



**CHILDREN'S HEALTH CARE**

Consolidated Financial Statements

December 31, 2017 and 2016

(With Independent Auditors' Report Thereon)

## CHILDREN'S HEALTH CARE

### Table of Contents

	<b>Page(s)</b>
Independent Auditors' Report	1-2
Consolidated Financial Statements:	
Statements of Financial Position	3
Statements of Operations and Changes in Net Assets	4-5
Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7-41
<b>Additional Information</b>	
Consolidating Schedule of Statement of Financial Position	42
Consolidating Schedule of Statement of Operations	43
Notes to Consolidating Schedules of Financial Statements Information	44



KPMG LLP  
4200 Wells Fargo Center  
90 South Seventh Street  
Minneapolis, MN 55402

## Independent Auditors' Report

The Board of Directors  
Children's Health Care  
Minneapolis, Minnesota:

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Children's Health Care and its subsidiaries, which comprise the consolidated statements of financial position as of December 31, 2017 and 2016, 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 accordance 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 from material misstatement, whether due to fraud or error.

#### *Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

#### *Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Children's Health Care and its subsidiaries as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



*Other Matter*

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The 2017 supplemental consolidating schedules on pages 42 to 43 are presented for the purpose of additional analysis of the consolidated financial statements and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, such schedules are fairly stated in all material respects in relation to the consolidated financial statements as a whole.

**Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated April 20, 2018 on our consideration of Children's Health Care internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Children's Health Care internal control over financial reporting and compliance.

*KPMG LLP*

Minneapolis, Minnesota  
April 20, 2018

## CHILDREN'S HEALTH CARE

### Consolidated Statements of Financial Position

December 31, 2017 and 2016

(In thousands)

	2017	2016
Current assets:		
Cash and cash equivalents	\$ 24,916	13,077
Short-term investments	9,130	4,458
Short-term investments, board-designated	165	189
Funds held by trustee	3,037	2,990
Patient accounts receivable – less allowance for uncollectible accounts \$9,790 and \$10,330 at 2017 and 2016, respectively	112,983	105,255
Prepaid expenses and other current assets	38,777	38,214
Total current assets	189,008	164,183
Long-term investments	589,620	511,168
Board-designated investments	112,181	103,004
Other assets	77,254	79,566
Land, buildings, and equipment – net	362,339	378,963
Total	\$ 1,330,402	1,236,884
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Current maturities of long-term debt	\$ 8,947	8,602
Accounts payable and accrued expenses	40,903	36,793
Accrued salaries, wages, and benefits	64,527	64,050
Other current liabilities	8,191	15,702
Total current liabilities	122,568	125,147
Fair value of interest rate swaps	25,733	28,728
Other long-term liabilities	42,723	37,427
Long-term debt – excluding current maturities	182,479	191,525
Total liabilities	373,503	382,827
Commitments and contingencies		
Net assets:		
Unrestricted	886,842	784,398
Temporarily restricted	38,123	39,238
Permanently restricted	31,934	30,421
Total net assets	956,899	854,057
Total	\$ 1,330,402	1,236,884

See accompanying notes to consolidated financial statements.

## CHILDREN'S HEALTH CARE

### Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2017 and 2016

(In thousands)

	<b>2017</b>	<b>2016</b>
Revenue:		
Net patient service revenue	\$ 854,790	848,053
Provision for uncollectible accounts	(10,969)	(13,554)
Net patient service revenue less provision for uncollectible accounts	843,821	834,499
Net assets released from restrictions for operations	13,313	11,710
Other	38,229	33,987
Total revenue	895,363	880,196
Expenses:		
Salaries, wages, and employee benefits	509,597	489,997
Professional fees and purchased services	120,951	114,446
Supplies	88,810	89,716
Facilities	17,440	16,590
Depreciation and amortization	46,522	43,443
Financing costs	8,994	9,547
Health services taxes	26,496	25,976
Other	50,580	52,083
Total expenses	869,390	841,798
Operating income	25,973	38,398
Nonoperating gains (losses):		
Investment income and realized gains	56,551	14,238
Income on investments accounted for under the equity method	2,749	3,950
Net unrealized gains on investments	13,257	24,951
Change in fair value of interest rate swaps	2,995	4,087
Other components of net periodic pension cost	(2,471)	(2,238)
Total nonoperating gains	73,081	44,988
Excess of revenue over expenses	99,054	83,386

## CHILDREN'S HEALTH CARE

### Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2017 and 2016

(In thousands)

	<b>2017</b>	<b>2016</b>
Unrestricted net assets:		
Excess of revenue over expenses	\$ 99,054	83,386
Net assets released from restrictions – capital acquisitions	3,848	6,265
RSVP plan-related changes other than net periodic plan expense	(458)	(492)
Inherent contribution related to Children's Health Network	—	3,515
Increase in unrestricted net assets	102,444	92,674
Temporarily restricted net assets:		
Contributions	10,707	11,563
Investment income	4,819	1,736
Net unrealized gains on investments	520	1,619
Net assets released from restrictions – operations	(13,313)	(11,710)
Net assets released from restrictions – capital acquisitions	(3,848)	(6,265)
Decrease in temporarily restricted net assets	(1,115)	(3,057)
Permanently restricted net assets:		
Contributions	934	569
Investment gain (loss)	2	(99)
Net unrealized gains on investments	112	37
Change in value of perpetual trusts held by others	465	52
Increase in permanently restricted net assets	1,513	559
Increase in net assets	102,842	90,176
Net assets – beginning of year	854,057	763,881
Net assets – end of year	\$ 956,899	854,057

See accompanying notes to consolidated financial statements.

**CHILDREN'S HEALTH CARE**  
Consolidated Statements of Cash Flows  
Years ended December 31, 2017 and 2016  
(In thousands)

	<u>2017</u>	<u>2016</u>
Cash flows from operating activities:		
Increase in net assets	\$ 102,842	90,176
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	46,522	43,443
Net unrealized gains on investments	(13,777)	(26,607)
Net realized gains on investments	(50,439)	(6,869)
RSVP plan-related changes other than net periodic plan expense	458	492
Change in fair value of interest rate swaps	(2,995)	(4,087)
Contributions restricted for long-lived purposes	(935)	(1,299)
Income on investments accounted for under the equity method	(2,749)	(3,950)
Provision for uncollectible accounts	10,969	13,554
Other	(932)	(609)
Changes in assets and liabilities:		
Patient accounts receivable	(18,697)	(15,012)
Prepaid expenses and other current assets	(2,331)	2,715
Other assets	1,014	(38,244)
Accounts payable and accrued expenses	(232)	(3,719)
Accrued salaries, wages, and benefits	477	4,739
Other liabilities	(2,487)	13,233
Net cash provided by operating activities	<u>66,708</u>	<u>67,956</u>
Cash flows from investing activities:		
Distributions received from joint ventures	2,736	4,719
Purchase of land, buildings, and equipment	(24,164)	(36,425)
Purchase of investments and funds held by trustee	(507,003)	(535,643)
Proceeds from sale and maturities of investments and funds held by trustee	<u>479,709</u>	<u>501,761</u>
Net cash used in investing activities	<u>(48,722)</u>	<u>(65,588)</u>
Cash flows from financing activities:		
Principal payments on long-term debt	(8,850)	(8,485)
Contributions restricted for long-lived purposes	<u>2,703</u>	<u>2,830</u>
Net cash used in financing activities	<u>(6,147)</u>	<u>(5,655)</u>
Net increase (decrease) in cash and cash equivalents	11,839	(3,287)
Cash and cash equivalents – beginning of year	<u>13,077</u>	<u>16,364</u>
Cash and cash equivalents – end of year	<u>\$ 24,916</u>	<u>13,077</u>
Supplemental cash flow disclosures:		
Cash paid for interest	\$ 4,056	3,652
Noncash gifts of property and equipment, and investments	2,297	1,725
Transfer of Mother Baby Pavilion, LLC assets to equity investment	—	27,119

See accompanying notes to consolidated financial statements.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

### (1) Organization and Summary of Significant Accounting Policies

#### (a) Organization

Children's Health Care (Children's), d/b/a Children's Hospitals and Clinics of Minnesota, is a not-for-profit corporation organized under the laws of the State of Minnesota for the treatment and care of infants, children, and adolescents and the promotion and administration of charitable care, research, and educational activities.

Children's owns and operates two tertiary facilities, Children's – Minneapolis and Children's – St. Paul, that operate under one provider license from the State of Minnesota: two separate and controlled not-for-profit corporations, Children's Health Care Services, Inc., d/b/a Children's – Minnetonka and Children's Health Care Foundation, d/b/a Children's Foundation (the Children's Foundation); and two wholly owned subsidiaries, Children's Health Insurance Network, Ltd. (CHIN), which handles professional liability claims (note 6), and Children's Clinic Network, which owns and operates community-based clinics. Children's is also the sole corporate and nonvoting member of Children's Health Network (CHN), a clinically integrated network created by Children's in 2013 to be a leading advocate for providing the highest quality of care for children and their families. The consolidated financial statements include the accounts of Children's and its subsidiaries. The "Obligated Group" consists of, collectively, Children's – Minneapolis; Children's – St. Paul; and Corporate, plus the subsidiaries, Children's – Minnetonka, Children's Foundation and Children's Clinic Network.

#### (b) Basis of Presentation

The consolidated financial statements are prepared on the accrual basis of accounting.

#### (c) Consolidation

All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements. Investments in entities that Children's does not control, but which Children's has a substantial ownership interest and can exercise significant influence, are accounted for using the equity method. Investments in entities that Children's does not control, does not have a substantial ownership interest, and cannot exercise significant influence are accounted for using the cost method.

#### (d) Related-Party Transactions

As of December 31, 2015, transactions with CHN were considered related party, and CHN was not consolidated into the financial statements of Children's. In February of 2016, the voting structure of CHN's board of directors was changed whereas under generally accepted accounting principles consolidation into Children's financial statements is required. Accordingly, the financial statements of CHN are now consolidated into the financial statements of Children's. The effect of the consolidation resulted in an inherent contribution of \$3,515 in 2016 representing the fair value of the net assets of CHN at the change in control, which is reflected as an addition to net assets in the accompanying consolidated financial statements. CHN is not a member of the Obligated Group.

#### (e) Mother Baby Joint Operating Agreement and Center

Children's has a joint operating agreement with Allina Health System (Allina), a Minnesota nonprofit corporation, to collaborate on certain obstetric, normal newborn, perinatology, and neonatal service lines.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

The joint operating agreement is herein referred to as the "Mother Baby" program and is governed by a joint operating committee with equal membership from Children's and Allina for a 20-year term, with extension provisions, that began on January 1, 2011. Under this collaborative arrangement, there is an equalization payment whereby Children's receives 72% of the cash flows related to these service lines, as defined in the agreement, and Allina receives 28% of the cash flows related to these service lines. Net equalization costs are reported as other operating expenses and were \$16,577 and \$17,421 for the years ended December 31, 2017 and 2016, respectively. The amount due to Allina was \$4,052 and \$4,750 at December 31, 2017 and 2016, respectively, which is included in accounts payable and accrued expenses in the consolidated statements of financial position.

Effective June 18, 2012, as a part of the Mother Baby joint operating agreement with Allina, Children's began operating the Special Care Nursery, a Level II neonatal intensive care unit located within the Abbott Northwestern Hospital facility. As a result of this agreement, 33 licensed bassinets were added to the Children's – Minneapolis facility. The Special Care Nursery was physically relocated to the Mother Baby facility in February 2013.

Children's completed construction and opened, on February 4, 2013, a new jointly owned facility in conjunction with the Mother Baby joint operating agreement with Allina. The facility was constructed on the Children's – Minneapolis campus at an incremental cost of \$49,071, of which Children's contributed \$25,517, in addition to a \$10,000 in-kind contribution for existing ambulatory, parking, and power-plant facilities, and owns 60% of the facility.

Buildings and equipment for the Mother Baby program and the related depreciation expense are accounted for using proportional accounting. Under proportional accounting, Children's records Mother Baby program capital assets that it acquires, recognizes the related depreciation and amortization as a program expense, and then shares in the cash flow impact of the capital expenditures at 72%, as noted above.

Effective July 1, 2016, Children's and Allina entered into an asset contribution agreement in which the parties agreed to transfer their respective tenancy-in-common interests related to the Mother Baby Program Facility, LLC (Pavilion LLC) in exchange for \$1 and the issuance of membership units in the Pavilion LLC. As a result of this transaction, Children's transferred its portion of the Pavilion LLC assets into a joint venture investment, the income/(loss) of which is recorded within income/(loss) on investments accounted for under the equity method on the consolidated statements of operations and changes in net assets. Children's only interest transferred to the joint venture investment was its net fixed assets of \$27,119. As fair value of the interest transferred approximates carrying value, no gain or loss was recognized.

### **(f) Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant estimated amounts in the consolidated financial statements include

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

contractual allowances, allowance for uncollectible accounts and pledges, and valuation of alternative investments.

### **(g) Subsequent Events**

Children's has evaluated all events or transactions that occurred after December 31, 2017 through April 20, 2018, the date the consolidated financial statements were issued. Children's is not aware of any material subsequent events that would require recognition or disclosure in the 2017 consolidated financial statements.

### **(h) Cash and Cash Equivalents**

All short-term investments purchased with a maturity of three months or less and not otherwise classified as noncurrent assets are considered to be cash and cash equivalents and are carried at fair value.

### **(i) Net Patient Service Revenue, Patient Accounts Receivable, and Allowance for Doubtful Accounts**

Children's has agreements with third-party payors that provide for payments to Children's at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, discounted charges, per diem payments, and lump-sum payments related to quality and cost performance.

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services provided, including settlement amounts under reimbursement agreements with third-party payors. Settlements are accrued on an estimated basis in the period the related services are provided and are adjusted in future periods as final settlements are determined.

Patient accounts receivable represent amounts due from federal and state agencies, managed healthcare plans, commercial insurance companies, employers, and patients. Children's grants credit to patients, most of whom are insured under third-party payor agreements, without collateral or any other security to support amounts due. Children's determines an allowance for doubtful accounts by considering a number of factors, including, but not limited to, the length of time accounts receivable are past due, previous loss history, the existence of a third-party payor, reimbursement trends, and other collection indicators. Accounts are written off when all reasonable internal and external collection efforts have been performed and payments subsequently received on such receivables are credited to the allowance. At December 31, 2017 and 2016, the allowance for uncollectible accounts was \$9,790 and \$10,330, respectively. Bad debt write-offs totaled approximately \$11,508 and \$12,740 for the years ended December 31, 2017 and 2016, respectively.

Children's recognizes that revenue and receivables from third-party payors, including governmental agencies, are significant to its operations, but does not believe there are significant credit risks associated with these organizations. In 2017, the top four third-party payors accounted for 30%, 26%, 18%, and 11% of net patient service revenue. In 2016, the top four third-party payors accounted for 28%, 28%, 17%, and 12% of net patient service revenue.

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Patient service revenue, net of contractual allowances and discounts (before the provision for uncollectible accounts) recognized for the years ended December 31, 2017 and 2016, by major payor source, was as follows:

	<u>2017</u>	<u>2016</u>
Government payors	\$ 257,387	235,538
Other third-party payors	552,528	569,455
Self-pay	<u>44,875</u>	<u>43,060</u>
Patient service revenue, net of contractual allowances and discounts	<u>\$ 854,790</u>	<u>848,053</u>

#### **(j) Investments**

Investments are carried at fair value, which generally are based on quoted market price at December 31, 2017 and 2016. Certain investments are valued at net asset value of the underlying fund as a practical expedient to fair value. Funds held by trustee are held under bond indenture agreements for debt service payments. The estimated values as determined by the respective funds' general partner or investment manager may differ significantly from the values that would have been used had ready markets existed. A portion of investments are not intended to be used for current operations and, therefore, is classified as noncurrent assets. Realized gains and losses on sales of securities are recognized using the average cost basis.

Children's classifies its investments as trading securities. Children's invests in various securities, including corporate equities, corporate bonds, municipal bonds, high yield bonds, U.S. government obligations, mortgage and asset-backed securities, limited partnerships, master limited partnerships, foreign investments, foreign currency contracts, mutual funds, exchange-traded futures and options, and swap contracts. Investment securities, in general, are exposed to various market risks, such as interest rate, credit, liquidity, foreign exchange, and price volatility. Because of these possible risks associated with the equity, bond, and currency markets, it is reasonably possible that changes in the values of various investment positions could occur in the near term and that such changes could materially affect the amounts reported in the consolidated financial statements. To monitor the risk of the investment portfolio, Children's has investment policies in place and monitors the performance of all investments on a regular basis.

#### **(k) Pending Investment Settlements Receivable and Payable**

Purchases and sales of securities are reflected on a trade-date basis. A receivable or payable is recorded for the proceeds to be paid or collected as of the settlement date of the purchase or sale of the security.

#### **(l) Land, Buildings, and Equipment**

Land, buildings, and equipment are recorded at cost at the date of purchase or fair market value at the date of donation. Depreciation is provided on a straight-line basis over the estimated useful lives of the related assets, which range from 3 years for certain equipment to 40 years for buildings. Equipment

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

under capital leases are depreciated on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment.

### **(m) *Deferred Financing Costs***

Deferred financing costs are amortized to financing costs over the term of the related bonds using the straight-line method, which approximates the effective-interest method.

### **(n) *MNCare Tax***

Children's pays a state tax of 2% on receipts other than Medicare receipts. Children's recognized \$15,993 and \$15,798 as MNCare tax in health services taxes expense for the years ended December 31, 2017 and 2016, respectively.

### **(o) *Temporarily and Permanently Restricted Net Assets***

Temporarily restricted net assets are those whose use at Children's has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by Children's in perpetuity.

### **(p) *Donor-Restricted Gifts***

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. In the absence of donor specification that income and gains on donated funds are restricted, such income and gains are reported as income of unrestricted net assets. Children's accounts for temporarily restricted donations where the time or purpose restriction has been satisfied during the year as temporarily restricted donations released from restriction.

### **(q) *Community Benefits and Charity Care***

To further its purpose as a charitable organization, Children's provides a wide variety of benefits to the community. These services and donations account for a measurable portion of Children's costs and serve to promote healthy lifestyles, community development, health education, and affordable access to care. Included in these community benefits are the costs of charity care. Children's provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because Children's does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The amount of charges forgone for services provided under Children's charity care policy was \$2,333 and \$2,121 for the years ended December 31, 2017 and 2016, respectively. Total direct and indirect costs related to these forgone charges were \$951 and \$882, respectively, based on an average ratio of cost to gross charges.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

**(r) Other Revenue**

Other revenue primarily includes revenue from cafeterias, parking ramps, medical education, pharmacies, grants, and other miscellaneous sources. Revenue is recognized upon delivery of the service or the product.

**(s) Medicaid Electronic Health Records Incentive Programs (Meaningful Use)**

Under certain provisions of the American Recovery and Reinvestment Act of 2009 (ARRA), federal incentive payments are available to hospitals, physicians, and certain other professionals when they adopt, implement, or upgrade (AIU) certified electronic health record (EHR) technology or become "meaningful users," as defined under ARRA, of EHR technology in ways that demonstrate improved quality, safety, and effectiveness of care. Medicaid providers can receive their initial incentive payment by satisfying AIU criteria but must demonstrate meaningful use of EHR technology in subsequent years in order to qualify for additional payments. Children's recognizes EHR incentive payments when: (1) the specified meaningful use criteria are met, and (2) uncertainties in estimating the amount of the incentive payments to be received are resolved. During 2017 and 2016, Children's recognized \$574 and \$1,233 of EHR incentive payments as other operating revenue in the consolidated statements of operations and changes in net assets, respectively.

**(t) Pledges Receivable**

The Foundation records pledges receivable at the time an unconditional pledge agreement is signed. All pledges receivable are classified as temporarily or permanently restricted based on the intent of the donor and represent pledges to be used primarily for the capital campaign and other program initiatives. Pledges due in more than one year are recorded at net present value of future cash flows, less an allowance for uncollectible pledges. A discount on each pledge is calculated using the risk-free interest rate at the time the pledge was made and for the duration of the pledge.

Pledges receivable at December 31, 2017 and 2016 were as follows:

	2017	2016
Pledges due:		
In less than one year	\$ 6,871	10,264
In one to five years	6,222	5,851
More than five years	4,807	4,799
Total pledges due	17,900	20,914
Less discount	(1,584)	(1,455)
Less allowance for uncollectible pledges	(2,567)	(2,028)
Pledges receivable – net	\$ 13,749	17,431

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

	2017	2016
Classified as:		
Prepaid expenses and other current assets	\$ 5,275	8,563
Other assets	8,474	8,868
Pledges receivable – net	\$ 13,749	17,431

**(u) Concentration of Risk**

At December 31, 2017, Children's had 38.4% of its employee population covered under labor contracts. Of those employees, 23.9% are covered under labor contracts that are set to expire the last day of February 2021 and 76.1% are covered under labor contracts that are set to expire on the last day of May 2019. Work stoppages in the course of contract negotiations are possible, which could lead to the disruption of normal operations. Any resulting disruption could have an adverse impact on operating costs and/or net patient service revenue.

**(v) Excess of Revenue over Expenses**

Children's consolidated results of operations include excess revenue over expenses. Changes in unrestricted net assets that are excluded from excess revenue over expenses, consistent with industry practice, include net assets released from restriction for capital acquisitions, the RSVP plan-related changes other than net periodic plan expense included in excess revenue over expenses primarily include unrestricted investment gains and losses, income and losses from investments accounted for under the equity method, unrealized gains or losses on investments, the change in interest rate swap valuation, and other components of net periodic pension cost.

**(w) Derivative Instruments and Hedging Activities**

From time to time, Children's makes use of certain exchange-traded options and futures contracts to manage its overall equity exposure, which are included in investments and recorded at fair value based on published market prices. Children's also makes use of interest rate swap agreements to hedge interest rate exposure on its variable rate debt. Interest rate swaps are recorded at fair value in the consolidated statements of financial position representing the funds that would be paid or received if the swap agreements were terminated. Changes in the fair values are recorded as a component of nonoperating gains or losses in the consolidated statements of operations and changes in net assets. Fair value is determined based on the use of models that consider various assumptions, including present value of cash flows, yield curve structure, as well as other relevant economic measures, which are inputs that are classified as Level 2 in the valuation hierarchy (note 2). The net interest paid or received on interest rate swaps is recognized as financing costs in the consolidated statements of operations and changes in net assets.

**(x) Recently Issued Accounting Standards**

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Updates (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. In August 2015, the FASB amended the guidance to defer the effective date of this standard by one year. ASU 2014-09 affects any

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principle of the guidance in ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

We have completed our evaluation of the requirements of the new standard to insure that we have processes, systems and internal controls in place to collect the necessary information to implement the standard, which became effective for us on January 1, 2018, and we are drafting the new disclosures required post implementation. We used a modified retrospective method of application to adopt ASU 2014-09 on January 1, 2018. For our hospital operations and other and ambulatory care segments, we used a portfolio approach to apply the new model to classes of payers with similar characteristics and analyzed cash collection trends over an appropriate collection look-back period depending on the payer. Adoption of ASU 2014-09 will result in changes to our presentation for and disclosure of revenue related to uninsured or underinsured patients.

Prior to the adoption of ASU 2014-09, a significant portion of our provision for doubtful accounts related to self-pay patients, as well as co-pays and deductibles owed to us by patients with insurance in our hospital operations and other segment. Under ASU 2014-09, the estimated uncollectible amounts due from these patients are generally considered a direct reduction to net operating revenues and, correspondingly, result in a material reduction in the amounts presented separately as provision for doubtful accounts. We also completed our assessment of the impact of the new standard on various reimbursement programs that represent variable consideration and concluded that accounting for these programs under the new standard is substantially consistent with our historical accounting practices. These include supplemental state Medicaid programs, disproportionate share payments and settlements with third party payors. The payment mechanisms for these types of programs vary by state. While the adoption of ASU 2014-09 will have a material effect on the presentation of net operating revenues in our consolidated statements of operations and changes in net assets and will impact certain disclosures, it will not materially impact our financial position, results of operations or cash flows. There was no cumulative effect of a change in accounting principle recorded related to the adoption of ASU 2014-09 on January 1, 2018.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. ASU 2016-02 will expand qualitative and quantitative disclosure requirements around leasing transactions while also requiring lessees to recognize most leases on-balance sheet. The provisions of ASU 2016-02 are effective for annual periods beginning after December 31, 2018. Children's is currently evaluating the impact on its consolidated financial statements from the adoption of this guidance.

In August 2016, the FASB issued ASU 2016-14, *Not-for Profit Entities (Topic 958)*, to change the way a not-for-profit entity (NFP) classifies and presents net assets on the face of the financial statements and to present information in the financial statements and notes about the NFP's liquidity, financial performance and cash flows. The amendment changes the way an NFP reports classes of net assets, from the currently required three classes to two, by eliminating the distinction between resources with permanent restrictions and those with temporary restrictions. The amendment also requires the NFP to provide enhanced disclosure about the nature, amounts and effects of the various types of donor-

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

imposed restrictions, the NFP's management of its liquidity to meet short-term demands for cash, and the types of resources used and how they are allocated to carrying out the NFP's activities. The standard is effective for Children's beginning January 1, 2018. Children's does not expect the standard to have a material effect on the consolidated financial statements other than the additional disclosure required by the standard.

### **(y) Recently Adopted Accounting Standards**

In March of 2017, the FASB issued ASU No. 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. ASU 2017-07 provides guidance on the presentation of the various components of net periodic pension and postretirement benefit cost (net benefit cost). The service cost component will be presented with other employee compensation costs in operating income on the statement of operations. All other components of net benefit cost will be reported separately outside of operating income. The provisions of ASU 2017-07 are effective for annual periods beginning after December 15, 2018. However, as early adoption is permitted, Children's chose to adopt the new guidance in 2017. The adoption of the new guidance did not have a material impact on the consolidated financial statements. As the adoption of ASU 2017-07 requires retrospective application, \$2,238 in other components of net periodic pension cost were reclassified from salaries, wages, and employee benefits expense into nonoperating gains (losses) within the consolidated statements of operations and changes in net assets.

### **(z) Reclassifications**

Certain 2016 amounts have been reclassified to conform to 2017 presentation.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

### (2) Financial Instruments, Risk Management Activities, and Fair Value

#### (a) Investments

The market value of Children's marketable debt, equity securities, and other investible securities at December 31, 2017 and 2016 is shown below:

	2017	2016
Fixed income securities	\$ 165,195	158,617
Corporate equities	119,831	142,933
Synthetic equity strategy	—	16,851
Global investments	117,856	120,236
Investments measured at net asset value	266,354	178,703
Pending purchases	40,000	—
Perpetual trusts held by others	4,473	4,008
Interest and dividends receivable	424	461
Total	\$ 714,133	621,809
Investments are reported as:		
Short-term investments	\$ 9,130	4,458
Short-term investments, board-designated	165	189
Funds held by trustee	3,037	2,990
Long-term investments	589,620	511,168
Board-designated investments	112,181	103,004
Total	\$ 714,133	621,809

Classification of marketable securities as current or noncurrent is dependent on their availability for current operations. Availability for current operations is determined by management intention, investment maturity date, and liquidity.

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

As of December 31, 2017 and 2016, the following schedule summarizes the investment gains (losses) and its classification in the consolidated statements of operations and changes in net assets:

	<b>2017</b>	<b>2016</b>
Investment earnings in unrestricted net assets:		
Interest and dividend income	\$ 15,587	12,519
Net realized gains on investments	40,995	1,647
Net unrealized gains on investments	13,257	24,951
Total	69,839	39,117
Investment earnings in temporarily restricted net assets:		
Interest and dividend income	1,170	1,154
Net realized gains on investments	3,649	582
Net unrealized gains on investments	520	1,619
Total	5,339	3,355
Total investment gains	\$ 75,178	42,472
Reported within:		
Other operating revenue	\$ 31	(72)
Investment income and realized gains	56,551	14,238
Net unrealized gains on investments	13,257	24,951
Changes in temporarily restricted net assets	5,339	3,355
Total investment gains	\$ 75,178	42,472

Children's periodically has investment strategies that use derivative instruments like swaps, swaptions, futures and options contracts which are within its investment policies. These derivative positions are not designated as hedges for accounting purposes. The changes in fair market value of these instruments are recorded as investments gains (losses) in the consolidated statements of operations and changes in net assets. Children's did not hold long derivative positions but did hold short derivative positions valued at \$366 as of December 31, 2017. These contracts are set to expire in March of 2018 and were held at fair value as of December 31, 2017. Children's did not hold long derivative positions but did hold short derivative positions valued at \$(39) as of December 31, 2016. These contracts were liquidated or expired in 2017.

**(b) Risk Management**

Children's is exposed to interest rate risk with its variable rate debt structure. To manage these risks, Children's has entered into certain fixed payor swap agreements that hedge a portion of its variable interest rate risk. Generally, under these swaps, Children's agrees with a counterparty to exchange the difference between fixed-rate and floating-rate interest amounts based on notional principal amounts. Swap valuations are derived from the London InterBank Offered Rate (LIBOR) swap curve and fluctuate with directional or yield curve changes in that market.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

### (c) Interest Rate Swaps

Children's has entered into four fixed payor interest rate swap agreements with Piper Jaffrey Financial Products Inc., which hedge the variable interest rate exposure associated with certain of its variable rate debt.

Children's records changes in the fair values of the interest rate swaps as a component of nonoperating gains (losses) in the consolidated statements of operations and changes in net assets. Children's has elected to not apply hedge accounting to these swap agreements. The fair values of the interest rate swaps are included on the face of the consolidated statements of financial positions and were a liability of \$25,733 and \$28,728 as of December 31, 2017 and 2016, respectively. This liability would have to be paid if the swap agreements were terminated. Swap payments are guaranteed through contracts with Assured Guarantee Municipal Corp.; therefore, there are currently no collateral posting requirements. The change in fair value of the interest rate swaps was \$2,995 and \$4,087 for the years ended December 31, 2017 and 2016, respectively. Children's recognized \$4,132 and \$4,950 as interest costs in financing costs expense related to these swap agreements during the years ended December 31, 2017 and 2016, respectively.

The notional amounts and interest rates of the interest rate swaps at December 31, 2017 and 2016 are as follows:

Swap agreement	Fair value	Change in fair value	Current notional amount	Rate paid	Rate received
As of December 31, 2017:					
2004A	\$ (3,918)	466	18,575	4.127%	0.792%
2004B	(2,809)	921	24,950	4.266	0.792
2007A1	(9,501)	804	45,600	3.518	0.758
2007A2	(9,505)	804	45,600	3.518	0.758
	<u>\$ (25,733)</u>	<u>2,995</u>	<u>134,725</u>		
As of December 31, 2016:					
2004A	\$ (4,384)	675	19,325	4.127%	0.328%
2004B	(3,730)	997	27,500	4.266	0.328
2007A1	(10,305)	1,208	46,625	3.518	0.314
2007A2	(10,309)	1,207	46,625	3.518	0.314
	<u>\$ (28,728)</u>	<u>4,087</u>	<u>140,075</u>		

Children's has credit risk in the event of nonperformance by the counterparty in the interest rate swap agreements.

### (d) Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, patient accounts receivable, accounts payable, and other accrued expenses approximate fair value due to their short-term nature. Marketable securities are

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

carried at fair value. All other assets and liabilities that qualify as financial instruments under GAAP are carried at contractual amounts, which generally approximate fair value.

Children's values its financial assets and liabilities in accordance with the accounting guidance that establishes a three-tier fair value hierarchy. Level 1 provides the most reliable measure of fair value, while Level 3 generally requires significant management judgment. Considerable judgment may be required in interpreting market data used to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value. Three levels are defined as follows:

*Level 1* – Inputs represent unadjusted quoted prices for identical assets or liabilities exchanged in active markets.

*Level 2* – Inputs include directly or indirectly observable inputs other than Level 1 inputs, such as quoted prices for similar assets or liabilities exchanged in active or inactive markets; quoted prices for identical assets or liabilities exchanged in inactive markets; or other inputs that are considered in fair value determinations of assets or liabilities.

*Level 3* – Inputs include unobservable inputs used in the measurement of assets and liabilities. Management is required to use its own assumptions regarding unobservable inputs because there is little, if any, market activity in the assets or liabilities or related observable inputs that can be corroborated at the measurement date.

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Financial assets and liabilities measured at fair value on a recurring basis at December 31, 2017 and 2016 are summarized in the following tables by type of inputs applicable to the fair value measurements:

	Fair value			Total
	Level 1	Level 2	Level 3	
As of December 31, 2017:				
Investments:				
Fixed-income securities:				
Money market and short-term bond funds	\$ 62,858	—	—	62,858
U.S. gov't and U.S. gov't agencies obligations	—	998	—	998
Municipal bond fund	19	—	—	19
Closed-end bond funds	—	57,907	—	57,907
Mortgage-backed securities	—	6	—	6
Investment grade corporate bonds	34,227	9,180	—	43,407
Total fixed-income securities	97,104	68,091	—	165,195
Corporate equities:				
Large cap	39,552	—	60	39,612
Closed-end equity funds	59,944	—	—	59,944
Equity futures options	366	—	—	366
Master limited partnerships	19,909	—	—	19,909
Total corporate equities	119,771	—	60	119,831
Global investments:				
Global bonds	\$ —	9,638	—	9,638
Global equities	108,218	—	—	108,218
Total global investments	108,218	9,638	—	117,856
Total investments measured at net asset value*				266,354
Pending purchases	40,000	—	—	40,000
Perpetual trusts held by others	—	4,473	—	4,473
Interest and dividends receivable	424	—	—	424
Total investments	\$ 365,517	82,202	60	714,133
Fair value of interest rate swaps liability	\$ —	25,733	—	25,733

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

	Fair value			Total
	Level 1	Level 2	Level 3	
As of December 31, 2016:				
Investments:				
Fixed-income securities:				
Money market and short-term bond funds	\$ 23,479	—	—	23,479
U.S. gov't and U.S. gov't agencies obligations	—	996	—	996
Municipal bond fund	13	—	—	13
Closed-end bond funds	—	57,542	—	57,542
Mortgage-backed securities	—	9	—	9
Investment grade corporate bonds	68,456	8,122	—	76,578
Total fixed-income securities	91,948	66,669	—	158,617
Corporate equities:				
Large cap	31,764	—	60	31,824
Mid cap	25,121	—	—	25,121
Small cap	44,136	—	—	44,136
Closed-end equity funds	17,605	—	—	17,605
Master limited partnerships	24,247	—	—	24,247
Total corporate equities	142,873	—	60	142,933
Synthetic equity strategy:				
Large-cap corp equities	8,505	—	—	8,505
U.S. gov't agencies	—	8,263	—	8,263
Money market and short-term bond funds	122	—	—	122
Swap/options/futures contracts	—	(39)	—	(39)
Total synthetic equity strategy	8,627	8,224	—	16,851
Global investments:				
Global bonds	\$ 7,143	—	—	7,143
Global equities	113,093	—	—	113,093
Total global investments	120,236	—	—	120,236
Total investments measured at net asset value*				178,703
Perpetual trusts held by others	—	4,008	—	4,008
Interest and dividends receivable	461	—	—	461
Total investments	\$ 364,145	78,901	60	621,809
Fair value of interest rate swaps liability	\$ —	28,728	—	28,728

\*Investments are measured at net asset value and included only for reconciliation purposes.

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Level 2 and Level 3 valuation methodologies are listed below.

For certain investments, Children's utilizes net asset value as a practical expedient to fair value. Below is a summary of investments accounted for at net asset value as of December 31, 2017:

	<u>Net asset value</u>	<u>Redemption frequency</u>	<u>Redemption notice</u>	<u>Unfunded commitments</u>
Commingled funds (a)	\$ 44,515	Monthly	10 Days	N/A
Global fixed income commingled fund (a)	95,021	Daily	10 Days	N/A
Limited partnerships (b)	108,927	None	None	97,519
Multi-strategy hedge fund (c)	1,595	Quarterly	Quarter in advance	—
Targeted strategy hedge fund (d)	16,296	None	None	8,821
	<u>\$ 266,354</u>			

- (a) Commingled fund investments – this category includes investments in portfolios that may not be sold to investors other than "accredited investors" within the meaning of Regulation D under the Securities Act of 1933 (Securities Act), unless sold pursuant to another available exemption from the Securities Act. The price of these funds' shares is based on the portfolio's net asset value. The net asset value is determined by dividing the total value of the portfolio's investments and other assets, less any liabilities, by the total number of shares outstanding. For purposes of calculating net asset value, portfolio securities and other assets for which market quotes are readily available are valued at market value. Market value is generally determined on the basis of official closing prices or the last reported sales prices, or if no sales are reported, based on quotes obtained from quotation reporting systems, established market makers, or pricing services.
- (b) Limited partnership investments – this category includes investments in private market funds, generally through limited partnerships, that invest in private companies, private debt, intellectual property, structured products, and special situations. The fair value of these investments has been estimated using the percentage share of ownership interest in partner's capital. Distributions from each fund are received when the underlying investments in the funds create distributable cash flow and when underlying investments are liquidated. These investments cannot be redeemed. It is estimated that the underlying assets of these funds will be liquidated over the next 1 to 15 years
- (c) Multi-strategy hedge fund – this category includes investments in the U.S. and global markets through a hedge fund structure.
- (d) Targeted strategy hedge fund – this category is a fund that executes a specific strategy within one sector of the U.S. markets.

Children's made no level transfers during 2017 or 2016.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

### (3) Land, Buildings, and Equipment

Land, buildings, and equipment at December 31, 2017 and 2016 consisted of the following:

	2017	2016
Land	\$ 15,936	15,936
Buildings and building improvements	476,377	474,118
Furniture, fixtures, and equipment	297,745	286,403
Construction in progress	8,314	3,253
Land, buildings, and equipment – gross	798,372	779,710
Less accumulated depreciation	(436,033)	(400,747)
Land, buildings, and equipment – net	\$ 362,339	378,963

The construction in progress at December 31, 2017 and 2016 relates to various equipment that has been received but not yet put into service and a large system implementation.

There was no interest capitalized on construction for the years ended December 31, 2017 and 2016.

Depreciation expense for the years ended December 31, 2017 and 2016 was \$45,211 and \$41,900, respectively.

### (4) Long-Term Debt

Long-term debt at December 31, 2017 and 2016 consisted of the following:

	2017	2016
Health Care Revenue Bonds, Series 1995B (remarketed), remaining fixed interest rate range from 4.0% to 5.0%, due in installments through August 15, 2025	\$ 12,700	14,000
Health Care Revenue Bonds, Series 2004A, interest rate at a variable rate, due through August 15, 2034 (average of 0.770% for 2017; 0.364% for 2016)	18,575	19,325
Health Care Revenue Bonds, Series 2004A-1 (remarketed), remaining fixed interest rate range from 3.0% to 5.0%, due in installments through August 15, 2034	17,500	18,300
Health Care Revenue Bonds, Series 2004B, interest rate at a variable rate, due through August 15, 2025 (average of 0.762% for 2017; 0.339% for 2016)	24,950	27,500

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

	2017	2016
Health Care Revenue Bonds, Series 2007A, interest rate at a variable rate, due through August 15, 2037 (average of 0.770% for 2017; 0.364% for 2016)	\$ 91,200	93,250
Health Care Revenue Bonds, Series 2010A, remaining fixed interest rate range from 4.0% to 5.25%, due in installments through August 15, 2035	29,310	30,710
Total long-term debt	194,235	203,085
Less:		
Unamortized bond premiums and discounts	(316)	(316)
Unamortized bond issuance costs	(2,493)	(2,642)
Current maturities	(8,947)	(8,602)
Long-term portion	\$ 182,479	191,525

Children's continues to retain the ability to convert the interest rate mode on the Series 2004A, Series 2004B, and Series 2007A bonds, subject to certain conditions, to bonds bearing interest at auction rates, fixed rates, or flexible rates.

All the bonds were issued through the conduit organizations of the City of Minneapolis, Minnesota and the Housing and Redevelopment Authority of the City of Saint Paul, Minnesota on behalf of the Obligated Group, pursuant to the Master Trust Indenture. The bonds are secured by a security interest in the unrestricted receivables of the Obligated Group, as defined under the Master Trust Indenture. All bonds, except for the 2010A bonds, are insured by Assured Guaranty Municipal Corp., a division of Assured Guaranty Ltd., which is currently rated AA with a stable outlook by Standard & Poor's and A2 with a stable outlook by Moody's Investors Service.

The Obligated Group must meet certain financial covenants required by the bond insurer and is limited in the amount of additional variable-rate indebtedness that can be incurred under Supplemental Indenture No. 7, dated March 1, 2010, to the Master Trust Indenture. The financial covenants include debt service coverage ratios, liquidity ratios, and capitalization ratios. The Obligated Group was in compliance with all covenants at December 31, 2017. All of the bonds are subject to optional redemption features by Children's, in whole or in part, at redemption price equal to 100% of the principal, plus accrued interest during various times as described in their respective Bond Trust Indentures.

Currently, interest rates are set daily on all variable-rate demand bond series by remarketing agents. Holders of the bonds have the option to tender the bonds for repurchase. The remarketing agent has agreed to remarket the bonds tendered for purchase upon the conditions in the manner and at the times specified in the indentures related to such bond series. Children's has a series of Standby Bond Purchase Agreements with U.S. Bank National Association, establishing an aggregate liquidity facility in the amount of \$142,032 to provide liquidity in the event tendered variable rate bonds cannot be remarketed. Bonds that are not remarketed for a continuous six-month period would be subject to the term out provisions under the Standby

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Bond Purchase Agreements upon their expiration, where bonds would be repaid over a 60-month term. U.S. Bank National Association's short-term deposit rating is A-1+ by Standard & Poor's and P-1 by Moody's Investors Service. These liquidity facilities presented expire on June 30, 2019 and can be renewed annually in June for additional two-year periods.

Under the Master Trust Indenture and related agreements for each bond series, the Obligated Group maintains with a trustee a bond interest fund and a bond principal fund, the aggregated balances of which as of December 31, 2017 and 2016, were as follows:

	<b>2017</b>	<b>2016</b>
Bond interest fund	\$ 1,105	1,127
Bond principal fund	1,932	1,863
Funds held by trustee	\$ 3,037	2,990

The funds are available to meet debt service.

Aggregate annual maturities of long-term debt for each of the five years as of December 31, 2017 and thereafter, are as follows:

Year ending December 31:		
2018	\$	9,195
2019		9,545
2020		9,905
2021		10,310
2022		10,720
Thereafter		144,560
Total	\$	194,235

#### **(5) Temporarily and Permanently Restricted Net Assets**

Temporarily restricted net assets at December 31, 2017 and 2016 are available for the following purposes:

	<b>2017</b>	<b>2016</b>
Department uses	\$ 22,298	21,809
Purchases of buildings and equipment	5,124	8,894
Health education and research	8,035	7,063
Community service	2,666	1,472
Total	\$ 38,123	39,238

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Net assets released from restrictions used for operations are included in other unrestricted revenue in the consolidated statements of operations and changes in net assets. Net assets as of December 31, 2017 and 2016 were released from donor restrictions by incurring expenses or by making capital expenditures satisfying the restricted purposes of the following:

	<u>2017</u>	<u>2016</u>
Department uses	\$ 10,637	8,460
Purchases of buildings and equipment	4,087	6,265
Health education and research	1,216	1,794
Community service	<u>1,221</u>	<u>1,456</u>
Total	<u>\$ 17,161</u>	<u>17,975</u>

Permanently restricted net assets represent investments to be held in perpetuity, a portion of the investment income from which is to be expended as directed by donors to support healthcare services, and the remainder of which is held as temporarily restricted until released per the spending policy.

Children's endowment consists of 114 individual funds established by donors for a variety of purposes. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

Included in permanently restricted net assets are two perpetual trusts in the aggregate amounts of \$4,473 and \$4,008 at December 31, 2017 and 2016, respectively. Children's has the irrevocable right to receive the income on these trust assets, subject to certain limitations. The unrealized gains or losses and the undistributed earnings on the trusts are reported as changes to the permanently restricted net asset balance.

#### **(a) Interpretation of Relevant Law**

Children's has interpreted Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation 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, Children's classifies as permanently restricted net assets: (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

assets until those amounts are appropriated for expenditure by Children's in a manner consistent with donor intent and the standard of prudence prescribed by UPMIFA.

	<b>Unrestricted Board Designated</b>	<b>Unrestricted</b>	<b>Temporarily restricted</b>	<b>Permanently restricted</b>	<b>Total</b>
For the year ended					
December 31, 2017:					
Endowment net assets – beginning of year	\$ 103,192	—	11,152	30,421	144,765
Net assets released from restrictions	—	1,894	(1,894)	—	—
Investment returns:					
Investment gains	12,090	—	4,819	2	16,911
Net unrealized gains	1,759	—	520	112	2,391
Change in value of perpetual trusts held by others	—	—	—	465	465
Total investment returns	13,849	—	5,339	579	19,767
Contributions	—	—	—	934	934
Appropriations of endowment assets for expenditure	(4,860)	(1,894)	—	—	(6,754)
Endowment net assets – end of year	\$ <u>112,181</u>	<u>—</u>	<u>14,597</u>	<u>31,934</u>	<u>158,712</u>

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

	<u>Unrestricted Board Designated</u>	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
For the year ended					
December 31, 2016:					
Endowment net assets – beginning of year	\$ —	—	9,237	29,862	39,099
Investments designated by the Board	100,000	—	—	—	100,000
Net assets released from restrictions	—	1,440	(1,440)	—	—
Investment returns:					
Investment gains (losses)	1,878	—	1,736	(99)	3,515
Net unrealized gains	1,314	—	1,619	37	2,970
Change in value of perpetual trusts held by others	—	—	—	52	52
Total investment returns	3,192	—	3,355	(10)	6,537
Contributions	—	—	—	569	569
Appropriations of endowment assets for expenditure	—	(1,440)	—	—	(1,440)
Endowment net assets – end of year	<u>\$ 103,192</u>	<u>—</u>	<u>11,152</u>	<u>30,421</u>	<u>144,765</u>

#### **(b) Funds with Deficiencies**

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or accounting guidance requires Children's to retain as a fund of perpetual duration. Deficiencies of this nature are funded by unrestricted net assets until the fair value of the assets returns to the required perpetual level. There were no deficiencies as of December 31, 2017.

#### **(c) Return Objectives and Risk Parameters**

Children's has adopted investment and spending policies for endowment assets that attempt to provide a stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the organization must hold in perpetuity or for a donor-specified period, as well as board-designated funds. In the current investment environment, Children's expects its endowment funds to provide an annualized rate of return greater than its spending rate. Actual returns in any given year may vary from this amount. In 2017 and 2016, the spending rate was 4% for both donor-restricted and board designated funds.

#### **(d) Strategies Employed for Achieving Objectives**

To satisfy its rate-of-return objectives, Children's relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current income (interest and dividends).

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

### **(e) *Spending Policy and how the Investment Objectives Relate to Spending Policy***

Children's has a policy of appropriating the spending rate times the fund's 3 year average balance in accordance with donor intent and restrictions. The endowment corpus is to be maintained in perpetuity. Certain donor-restricted endowments require a portion of annual earnings to be maintained in perpetuity along with the corpus.

### **(6) Insurance**

Children's has a wholly owned subsidiary, CHIN, which handles professional liability claims. CHIN is domiciled in the Cayman Islands. CHIN is funded through Children's operations. Premiums paid to the captive for the professional liability coverage during 2017 and 2016 were \$3,970 and \$2,129, respectively. CHIN insures Children's for hospital professional liability for \$1,000 for each claim and \$3,000 in the annual aggregate. In addition, Children's has purchased excess professional liability insurance for claims above the respective limits from commercial carriers in the amount of \$35 million.

The consolidated financial statements of Children's include the investments held for professional liability claims, claims payments, and estimated professional liability reserves. The liability for losses and loss adjustment expenses (undiscounted) of \$3,655 and \$2,640 at December 31, 2017 and 2016, respectively, includes an amount determined from loss reports and individual cases and an amount, based on past experience and an actuarial report, for further development of reported losses. These estimates are continually reviewed and are subject to the impact of future changes in such factors as claim severity and frequency. Although management has made its best estimate of the liability for losses and loss adjustment expenses using the available information, ultimate settlement could vary significantly from such liability. Any adjustments to recorded liabilities will be reflected in the periods in which they become known.

Children's is self-insured for medical, dental, and workers' compensation claims and has recorded a liability for the estimated cost of claims incurred in accounts payable and accrued liabilities in the consolidated statements of financial position. CHIN insures Children's for medical liability for individual claims between \$250,000 and \$800,000. Children's has purchased excess medical liability insurance for individual claims in excess of \$800,000.

### **(7) Employee Benefit Plans**

Children's has noncontract and various union-sponsored pension or retirement plans covering substantially all employees.

#### **(a) *Pension Plan***

The Children's Health Care RSVP Retirement Plan provides benefits to eligible noncontract employees based on final average salary and accumulated pension credits which are based on years of service.

Contributions to the plan are made in accordance with funding principles as recommended by Children's actuaries and in accordance with Employee Retirement Income Security Act of 1974 requirements, as amended by the Pension Protection Act of 2006. Assets of the plan at year end are invested primarily in U.S. government debt securities, corporate debt instruments, and mutual funds. Children's uses a December 31 measurement date for its benefit plans.

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

The plan was amended effective December 31, 2012 to freeze benefits for plan participants. During 2012, no new employees were eligible to join the plan and all current employees enrolled in the plan continued to earn benefits. These plan changes eliminated future benefit accruals as designed under the plan after the effective date, which met the criteria for a curtailment as defined by authoritative accounting guidance. In conjunction with the curtailment, beginning January 1, 2013, participants receive an annual earnings credit at the lesser of 4% or the average U.S. Treasury 30-year interest rate in the month of November prior to the plan's year-end with a minimum crediting rate of 2.75%, which has resulted in an increase to the accumulated benefit obligation.

Total plan settlements for the year ended December 31, 2017 were \$5,676, which exceeded the aggregate of the plan's service and interest costs requiring the application of settlement accounting. Under settlement accounting, Children's recognized a loss of \$1,017 for the year ended December 31, 2017.

The information for the defined-benefit pension plan as of and for the years ended December 31, 2017 and 2016 is as follows:

	2017	2016
Change in benefit obligation:		
Obligation – beginning of year	\$ 94,332	92,899
Interest cost	3,542	3,797
Plan settlements	(5,676)	(3,871)
Actuarial loss	2,614	1,919
Benefit payments	(490)	(412)
Obligation – end of year	\$ 94,322	94,332
Change in plan assets:		
Fair value of plan assets – beginning of year	\$ 80,604	81,902
Employer contributions	2,200	—
Plan settlements	(5,676)	(3,871)
Benefit payments	(490)	(412)
Actual return on plan assets	3,226	2,985
Fair value of plan assets – end of year	79,864	80,604

**CHILDREN'S HEALTH CARE**

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

	<u>2017</u>	<u>2016</u>
Net amount recognized:		
Current portion (included in accrued salaries, wages, and benefits)	\$ —	(2,000)
Long-term portion (included in other long-term liabilities)	<u>(14,458)</u>	<u>(11,728)</u>
Funded status – end of year	<u>(14,458)</u>	<u>(13,728)</u>
Accumulated benefit obligation	\$ <u>94,322</u>	<u>94,332</u>

Components of net periodic benefit cost for the plan for 2017 and 2016 are as follows:

	<u>2017</u>	<u>2016</u>
Interest cost	\$ 3,542	3,797
Expected return on plan assets	(2,262)	(2,337)
Settlement loss	1,017	642
Amortization of loss	<u>174</u>	<u>136</u>
Net periodic pension cost	\$ <u>2,471</u>	<u>2,238</u>

Components of RSVP plan-related changes other than net periodic plan expense for 2017 and 2016 are as follows:

	<u>2017</u>	<u>2016</u>
Net loss	\$ (1,649)	(1,277)
Amortization of loss	<u>1,191</u>	<u>785</u>
Total	\$ <u>(458)</u>	<u>(492)</u>

Amount recognized in unrestricted net assets but not yet recognized as a component of net periodic benefit cost for the plan at December 31, 2017 and 2016 is as follows:

	<u>2017</u>	<u>2016</u>
Accumulation of loss	\$ (16,110)	(15,652)

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Weighted average assumptions used to determine the benefit obligations and net periodic benefit costs at December 31, 2017 and 2016 are as follows:

	<b>2017</b>	<b>2016</b>
Discount rate – benefit obligation	3.55 %	4.00 %
Discount rate – net periodic benefit cost	4.00	4.30
Rate of compensation increase	N/A	N/A
Expected return on plan assets	3.00	3.00

Children's pension plan asset allocation at December 31, 2017 and 2016 by asset category is as follows:

	<b>Plan assets</b>	
	<b>2017</b>	<b>2016</b>
Cash and cash equivalents	12 %	1 %
Synthetic equity strategy investments	15	22
Fixed income investments	45	55
Mutual funds	28	22
Total	100 %	100 %

The pension plan's target asset allocation is approximately 100% fixed income.

Children's pension plan investments measured at fair value on a recurring basis at December 31, 2017 and 2016 are summarized in the following tables by type of inputs applicable to the fair value measurements:

	<b>Fair value</b>		
	<b>Level 1</b>	<b>Level 2</b>	<b>Total</b>
As of December 31, 2017:			
Cash, cash equivalents, and accrued interest	\$ 9,880	—	9,880
Synthetic equity strategy investments:			
Cash and cash equivalents	332	—	332
U.S. government agency and municipal issues	—	857	857



## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

	Fair value		
	Level 1	Level 2	Total
Asset-backed securities	\$ —	8,625	8,625
Investment grade securities	—	200	200
Collateralized mortgage obligations	—	2,611	2,611
Total synthetic equity strategy investments	5,672	12,143	17,815
Fixed income investments:			
Investment grade	—	22,482	22,482
High yield	—	24	24
Closed end funds	15,623	—	15,623
U.S. government agency and municipal issues	—	3,928	3,928
Asset-backed securities	—	862	862
Collateralized mortgage obligations	—	1,599	1,599
Total fixed income investments	15,623	28,895	44,518
Mutual funds:			
Fixed-income funds	17,348	—	17,348
Total mutual funds	17,348	—	17,348
Total pension plan investments	39,566	41,038	80,604

See note 2 for discussion over the fair value hierarchy, fair value inputs, and valuation methodologies used at December 31, 2017 and 2016.

Children's made no transfers between levels during 2017 and 2016.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Benefits expected to be paid through the defined-benefit pension plan, by year, as of December 31, 2017 are as follows:

2018	\$	9,539
2019		8,073
2020		6,990
2021		7,644
2022		6,616
Subsequent five years		29,305

Children's expects to make a contribution of \$262 during 2018. The estimated net actuarial gain for the plan that will be amortized from unrestricted net assets into net periodic benefit cost during 2018 is \$204 and there is no prior-service cost as a result of the curtailment noted above.

The long-term rate of return on assets reflected in the 2017 expense was 3%. The rate is determined based on Children's asset allocation during 2017 of 20% equities and 80% fixed income and an actuarial model that analyzes historical returns and projects a range of future annual returns. Annually, management reviews the actual long-term rate of return on assets and compares this return with the actuarial model of expected returns and adjusts accordingly.

### **(b) Multiemployer Plans**

Children's contributes to various union-sponsored multiemployer pension plans under the terms of collective bargaining agreements. These contributions are determined in accordance with the provisions of negotiated labor contracts and generally are based on salary and the number of hours worked. The risks of participating in these multiemployer plans are different from single-employer plans in the following aspects:

- a. Assets contributed to the multiemployer plan by one employer may be used to provide benefits to employees of other participating employers.
- b. If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers.
- c. If Children's chooses to stop participating in some of its multiemployer plans, Children's may be required to pay those plans an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

Children's participation in these plans for the year ended December 31, 2017 is outlined in the table below. The "EIN/Pension Plan Number" column provides the Employee Identification Number (EIN) and the three-digit plan number. The zone status is based on information that Children's received from the plan and is certified by the plan's actuary. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are less than 80% funded, and plans in the green zone are at least 80% funded. The "FIP/RP Status Pending/Implemented" column indicates plans for which a financial improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented.

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

The last column lists the expiration date of the collective bargaining agreement to which the plans are subject. There have been no significant changes that affect the comparability of 2017 and 2016 contributions.

Pension fund	EIN/ Pension plan number	Pension protection act zone status (a)		FIP/RP status pending/ implemented	Contributions of Children's		Surcharge imposed	Expiration date of collective- bargaining agreement
		January 1,			Plan year ended			
		2017	2016		2017	2016		
Twin City Hospitals – Minnesota Nurses Association Pension Plan	41-6184922/001	Green	Green	Implemented	\$ 13,020	12,340	No	5/31/2019
Other funds	—	—	—	—	620	602	—	—
Total contributions					\$ 13,640	12,942		

(a) The plan's funding level on January 1, 2017 is determined based on the actual December 31, 2016 asset values and projected liabilities as of January 1, 2017 that are a rollforward of liabilities from the previous valuation date of January 1, 2016, assuming no actuarial gains/losses occur during the period.

In January 2018, Children's contributed \$13,985 to the Twin City Hospitals – Minnesota Nurses Association Pension Plan, which is Children's proportionate share of the minimum 2018 contribution requirement according to the collective bargaining agreement. Children's does not expect to make further contributions during 2018.

Children's was listed in the Twin City Hospitals Minnesota Nurses Association Pension Plan Form 5500 as providing more than 5% of the total contributions for the plan years ended December 31, 2017 and 2016. At the date the consolidated financial statements were issued, Form 5500 was not available for the plan year ended in 2017.

#### (c) **Postretirement Healthcare Plan**

Children's extends health insurance coverage to nurses covered by the Minnesota Nurses Association labor contract who elect to retire and begin receiving pension benefits at age 55 or older. The postretirement healthcare benefit plans are unfunded. The accumulated postretirement benefit obligation

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

and the amounts recognized in the consolidated financial statements as of and for the years ended December 31, 2017 and 2016 are as follows:

	2017	2016
Change in benefit obligations:		
Obligation – beginning of year	\$ 3,469	3,296
Service cost	134	127
Interest cost	135	134
Net loss	245	84
Benefit payments	(173)	(172)
Obligation included in other long-term liabilities – end of year	\$ 3,810	3,469

For the 2017 postretirement benefit obligation, certain actuarial assumptions were changed from 2016, including the discount rate, healthcare trend rate, mortality assumptions, and termination rates. Children's recognizes these gains and losses in the year the assumptions are changed.

The discount rate used in determining the accrued postretirement liability was 3.5% for 2017 and 3.9% for 2016. For measurement purposes, a 7.0% annual rate increase in the cost of covered healthcare benefits was assumed for 2017; the rate was assumed to decrease by 0.5% per year for four years beginning in 2019, reaching 5.0% in 2022 and thereafter. Healthcare cost trend rates would affect the accrued postretirement obligation and the sum of service cost and interest cost as follows:

	1% Increase	1% Decrease
Accrued postretirement benefit liability	\$ 466	(397)
Sum of service cost and interest cost	46	(38)

#### **(d) Defined-Contribution Plan**

Children's has a defined-contribution plan covering substantially all employees. In conjunction with the RSVP plan amendment effective December 31, 2012 to freeze benefits for plan participants (curtailment impact discussed above), Children's enhanced the defined-contribution plan. Prior to January 1, 2013, Children's matched 50% of contributions made up to 6% of total salaries. Effective January 1, 2013, Children's matches 100% of contributions made up to 6% of total salaries. Also effective January 1, 2013, employees have a five-year vesting period to receive the employer match, vesting an additive 20% per year of employment. The vesting requirement was waived for all employees hired before January 1, 2012. The amount expensed to the consolidated statements of operations and changes in net assets was \$14,332 and \$13,073 for the years ended December 31, 2017 and 2016, respectively.

Effective January 1, 2015, the defined-contribution plan incorporated an annual auto-enrollment feature of at least a 4% contribution for noncontract employees not currently participating and for noncontract

## CHILDREN'S HEALTH CARE

### Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

employees actively participating below the 4% contribution level. Additionally, on each automatic enrollment date going forward, participant contributions will be automatically increased by 1% up to 6%.

#### (e) *Deferred Compensation Plans*

Children's also maintains other nonqualified deferred compensation plans to provide supplemental retirement benefits for executive management and employed physicians. As of December 31, 2017, there were 11 executives and 147 employed physicians active in the plan. The liability for these plans at December 31, 2017 and 2016 was \$7,311 and \$7,413, respectively, of which \$4,904 and \$5,048 were included in other long-term liabilities and \$2,407 and \$2,365 were included in accrued salaries, wages, and benefits in the consolidated statements of financial position.

#### (8) **Functional Expenses**

Children's provides general healthcare services to residents primarily within its geographic location. Expenses related to providing these services included in the consolidated statements of operations and changes in net assets for the years ended December 31, 2017 and 2016 are as follows:

	<u>2017</u>	<u>2016</u>
Healthcare services	\$ 749,041	720,717
General and administrative	<u>120,349</u>	<u>121,081</u>
Total expenses	<u>\$ 869,390</u>	<u>841,798</u>

#### (9) **Income Taxes**

The IRS has determined that Children's and its subsidiaries, except for CHN, which is a taxable nonprofit corporation under the Minnesota Nonprofit Corporations Act, are exempt organizations as described in Section 501(c)(3) of the Internal Revenue Code. For those tax exempt organizations, Children's believes that it continues to meet the requirements of the IRC to sustain its tax-exempt status. In accordance with Accounting Standards Codification Subtopic 740-10, *Income Taxes – Overall*, Children's recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. Management determined there were no material income tax positions for the years ended December 31, 2017 and 2016. Children's is not subject to an income tax examination for years before 2014.

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

### (10) Other Assets

Other assets for the years ended December 31, 2017 and 2016 consist of the following:

	<b>2017</b>	<b>2016</b>
Investments in unconsolidated joint ventures	\$ 46,223	46,695
Deferred compensation	7,311	7,637
Foundation long-term pledges receivable – restricted	8,474	8,868
Other	15,246	16,366
Total other assets	\$ 77,254	79,566

Children's uses the equity method of accounting for joint ventures or investments in which Children's has determined that it has significant influence. The following table represents Children's investment in and share of net earnings of unconsolidated entities recorded under the equity method of accounting as of and for the years ended December 31:

	<b>Percentage ownership</b>	<b>Equity investment</b>		<b>Share of net earnings (loss)</b>	
		<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
HealthEast Woodwinds Hospital Diagnostic Treatment Center	20 %	9,028	9,050	3,703	4,196
Critical Care Services, Inc. (d/b/a Life Link III)	11	3,628	3,299	329	309
Health System Cooperative Laundries	6	783	775	25	88
Mother Baby Pavilion, LLC	50	25,284	26,571	(1,286)	(643)
Other	Various	500	—	(22)	—
		39,223	39,695	2,749	3,950

Children's received \$2,736 and \$4,719 in distributions from joint ventures for the years ended December 31, 2017 and 2016, respectively.

The following table represents summarized financial information for unconsolidated entities recorded under the equity method of accounting as of and for the years ended December 31:

	<b>2017</b>	<b>2016</b>
Total assets	\$ 118,785	115,348
Total liabilities	24,579	21,002
Total net assets	94,206	94,346
Total revenue	167,467	160,915
Total operating expenses	147,544	136,817
Excess of revenues over expenses	19,923	24,098

## CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2017 and 2016

(In thousands)

Investments accounted for under the cost method were \$7,000 at December 31, 2017 and 2016 and are recorded as investments in unconsolidated joint ventures in other assets.

### (11) Commitments and Contingencies

#### (a) Litigation

Children's is a defendant in legal proceedings arising in the ordinary course of business. Although the outcome of these proceedings cannot presently be determined, in the opinion of management, disposition of these proceedings will not have a material adverse effect on the consolidated financial statements of Children's.

#### (b) Compliance with Laws and Regulations

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations can be subject to government review and interpretations, as well as regulatory actions unknown and unasserted at this time. Government activity continues to focus on possible violations of regulations by healthcare providers, which could result in the imposition of significant fines and penalties, as well as significant repayments of previously billed and collected revenue. Management believes that Children's compliance procedures lead to substantial compliance with current laws and regulations.

#### (c) Letter of Credit

Children's is required by the Minnesota Department of Commerce to maintain a standby letter of credit for the purposes of funding the workers' compensation liabilities, which total \$3,646. As of December 31, 2017, Children's has a letter of credit in the amount \$4,493 to meet this requirement.

### (12) Other Long-Term Liabilities

Other long-term liabilities for the years ended December 31, 2017 and 2016 consist of the following:

	<u>2017</u>	<u>2016</u>
RSVP retirement plan	\$ 14,458	11,728
Other benefit plans	8,792	8,536
Self insured reserves	5,378	4,551
Deferred revenue	12,771	10,823
Other	<u>1,324</u>	<u>1,789</u>
Total other long-term liabilities	<u>\$ 42,723</u>	<u>37,427</u>

**CHILDREN'S HEALTH CARE**

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

(In thousands)

**(13) Accounts Receivable by Payor**

Children's grants credit without collateral to its patients, most of whom are insured under third-party payor agreements. The mix of receivables from patients and third-party payors, net of contractual allowances at December 31, 2017 and 2016 was as follows:

	<u>2017</u>	<u>2016</u>
Government payors	33 %	34 %
Other third-party payors	55	52
Patients	<u>12</u>	<u>14</u>
	<u>100 %</u>	<u>100 %</u>

**(14) Leases**

Children's leases certain space and equipment under noncancelable operating leases with varying terms. The space leases also require a payment of an allocated share of common operating costs. Total rent expense for the years ended December 31, 2017 and 2016 included in facilities expenses, including allocated common costs, was approximately \$14,026 and \$12,925, respectively. Children's subleases portions of its medical office facilities. Total sublease rental income included in other revenue was \$2,398 and \$3,061 for the years ended December 31, 2017 and 2016, respectively.

Future minimum lease payments, excluding an allocated share of common operating costs and pro rata operating costs under terms of leases, by year and in the aggregate under noncancelable operating leases with initial or remaining terms of one year or more are due as follows:

	<b>Future minimum lease payments</b>	
	<u>As lessee</u>	<u>As lessor</u>
2018	\$ 7,001	1,511
2019	7,012	1,339
2020	6,683	1,260
2021	6,727	1,241
2022	6,812	1,044
Thereafter	<u>37,727</u>	<u>1,618</u>
	<u>\$ 71,962</u>	<u>8,013</u>

## **ADDITIONAL INFORMATION**

**CHILDREN'S HEALTH CARE**

Consolidating Schedule of Statement of Financial Position

December 31, 2017

(In thousands)

<b>Assets</b>	<b>Obligated group total</b>	<b>Children's Health Insurance Network, Ltd</b>	<b>Children's Health Network</b>	<b>Eliminating entries</b>	<b>Consolidated total</b>
<b>Current assets:</b>					
Cash and cash equivalents	\$ 22,788	2,128	—	—	24,916
Short-term investments	9,130	—	—	—	9,130
Short-term investments, board-designated	165	—	—	—	165
Funds held by trustee	3,037	—	—	—	3,037
Patient accounts receivable – net	112,983	—	—	—	112,983
Prepaid expenses and other current assets	43,141	—	251	(4,615)	38,777
<b>Total current assets</b>	<b>191,244</b>	<b>2,128</b>	<b>251</b>	<b>(4,615)</b>	<b>189,008</b>
Long-term investments	580,440	9,180	—	—	589,620
Board-designated investments	112,181	—	—	—	112,181
Other assets	77,504	—	—	(250)	77,254
Land, buildings, and equipment – net	362,336	—	3	—	362,339
<b>Total</b>	<b>\$ 1,323,705</b>	<b>11,308</b>	<b>254</b>	<b>(4,865)</b>	<b>1,330,402</b>
<b>Liabilities and Net Assets</b>					
<b>Current liabilities:</b>					
Current maturities of long-term debt	\$ 8,947	—	—	—	8,947
Accounts payable and accrued expenses	40,901	4,567	50	(4,615)	40,903
Accrued salaries, wages, and benefits	64,527	—	—	—	64,527
Other current liabilities	7,655	536	—	—	8,191
<b>Total current liabilities</b>	<b>122,030</b>	<b>5,103</b>	<b>50</b>	<b>(4,615)</b>	<b>122,568</b>
Intercompany accounts	2,554	—	(2,554)	—	—
Fair value of interest rate swaps	25,733	—	—	—	25,733
Other long-term liabilities	39,603	3,120	—	—	42,723
Long-term debt – excluding current maturities	182,479	—	—	—	182,479
<b>Total liabilities</b>	<b>372,399</b>	<b>8,223</b>	<b>(2,504)</b>	<b>(4,615)</b>	<b>373,503</b>
<b>Net assets:</b>					
Unrestricted	881,249	3,085	2,758	(250)	886,842
Temporarily restricted	38,123	—	—	—	38,123
Permanently restricted	31,934	—	—	—	31,934
<b>Total net assets</b>	<b>951,306</b>	<b>3,085</b>	<b>2,758</b>	<b>(250)</b>	<b>956,899</b>
<b>Total</b>	<b>\$ 1,323,705</b>	<b>11,308</b>	<b>254</b>	<b>(4,865)</b>	<b>1,330,402</b>

See notes to consolidating schedules of financial statements information.

**CHILDREN'S HEALTH CARE**

Consolidating Schedule of Statement of Operations

Year ended December 31, 2017

(In thousands)

	<u>Obligated group total</u>	<u>Children's Health Insurance Network, Ltd</u>	<u>Children's Health Network</u>	<u>Eliminating entries</u>	<u>Consolidated total</u>
Revenue:					
Net patient service revenue	\$ 854,390	—	—	400	854,790
Provision for uncollectible accounts	(10,969)	—	—	—	(10,969)
Net patient service revenue less provision for uncollectible accounts	843,421	—	—	400	843,821
Net assets released from restrictions for operations	13,313	—	—	—	13,313
Other	36,150	3,970	4,620	(6,511)	38,229
Total revenue	<u>892,884</u>	<u>3,970</u>	<u>4,620</u>	<u>(6,111)</u>	<u>895,363</u>
Expenses:					
Salaries, wages, and employee benefits	505,613	—	3,984	—	509,597
Professional fees and purchased services	122,577	93	139	(1,858)	120,951
Supplies	88,783	—	27	—	88,810
Facilities	17,209	—	231	—	17,440
Depreciation and amortization	46,513	—	9	—	46,522
Financing costs	9,015	—	—	(21)	8,994
Health services taxes	26,475	—	21	—	26,496
Other	50,523	3,966	344	(4,253)	50,580
Total expenses	<u>866,708</u>	<u>4,059</u>	<u>4,755</u>	<u>(6,132)</u>	<u>869,390</u>
Operating income (losses)	<u>26,176</u>	<u>(89)</u>	<u>(135)</u>	<u>21</u>	<u>25,973</u>
Nonoperating gains (losses):					
Investment income and realized gains	56,551	—	21	(21)	56,551
Income on investments accounted for under the equity method	2,749	—	—	—	2,749
Net unrealized gains on investments	12,199	1,058	—	—	13,257
Change in fair value of interest rate swaps	2,995	—	—	—	2,995
Other components of net periodic pension cost	(2,471)	—	—	—	(2,471)
Total nonoperating (losses) gains	<u>72,023</u>	<u>1,058</u>	<u>21</u>	<u>(21)</u>	<u>73,081</u>
Excess (deficiency) of revenue over expenses	98,199	969	(114)	—	99,054
Other changes in unrestricted net assets:					
Net assets released from restrictions – capital acquisitions	3,848	—	—	—	3,848
RSVP plan-related changes other than net periodic plan expense	(458)	—	—	—	(458)
Net asset transfer between affiliates	—	—	—	—	—
Increase in unrestricted net assets	\$ <u>101,589</u>	<u>969</u>	<u>(114)</u>	<u>—</u>	<u>102,444</u>

See notes to consolidating schedules of financial statements information.

## CHILDREN'S HEALTH CARE

Notes to Consolidating Schedules of Financial Statements Information

December 31, 2017

### **(1) Obligated Group**

Children's Health Care (Children's) master indenture provides for the creation of a group of entities (Obligated Group), the members of which are jointly and severally obligated for the payment of debt services on all obligations issued thereunder. The Obligated Group currently consists of Children's; Children's Clinic Network, a Minnesota nonprofit corporation that is a wholly controlled affiliate; Children's Health Care Services, Inc., a Minnesota nonprofit corporation that is a wholly controlled affiliate; and Children's Health Care Foundation, d/b/a Children's Foundation, a wholly controlled affiliate that performs fund-raising functions and endowment management. Children's Health Insurance Network, Ltd., a Cayman Island domiciled insurance entity, is a wholly controlled affiliate of Children's and is not currently a member of the Obligated Group. Children's is also the sole corporate and nonvoting member of Children's Health Network (CHN), a clinically integrated network created by Children's in 2013 to be a leading advocate for providing the highest quality of care for children and their families. CHN is not currently a member of the Obligated Group.

### **(2) Basis of Reporting**

The consolidating schedule of statement of financial position and the consolidating schedule of statement of operations are presented for additional analysis of the sources and uses of funds within the consolidated amounts. All intercompany balances and transactions have been eliminated for consolidation purposes.