the Indiana University Health System.

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

Board-designated and donor-restricted investment funds are invested in accordance with Board-approved policies. The estimated fair value of the assets limited as to use is determined using market information and other appropriate valuation methodologies. The methods and assumptions used to estimate the fair value of assets limited as to use are as follows: (i) cash and cash equivalents: the carrying amounts reported in the consolidated balance sheets approximate fair value; (ii) marketable securities: the fair values are based on quoted market prices or, if quoted market prices are not available, quoted market prices of comparable instruments and other observable inputs; and (iii) other investments, including alternative investments. Certain alternative investments (such as hedged strategies and private investments) are accounted for using the equity method of accounting based upon the net asset values as determined by third-party valuation firms and/or administrators of each fund in consultation with and approval of the fund investment managers.

The Indiana University Health System is a limited partner in funds that employ hedged investment strategies and private funds that employ investment strategies that require long holding periods to create value, both of which are designed to reduce overall portfolio volatility.

In the case of hedge funds, redemptions generally may be made quarterly with written notice ranging from 30 to 90 days; however, some funds employ lock-up periods that restrict redemptions or charge a redemption fee during the lock-up period. Lock-up periods range from one to three years with redemption charges of up to 5% of net asset value for redemptions made on or before

## Indiana University Health, Inc. and Subsidiaries

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

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

the anniversary date of the initial investment or additional contribution. Upon complete redemption, many of the funds have holdback provisions that allow the fund to retain up to 10% of the assets until the fund completes its audited financial statements for the redemption period. These investments are accounted for using the equity method of accounting, based on the fund's financial information.

In the case of private funds, capital is returned as monetization events occur, which may be infrequent in nature. Generally, capital is committed to a partnership for a period of five to ten years with the ability of the general partner to extend the life of the fund one to three additional years. During the first three to five years of a fund life, the general partner, in order to facilitate its funding of investments, will call capital from the limited partners up to the amount of each limited partner's commitment. As of December 31, 2017, there is \$434,660 of unfunded commitments relating to private funds, which is expected to be funded over the next five years. As of December 31, 2016, there was \$306,798 of unfunded commitments relating to private fund investments, which are generally expected to be funded over the next five years.

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

The largest fund allocation to any fund manager, which is an alternative fund of funds investment, is \$281,099 at December 31, 2017, and there are no investments in any individual fund greater than 38.54% of that fund's net assets. Changes in the value of these funds are included in nonoperating income (loss) in the accompanying consolidated statements of operations and changes in net assets.

Indiana University Health, Inc. and Subsidiaries

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

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

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

	<b>December 31,</b>	
	<b>2017</b>	<b>2016</b>
Assets limited as to use:		
Cash and cash equivalents	\$ 130,530	\$ 55,071
Debt securities:		
Asset backed	107,600	111,153
Bank loans	238,242	265,794
Corporate debt	253,876	218,956
Government and agencies	152,561	163,453
Bond funds	376,148	315,319
Total debt securities	<u>1,128,427</u>	<u>1,074,675</u>
Equity securities:		
Domestic equities	58,232	68,918
Domestic equity funds	874,683	747,219
International equities	72,751	75,869
International equity funds	765,607	573,554
Total equity securities	<u>1,771,273</u>	<u>1,465,560</u>
Commodities	197,906	167,494
Alternatives:		
Hedge funds	1,422,190	1,284,520
Private	373,178	221,569
Total alternatives	<u>1,795,368</u>	<u>1,506,089</u>
Less current portion of assets limited to use	<u>(143,611)</u>	<u>(56,958)</u>
Total assets limited as to use	<u><u>\$ 4,879,893</u></u>	<u><u>\$ 4,211,931</u></u>

Indiana University Health, Inc. and Subsidiaries

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

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

Assets limited as to use include funds held by the foundations whose fair values as of December 31, 2017, aggregated \$188,614, of which \$125,704 is considered board-designated investment funds and \$62,910 is considered donor-restricted investment funds. Assets limited as to use include funds held by the foundations whose fair values as of December 31, 2016, aggregated \$173,416, of which \$121,647 is considered board-designated investment funds and \$51,769 is considered donor-restricted investment funds.

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

	<b>Year Ended December 31,</b>	
	<b>2017</b>	<b>2016</b>
Investment income:		
Interest and dividend income	\$ 75,568	\$ 63,563
Investment management and administrative fees	(10,118)	(8,122)
Realized gains on sale of investments, net	66,193	17,704
Unrealized gains on investments	298,720	148,164
Unrealized equity gains on alternative investments	74,552	40,591
	<u>\$ 504,915</u>	<u>\$ 261,900</u>

**6. Property and Equipment**

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

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
Land and improvements	\$ 238,098	\$ 232,837
Buildings and improvements	3,154,153	3,191,141
Equipment	2,144,482	2,107,421
	<u>\$ 5,536,733</u>	<u>\$ 5,531,399</u>

Indiana University Health, Inc. and Subsidiaries

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

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

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

Construction-in-progress for assets currently under development was \$69,775 and \$40,593 at December 31, 2017 and 2016, respectively, and includes commitments for the construction, refurbishment, and replacement of facilities and equipment.

Firm commitments for construction-in-progress totaled \$57,695 at December 31, 2017.

Certain buildings, equipment, and software are accounted for as capital leases expiring in various years through 2022 and are included in property and equipment. Amortization of assets under capital leases is included in depreciation expense (see Note 7).

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

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
Equipment	\$ 5,839	\$ 5,571
Buildings	2,928	95,990
	<u>8,767</u>	<u>101,561</u>
Less accumulated amortization	<b>(6,263)</b>	<b>(16,449)</b>
	<u><b>\$ 2,504</b></u>	<u><b>\$ 85,112</b></u>

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

## Indiana University Health, Inc. and Subsidiaries

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

#### 7. Debt

##### Obligated Groups

The Indiana University Health System operates under two separate Master Trust Indentures (MTIs). Each MTI provides for the issuance of long-term debt and sets forth the terms pursuant to which underlying debt is issued. These MTIs set forth the provisions governing membership for the respective obligated groups, which presently consist of the following specific separate entities: (i) the Indiana University Health Obligated Group includes Indiana University Health (entity that includes divisions such as the Downtown Hospitals of the Academic Health Center, Saxony, and Morgan) as the sole member and (ii) the Rehabilitation Hospital of Indiana Obligated Group includes RHI as the sole member. During 2015, in anticipation of the sale transaction described in Note 4, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of La Porte from the Indiana University Health Obligated Group. Additionally, during 2016, as part of the separation transaction described in Note 4, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of Goshen from the Indiana University Health Obligated Group and Affiliates. Each obligated group is required to meet certain covenants, and future members, if any, together with existing members will be jointly and severally liable for the obligations under their respective MTI. Each is subject to financial performance covenants that, among other compliance requirements, require the maintenance of debt service ratios and limit its ability to encumber certain of its respective assets. As of December 31, 2017, the Indiana University Health System was in compliance with all financial covenants.

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

The Indiana University Health Obligated Group has executed direct-pay letter-of-credit agreements in support of all of its publicly remarketed variable-rate bond series, which require the credit provider to purchase bonds in the event the bonds are not remarketed. In addition, it has executed direct purchase agreements whereby the credit provider purchases bonds for a predetermined period of time, after which the agreement must be extended or the bonds must be remarketed or reissued. In each of these two instances, the bonds have a longer nominal maturity than the agreement, but the existence and terms of these agreements allow for the long-term classification of the associated variable-rate bond series. When these letter of credit agreements have expiration dates within the succeeding 12-month period, a greater portion of the associated debt is classified as current, because if not otherwise extended, the agreements with the credit providers would require the principal balance of the related bonds to be repaid over a shortened time frame. Accordingly, \$6,263 was reclassified to current portion of long-term debt as of

## Indiana University Health, Inc. and Subsidiaries

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

#### 7. Debt (continued)

December 31, 2016, to reflect the associated amount for 2017. No such reclassification was made as of December 31, 2017.

On October 12, 2017, through the Indiana Finance Authority, Indiana University Health amended its 2011 Series H & I tax exempt, variable-rate, direct-purchase bonds changing both the variable rate and principal repayment schedule. Indiana University Health sold the bonds to a new direct purchaser with the expiration date of the direct-purchase agreement being the same date as the final maturity of the bonds.

On October 31, 2016, through the Indiana Finance Authority, RHI reissued its Series 2011A tax-exempt, variable-rate bonds and converted them to a tax-exempt, fixed-rate, direct-purchase interest rate mode. The expiration date of the direct-purchase agreement is the same date as the final maturity of the bonds.

On June 29, 2016, Indiana University Health provided notice of intent to exercise its one-time contractual option to prepay, without penalty, the remaining debt balance relating to a capital lease obligation. The transaction closed on January 3, 2017, and resulted in the acquisition of the leased building and termination of the lease. Accordingly, \$92,278 was reclassified from long-term debt to the current portion of long-term debt as of December 31, 2016.

On February 18, 2016, through the Indiana Finance Authority, Indiana University Health issued \$158,205 in par value of Series 2016A tax-exempt, fixed-rate bonds at a premium of \$32,406. Proceeds were used to refund (on a current basis) \$189,415 in par of the Series 2006B tax-exempt, fixed-rate bonds and to pay certain costs related to the issuance.

Additionally, on February 18, 2016, through the Indiana Finance Authority, Indiana University Health issued at par \$100,000 of Series 2016B and 2016C tax-exempt, variable-rate bonds. Proceeds were used to refund (on a current basis) \$99,555 in par of the Series 2006B tax-exempt, fixed-rate bonds and to pay certain costs related to the issuance.

Also on February 18, 2016, Indiana University Health drew \$10,050 under its existing revolving line of credit to refund (on a current basis) \$10,050 in par of the Series 2006B tax-exempt, fixed-rate bonds. The remaining \$21,590 in par (after a routine principal payment of \$6,490 on February 15, 2016) of the Series 2006B tax-exempt, fixed-rate bonds was repaid with cash.

Indiana University Health, Inc. and Subsidiaries

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

**7. Debt (continued)**

The refunding of Series 2006B was accounted for as a debt extinguishment, resulting in a gain of \$5,532 based upon carrying values in excess of the funds expended plus unamortized premium less unamortized issuance costs associated with the refunded debt. This gain is shown within debt extinguishment and other nonoperating loss on the consolidated statement of operations and changes in net assets.

As of December 31, 2017 and 2016, the Indiana University Health System maintained several lines of credit totaling \$105,000. As of December 31, 2017 and 2016, the total balance drawn on the lines of credit was \$50,000 and \$0, respectively. The balance is included in the current portion of long-term debt as the line of credit associated with the drawn balance matures June 30, 2018.

Long-term debt consists of the following:

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
<b>Indiana University Health Obligated Group</b>		
Indiana Finance Authority:		
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2016A Serial Bonds, payable in varying principal installments through 2025, with an interest rate of 5.00% at December 31, 2017	<b>\$ 150,020</b>	\$ 158,205
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2015A Serial and Term Bonds, payable in varying principal installments through 2040, with interest rates ranging from 4.00% to 5.00% at December 31, 2017	<b>287,395</b>	287,395
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2014A Serial Bonds, payable in varying principal installments through 2030, with interest rates ranging from 4.00% to 5.00% at December 31, 2017	<b>58,230</b>	62,235
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2011N Serial and Term Bonds, payable in varying principal installments through 2038, with interest rates ranging from 3.00% to 5.13% at December 31, 2017	<b>122,935</b>	139,605

Indiana University Health, Inc. and Subsidiaries

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

**7. Debt (continued)**

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
<b>Indiana University Health Obligated Group (continued)</b>		
Indiana Finance Authority:		
Variable-Rate, Tax-Exempt Hospital Revenue Bonds, Series 2011A, B, C, D, E, H, I, L, and M, Series 2015B and C, and Series 2016B and C, payable in varying principal installments through 2046, with variable interest rates ranging from 1.31% to 2.26% at December 31, 2017	\$ 698,470	\$ 710,220
Variable Rate Commercial Bank Revolving Line of Credit, maturing June 30, 2018	50,000	–
<b>Rehabilitation Hospital of Indiana Obligated Group</b>		
Indiana Finance Authority: Fixed-Rate, Tax-Exempt Hospital Revenue Bonds, Series 2011A, payable in varying principal installments through 2031, with an interest rate of 2.22% at December 31, 2017	13,000	13,695
Variable-Rate, Subordinated Promissory Note, repaid in 2017	–	1,500
<b>Other debt</b>		
Capital lease obligations	3,023	96,320
Other	11,581	14,841
Total long-term debt	<u>1,394,654</u>	<u>1,484,016</u>
Unamortized premium, net of unamortized discount	62,451	69,851
Unamortized bond issuance costs	(5,885)	(6,671)
Less current portion	<u>(100,105)</u>	<u>(144,389)</u>
Long-term debt, less current portion	<u>\$ 1,351,115</u>	<u>\$ 1,402,807</u>

Indiana University Health, Inc. and Subsidiaries

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

**7. Debt (continued)**

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

	<b>Indiana University Health Obligated Group MTI Debt</b>	<b>RHI Obligated Group MTI Debt</b>	<b>Other</b>	<b>Total</b>
Year ending December 31:				
2018	\$ 94,855	\$ 740	\$ 4,510	\$ 100,105
2019	47,360	785	4,258	52,403
2020	50,295	840	3,586	54,721
2021	54,945	890	1,038	56,873
2022	57,530	905	829	59,264
Thereafter	1,062,066	8,840	382	1,071,288
	<u>\$ 1,367,051</u>	<u>\$ 13,000</u>	<u>\$ 14,603</u>	<u>\$ 1,394,654</u>

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

Total interest paid on long-term debt for the years ended December 31, 2017 and 2016, aggregated \$41,820 and \$42,749, respectively. Total interest capitalized during the years ended December 31, 2017 and 2016, amounted to \$624 and \$789, respectively.

Indiana University Health, Inc. and Subsidiaries

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

**8. Derivative Financial Instruments**

Long-term interest rate swap arrangements have been entered into with the primary objective being to mitigate interest rate risk. The following fixed-pay swaps, stated at current notional amounts, remain in place as of December 31, 2017:

<b>Notional Amount</b>	<b>Effective Date</b>	<b>Maturity Date</b>	<b>Rate Received</b>	<b>Rate Paid</b>
\$ 25,525	11/15/2005	2/16/2021	62.30% LIBOR plus 0.24%	3.19%
56,185	6/23/2011	3/1/2036	62.30% LIBOR plus 0.24%	2.68%
65,300	11/15/2005	2/15/2030	62.30% LIBOR plus 0.24%	3.35%
65,600	6/20/2011	2/15/2030	62.30% LIBOR plus 0.24%	3.35%
53,225	6/26/2003	3/1/2033	LIBOR	4.92%
17,733	6/16/2011	3/1/2033	LIBOR	4.92%
70,930	6/16/2011	3/1/2033	LIBOR	4.92%
17,725	6/16/2011	3/1/2033	LIBOR	4.92%
17,725	6/26/2003	3/1/2033	LIBOR	4.92%
			SIFMA	
4,900	1/27/2006	11/2/2020	Municipal Swap Index	3.98%

After giving effect to the above derivative transactions, the Indiana University Health System's variable-rate debt was approximately 24.4% and 19.3% of total debt outstanding as of December 31, 2017 and 2016, respectively.

Indiana University Health, Inc. and Subsidiaries

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

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

In addition, long-term basis swap arrangements were entered into for the purpose of managing the effect of interest rates on cash flows and were in place as of December 31, 2017, as follows:

Notional Amount	Effective Date	Maturity Date	Swap Type	Rate Received	Rate Paid
\$ 140,446	3/10/2021	2/15/2033	Forward starting basis	75.00% three-month LIBOR minus 0.05%	SIFMA
309,200	3/10/2021	1/7/2033	Forward starting basis	75.00% three-month LIBOR minus 0.04%	SIFMA
309,200	1/7/2020	1/7/2033	Forward starting basis	75.0% one-month LIBOR	SIFMA

Guidance on fair value accounting stipulates that a credit valuation adjustment (CVA) should be applied to the mark-to-market valuation position of interest rate swaps to more closely capture the fair value of such instruments. Collateral arrangements reduce the credit exposure and are considered in determining the CVA. As of December 31, 2017, the fair value of interest rate swaps was a liability of \$75,813, which is net of CVA of \$3,536. As of December 31, 2016, the fair value of interest rate swaps was a liability of \$92,240, which is net of CVA of \$7,232. The fair values of the swaps have been included with noncurrent liabilities in the accompanying consolidated balance sheets.

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

	Year Ended December 31	
	2017	2016
Gains on interest rate swaps, net:		
Unrealized gains on interest rate swaps	\$ 16,427	\$ 18,434
Realized losses on interest rate swaps	(10,707)	(15,374)
	<u>\$ 5,720</u>	<u>\$ 3,060</u>

As of December 31, 2017, interest rate swaps had a total notional amount of \$1,153,694, including \$394,848 of fixed-pay swaps and \$758,846 of forward basis swaps. Under agreements executed with counterparties, Indiana University Health is obligated to fund collateral amounts when the

## Indiana University Health, Inc. and Subsidiaries

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

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

aggregate market value of swaps with a given counterparty exceeds a threshold set forth in the related agreement. The aggregate fair value of all derivative instruments, consisting of fixed-pay and basis swaps, with credit risk-related contingent features that are in a liability position on December 31, 2017 and 2016, was \$63,996 and \$81,280, respectively. No collateral was posted as of December 31, 2017 or 2016.

During August 2016, Indiana University Health terminated two identical basis swaps, both with a notional amount of \$250,000 and a maturity date of September 30, 2038, for a one-time cash payment of \$1,375 each, which were recorded as realized losses, after which no payments or other amounts are owed to either party with respect to these swaps.

#### **9. Fair Value Measurements**

The accounting guidance for the application of fair value provides, among other matters, for the following: (i) defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establishes a framework for measuring fair value, (ii) establishes a three-level hierarchy for fair value measurements based upon the observability of inputs to the valuation of an asset or liability as of the measurement date, (iii) requires consideration of nonperformance risk when valuing liabilities, and (iv) expands disclosures about instruments measured at fair value. The three-level hierarchy is based upon the nature of valuation techniques and whether such techniques are based upon observable or unobservable inputs, as defined.

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

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities as of the reporting date. Includes debt issued by U.S. agencies.
- Level 2 – Pricing inputs other than quoted prices included in Level 1 that are either directly observable or that can be derived or supported from observable data as of the reporting date.

## Indiana University Health, Inc. and Subsidiaries

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

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

- Level 3 – Pricing inputs include those that are significant to the fair value of the financial asset or financial liability and are not observable from objective sources. In evaluating the significance of inputs, the Indiana University Health System generally classifies assets or liabilities as Level 3 when their fair value is determined using unobservable inputs that, individually or when aggregated with other unobservable inputs, represent more than 10% of the fair value of the assets or liabilities. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

The following tables set forth by level within the fair value hierarchy the Indiana University Health System's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2017 and 2016. The financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The assessment of the significance of a particular input to the fair value measurement requires judgment, could be subject to change or variation, and may affect the valuation of fair value assets and liabilities and their classification within the fair value hierarchy levels.

Indiana University Health, Inc. and Subsidiaries

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

9. Fair Value Measurements (continued)

	December 31, 2017						Equity Method	Carrying Value
	Level 1	Level 2	Level 3	NAV	Fair Value			
<b>Assets</b>								
Cash and cash equivalents	\$ 414,674	\$ -	\$ -	\$ -	\$ 414,674	\$ -	\$ -	\$ 414,674
Short-term investments:								
Corporate debt	-	5,081	-	-	5,081	-	-	5,081
Assets limited as to use:								
Cash and cash equivalents	130,530	-	-	-	130,530	-	-	130,530
Debt securities:								
Asset backed	-	106,700	900	-	107,600	-	-	107,600
Bank loans	-	224,414	13,828	-	238,242	-	-	238,242
Corporate debt	-	253,852	24	-	253,876	-	-	253,876
Government and agencies	152,561	-	-	-	152,561	-	-	152,561
Bond funds	163,075	-	-	213,073	376,148	-	-	376,148
Equity securities:								
Domestic equities	58,232	-	-	-	58,232	-	-	58,232
Domestic equity funds	215,690	-	-	658,993	874,683	-	-	874,683
International equities	72,751	-	-	-	72,751	-	-	72,751
International equity funds	210,022	-	-	555,585	765,607	-	-	765,607
Commodities	197,906	-	-	-	197,906	-	-	197,906
Alternatives:								
Hedge Funds	-	-	-	-	-	1,422,190	-	1,422,190
Private Funds	-	-	-	-	-	373,178	-	373,178
Beneficial interests in charitable remainder and perpetual trusts	-	10,307	-	-	10,307	-	-	10,307
Total cash and investments	\$ 1,615,441	\$ 600,354	\$ 14,752	\$ 1,427,651	\$ 3,658,198	\$ 1,795,368	\$ -	\$ 5,453,566
<b>Liabilities</b>								
Interest rate swaps	\$ -	\$ 75,813	\$ -	\$ -	\$ 75,813	\$ -	\$ -	\$ 75,813
Total liabilities measured at fair value on a recurring basis	\$ -	\$ 75,813	\$ -	\$ -	\$ 75,813	\$ -	\$ -	\$ 75,813

Indiana University Health, Inc. and Subsidiaries

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

9. Fair Value Measurements (continued)

	December 31, 2016						Equity Method	Carrying Value
	Level 1	Level 2	Level 3	NAV	Fair Value			
<b>Assets</b>								
Cash and cash equivalents	\$ 415,860	\$ –	\$ –	\$ –	\$ 415,860	\$ –	\$ 415,860	
Short-term investments:								
Corporate debt	–	15,343	–	–	15,343	–	15,343	
Government and agencies	159	–	–	–	159	–	159	
Assets limited as to use:								
Cash and cash equivalents	55,071	–	–	–	55,071	–	55,071	
Debt securities:								
Asset backed	–	111,153	–	–	111,153	–	111,153	
Bank loans	–	252,081	13,713	–	265,794	–	265,794	
Corporate debt	–	218,932	24	–	218,956	–	218,956	
Government and agencies	163,453	–	–	–	163,453	–	163,453	
Bond funds	157,974	–	–	157,345	315,319	–	315,319	
Equity securities:								
Domestic equities	68,918	–	–	–	68,918	–	68,918	
Domestic equity funds	191,904	–	–	555,315	747,219	–	747,219	
International equities	75,869	–	–	–	75,869	–	75,869	
International equity funds	149,249	–	–	424,305	573,554	–	573,554	
Commodities	167,494	–	–	–	167,494	–	167,494	
Alternatives:								
Hedge Funds	–	–	–	–	–	1,284,520	1,284,520	
Private Funds	–	–	–	–	–	221,569	221,569	
Beneficial interests in charitable remainder and perpetual trusts	–	9,468	–	–	9,468	–	9,468	
Total cash and investments	\$ 1,445,951	\$ 606,977	\$ 13,737	\$ 1,136,965	\$ 3,203,630	\$ 1,506,089	\$ 4,709,719	
<b>Liabilities</b>								
Interest rate swaps	\$ –	\$ 92,240	\$ –	\$ –	\$ 92,240	\$ –	\$ 92,240	
Total liabilities measured at fair value on a recurring basis	\$ –	\$ 92,240	\$ –	\$ –	\$ 92,240	\$ –	\$ 92,240	

Indiana University Health, Inc. and Subsidiaries

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

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

The fair value of cash and cash equivalents is based on quoted market prices and classified as Level 1. The fair value of Level 1 trading securities is based on quoted market prices from an active exchange or deemed to have similar liquidity characteristics. The fair value of Level 2 trading securities is based on third-party market quotes in an inactive market or similar securities in an active market and other observable inputs. The fair value of Level 3 trading securities is based on historical costs provided by a third-party valuation firm.

The beneficial interests in charitable remainder and perpetual trusts are shown within other assets in the accompanying consolidated balance sheets.

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

Fair value at January 1, 2016	\$ 11,564
Bank loan paydown	(1,109)
Bank loan purchase	4,469
Transfers out	(1,248)
Other	61
Fair value at December 31, 2016	<u>13,737</u>
Bank loan paydown	(2,447)
Bank loan purchase	6,902
Transfers in	341
Transfers out	(3,798)
Other	17
Fair value at December 31, 2017	<u><u>\$ 14,752</u></u>

## Indiana University Health, Inc. and Subsidiaries

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

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

The fair value of interest rate swaps is based upon forward interest rate curves, as adjusted for CVA (see Note 8). The Indiana University Health System engages a third party to assist in valuing the CVA. The third party uses the income approach to present value the cash flows using the relevant rate of return for the corresponding swap contracts. Where observable, this return would be the observed market rate(s) of return associated with the swap counterparty in a liability position. Collateral amounts posted, if any, are also taken into consideration. The CVA depicts the difference in the mark-to-market absent any credit risk, and the fair value of the swap that incorporates the credit risk of the party holding the swap in a liability position at that point in time. For swaps for which Indiana University Health is in a liability position, this credit risk is measured by comparing the mark-to-market value derived using the London Interbank Offered Rate (LIBOR) swap curve to the fair value derived using a published AA-rated Municipal Healthcare curve (or the AA+ rated Municipal General Obligation curve for the swaps insured by Assured Guaranty Municipal Corporation) or comparable market data, adjusted to a taxable basis using the relevant Securities Industry and Financial Markets Association (SIFMA)/LIBOR ratio.

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

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

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

#### 10. Commitments and Contingencies

The Indiana University Health System is from time to time subject to various legal proceedings and claims arising in the ordinary course of business. The Indiana University Health System's management does not expect that the outcome in any of its currently ongoing legal proceedings or

Indiana University Health, Inc. and Subsidiaries

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

**10. Commitments and Contingencies (continued)**

the outcome of any other claims, individually or collectively, will have a material adverse effect on the Indiana University Health System's consolidated financial condition, results of operations, or cash flow.

**Leases**

Buildings and medical and office equipment are leased under noncancelable operating and capital leases. Future minimum lease payments as of December 31, 2017, are as follows:

	<b>Operating Leases</b>	<b>Capital Leases</b>
Year ending December 31:		
2018	\$ 37,894	\$ 1,436
2019	31,160	982
2020	26,449	825
2021	19,746	341
2022	14,727	55
Thereafter	46,359	—
Total minimum lease payments	<u>\$ 176,335</u>	<u>3,639</u>
Less amount representing interest		(616)
Present value of net minimum lease payments		<u>\$ 3,023</u>

Rent and lease expense, included in supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, amounted to \$57,181 and \$55,541 for the years ended December 31, 2017 and 2016, respectively.

**11. Medical Malpractice**

The Indiana University Health System's medical malpractice coverage is provided through the Indiana University Health Risk Retention Group, Inc. (IUHRRG), a 97%-owned subsidiary. The program of medical malpractice coverage considers the per claim limitation of liability prescribed by the Indiana Medical Malpractice Act (the Act), which limits the amount of individual claims to (i) for acts of negligence prior to June 30, 2017, \$1,250 and annual aggregate claims to \$7,500, of

## Indiana University Health, Inc. and Subsidiaries

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

#### **11. Medical Malpractice (continued)**

which up to \$1,000 would be paid by the State of Indiana Patient Compensation Fund (the Fund) and \$250 by the Indiana University Health System for each occurrence of malpractice and (ii) for acts of negligence from July 1, 2017 to June 30, 2019, \$1,650 and annual aggregate claims to \$12,000 of which up to \$1,250 would be paid by the Fund and \$400 by the Indiana University Health System for each occurrence of malpractice. The Act also requires that health care providers meet certain requirements, including making funding payments to the Fund and maintaining certain insurance levels. The Indiana University Health System has met these requirements and is a qualified provider under the Act, retaining risk of \$250 per occurrence and \$7,500 in the annual aggregate for acts of negligence occurring prior to June 30, 2017, and \$400 per occurrence and \$12,000 in the annual aggregate for acts of negligence occurring from July 1, 2017 to June 30, 2019. The Indiana University Health System's medical malpractice program includes coverage offered by IUHRRG and reinsured by Indiana University Health Assurance SPC, Ltd., a wholly owned subsidiary. This reinsurance also serves as excess insurance for general liability, automobile liability, employer's liability, managed care errors and omissions, and professional liability. This coverage is provided on a claims-made basis (aggregating \$70,000 as of July 1, 2014, and \$100,000 prior).

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

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

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

Retirement benefits are provided to substantially all employees of the Indiana University Health System, primarily through defined contribution plans. Contributions, which are included in benefits expense, to the defined contribution plans are based on compensation of qualified employees and amounted to \$108,435 and \$96,619 in 2017 and 2016, respectively (net of forfeitures of \$778 and \$1,708 in 2017 and 2016, respectively).

## Indiana University Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Dollars in Thousands)*

#### **12. Retirement Plans (continued)**

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

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

Pension benefits are based on years of service and compensation of employees (as defined) and are actuarially determined. Where applicable, the funding policy is to annually contribute the amount required to comply with applicable legislation and IRS regulations. Adjustments to pension liabilities to reflect funded status are charged or credited to unrestricted net assets.

Indiana University Health terminated one of the defined benefit pension plans effective December 31, 2016. A lump-sum benefit payout option was offered to participants. The lump-sum offering window closed in November 2017. The remaining assets of the plan were liquidated and annuitized in December 2017. The outstanding net actuarial loss of \$17,933 was recognized as a curtailment loss in 2016 (see Note 4).

During the third quarter of 2016, Indiana University Health offered a lump-sum benefit payout option to participants of three defined benefit pension plans who were terminated and fully vested as of December 31, 2015. The lump-sum offering window closed in November 2016. Additionally, terminated and fully vested participants of one defined benefit pension plan may elect a lump-sum benefit payout. Accordingly, as of December 31, 2016, Indiana University Health recognized \$16,066 of settlement losses, included in salaries, wages, and benefits in the accompanying consolidated statements of operations and changes in net assets, not included in net periodic pension income (cost).

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

Indiana University Health, Inc. and Subsidiaries

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

**12. Retirement Plans (continued)**

	<b>December 31</b>	
	<b>2017</b>	<b>2016</b>
Accumulated benefit obligation	<b>\$ 420,996</b>	<b>\$ 458,186</b>
Changes in benefit obligation of the plans:		
Benefit obligation at beginning of year	<b>\$ 458,186</b>	<b>\$ 498,230</b>
Interest cost	<b>16,000</b>	21,843
Actuarial gain	<b>26,072</b>	10,635
Benefits paid	<b>(47,095)</b>	(72,522)
Annuity premium	<b>(32,167)</b>	—
Benefit obligation at end of year	<b>\$ 420,996</b>	<b>\$ 458,186</b>
Changes in assets of the plans:		
Fair value of assets at beginning of year	<b>\$ 358,064</b>	<b>\$ 398,782</b>
Actual return on assets	<b>41,976</b>	22,221
Employer contributions	<b>90,523</b>	9,583
Assets to revert back to employer	<b>(439)</b>	—
Benefits paid	<b>(47,095)</b>	(72,522)
Annuity premium	<b>(32,167)</b>	—
Fair value of assets at end of year	<b>\$ 410,862</b>	<b>\$ 358,064</b>
Unfunded status at December 31	<b>\$ (10,134)</b>	<b>\$ (100,122)</b>
Included in unrestricted net assets are the following items not yet recognized as a component of net periodic pension cost (income):		
Net actuarial loss	<b>\$ 129,237</b>	<b>\$ 148,268</b>
Acceleration of termination loss	<b>—</b>	<b>(17,933)</b>
	<b>\$ 129,237</b>	<b>\$ 130,335</b>

Indiana University Health, Inc. and Subsidiaries

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

**12. Retirement Plans (continued)**

The following amounts related to plan activity have been recognized a (decrease) increase in unrestricted net assets for the year ended December 31:

	<u>2017</u>	<u>2016</u>
Net actuarial gain (loss)	\$ 3,612	\$ (12,562)
Amortization of net actuarial (loss) gain	(3,592)	3,993
Net periodic pension cost	(1,118)	33,999
	<u>\$ (1,098)</u>	<u>\$ 25,430</u>

	<u>December 31</u>	
	<u>2017</u>	<u>2016</u>
Components of net pension benefit cost (income):		
Interest cost	\$ 16,000	\$ 21,843
Expected return on assets	(18,350)	(24,105)
Amortization of unrecognized net loss	3,592	3,993
(Settlement expense) and termination benefit	(49)	16,066
Net periodic pension cost	<u>\$ 1,193</u>	<u>\$ 17,797</u>

	<u>December 31</u>	
	<u>2017</u>	<u>2016</u>
Weighted average actuarial assumptions to determine benefit cost:		
Discount rate for net periodic pension cost	4.12%	4.49%
Discount rate for benefit obligations	3.67	4.12
Expected rate of return on plan assets	4.00	4.78

Expected future benefit payments:		
2018	\$	25,268
2019		25,529
2020		25,958
2021		26,311
2022		26,623
2023–27		128,678

## Indiana University Health, Inc. and Subsidiaries

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

#### 12. Retirement Plans (continued)

Expected amortization of amounts in unrestricted net assets is expected to increase net periodic pension costs by \$3,592 during the year ending December 31, 2018. There are no required contributions for 2018.

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

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

Asset category	December 31	
	2017	2016
Cash and cash equivalents	1%	1%
Debt securities	88	45
Equity securities	9	34
Alternatives	2	20
	<u>100%</u>	<u>100%</u>

The allocation strategy for the group trust in which the plans participate is currently composed of approximately 10% of growth-oriented investments and 90% of duration-oriented investments. The largest component of these growth-oriented assets is public equity securities that are diversified and invested in U.S. companies.

Indiana University Health, Inc. and Subsidiaries

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

**12. Retirement Plans (continued)**

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

	Level 1	Level 2	Level 3	NAV	Total
<b>December 31, 2017</b>					
<b>Assets</b>					
Cash and cash equivalents	\$ 5,386	\$ —	\$ —	\$ —	\$ 5,386
Debt securities:					
Asset backed	—	602	—	—	602
Bank loans	—	1,191	—	—	1,191
Corporate debt	—	33,883	—	—	33,883
Government and agencies	113,193	—	—	—	113,193
Bond funds	—	—	—	214,125	214,125
Equity securities:					
Domestic equity funds	3,977	—	—	31,496	35,473
Alternatives:					
Hedge funds	—	—	—	7,010	7,010
Total plan assets at fair value	<u>\$ 122,556</u>	<u>\$ 35,676</u>	<u>\$ —</u>	<u>\$ 252,631</u>	<u>\$ 410,863</u>

Indiana University Health, Inc. and Subsidiaries

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

**12. Retirement Plans (continued)**

	Level 1	Level 2	Level 3	NAV	Total
<b>December 31, 2016</b>					
<b>Assets</b>					
Cash and cash equivalents	\$ 3,103	\$ –	\$ –	\$ –	\$ 3,103
Debt securities:					
Asset backed	–	5,492	–	–	5,492
Bank loans	–	1,438	–	–	1,438
Corporate debt	–	29,880	–	–	29,880
Government and agencies	33,357	–	–	–	33,357
Bond funds	–	–	–	92,909	92,909
Equity securities:					
Domestic equity funds	15,885	–	–	47,660	63,545
International equity funds	30,431	–	–	27,117	57,548
Alternatives:					
Hedge funds	–	–	–	70,792	70,792
Total plan assets at fair value	<u>\$ 82,776</u>	<u>\$ 36,810</u>	<u>\$ –</u>	<u>\$ 238,478</u>	<u>\$ 358,064</u>

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

The plans invest in hedged funds for which the net asset value per share represents the fair value of the investment held. Risks and redemption restrictions for these investments are similar to the alternative investments described in Note 5. Management opted to use the NAV per share, or its equivalent, as a practical expedient for the fair value of the plan's interest in hedge funds and commingled funds. Valuations provided by the respective fund's management consider variables, such as the financial performance of underlying investments, recent sales prices of underlying investments, and other pertinent information.

## Indiana University Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Dollars in Thousands)*

#### **13. Endowments**

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

The board of directors of both foundations have interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the foundations classify as permanently restricted net assets the following: (i) the original value of gifts donated to the permanent endowment, (ii) the original value of subsequent gifts to the permanent endowment, and (iii) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the foundations in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the foundations consider the various factors in making a determination to appropriate or accumulate donor-restricted endowment funds, such as the duration and preservation of the fund, the purposes of the foundations and the donor-restricted endowment fund, general economic conditions, the possible effect of inflation and deflation, the expected total return from income and the appreciation of investments, other resources of the organization, and the investment policies of the foundations.

Indiana University Health, Inc. and Subsidiaries

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

**13. Endowments (continued)**

Changes in and composition of donor-restricted endowment net assets for both foundations were as follows:

	<b>Temporarily Restricted</b>	<b>Permanently Restricted</b>	<b>Total</b>
Endowment net assets at January 1, 2016	\$ 11,944	\$ 45,601	\$ 57,545
Contributions	5	373	378
Investment return	3,420	–	3,420
Reclassification	5	–	5
Appropriation of endowment assets for expenditures	(2,014)	–	(2,014)
Endowment net assets at December 31, 2016	13,360	45,974	59,334
Contributions	–	573	573
Investment return	4,548	–	4,548
Reclassification	557	700	1,257
Appropriation of endowment assets for expenditures	(1,628)	–	(1,628)
Endowment net assets at December 31, 2017	<u>\$ 16,837</u>	<u>\$ 47,247</u>	<u>\$ 64,084</u>

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

## Indiana University Health, Inc. and Subsidiaries

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

#### 14. Related-Party Transactions

##### Indiana University School of Medicine

The Consolidation Agreement requires that Indiana University Health fund salaries and related employee benefit costs for medical doctor interns and residents of the School of Medicine who provide services at the Indiana University Health System's facilities. These costs totaled \$43,851 and \$45,458 in 2017 and 2016, respectively, and have been reported with salaries, wages, and benefits expense in the accompanying consolidated statements of operations and changes in net assets.

The Indiana University Health System purchases certain services from the School of Medicine. These expenses, principally for certain physician and staff salaries, medical directors, medical care case management services, utilities, laboratory services, and other services, totaled \$48,335 and \$47,502, net of offsetting funds from the School of Medicine, for the years ended December 31, 2017 and 2016, respectively, and have been reported within salaries, wages, and benefits and supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets.

The Indiana University Health System also provides additional support to the School of Medicine to assist with medical education and research. During 2017 and 2016, Indiana University Health expensed \$56,752 and \$54,550, respectively, within educational and research support to Indiana University and supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets.

Additionally, in 2012, Indiana University Health committed to support ratably for a five-year period ended December 31, 2016, certain basic, clinical, and translational research programs of the School of Medicine. The total commitment aggregated \$75,000. In 2017, a new five-year commitment of \$50,000 was agreed upon effective July 1, 2017 through June 30, 2022. For the years ended December 31, 2017 and 2016, the Indiana University Health System expensed \$5,000 and \$15,000, respectively, under these agreements within supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, of which \$32,875 and \$37,380 was accrued related to these agreements within accounts payable and accrued expenses at December 31, 2017 and 2016, respectively.

## Indiana University Health, Inc. and Subsidiaries

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

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

##### **Other Foundations**

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

The financial statements of these foundations are not included in the consolidated financial statements. The interests in net assets of these other foundations, which totaled \$21,654 and \$13,775 at December 31, 2017 and 2016, respectively, are included with other assets and net assets in the accompanying consolidated balance sheets and principally represent donor-restricted funds.

These foundations also hold other net assets that are subject to the direction of their respective boards of directors. Other changes in the net assets of these foundations are generally reflected within temporarily and permanently restricted net assets.

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

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

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

The Affordable Care Act and its associated legislation are designed, in part, to expand access to coverage to substantively all U.S. citizens through a combination of states' expansion of their

## Indiana University Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

*(Dollars in Thousands)*

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

Medicaid programs and the health insurance marketplace. For Indiana, the CMS approved the Healthy Indiana Plan 2.0, which was Indiana's response to expanding its Medicaid program. The State of Indiana's request for renewal of the Healthy Indiana Plan 2.0 waiver is currently under review by CMS. The program waiver was recently approved by CMS for an additional three years, meaning that the state will continue to engage eligible adults in its signature health program through at least the year 2020. Changes to existing Medicare and Medicaid coverage and payments have also occurred as a result of this legislation. There is uncertainty regarding the future of the Affordable Care Act, but the specific impact of any changes or new legislation on the Indiana University Health System is not determinable at this time.

**About EY**

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit [ey.com](http://ey.com).

© 2018 Ernst & Young LLP.  
All Rights Reserved.

**[ey.com](http://ey.com)**

