



CHILDREN'S HEALTH CARE
Consolidated Financial Statements
December 31, 2018 and 2017
(With Independent Auditors' Report Thereon)

CHILDREN'S HEALTH CARE

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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, 2018 and 2017, 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. 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 consolidated financial position of Children's Health Care and its subsidiaries as of December 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Emphasis of Matter

As discussed in note 1(h) to the consolidated financial statements, Children's Health Care adopted new accounting guidance for ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and ASU 2016-16, *Presentation of Financial Statements of Not-for-Profit Entities*. Our opinion is not modified with respect to these matters.

Other Matter

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The 2018 supplemental consolidating schedules on pages 45 to 46 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.

KPMG LLP

Minneapolis, Minnesota

April 19, 2019

CHILDREN'S HEALTH CARE

Consolidated Statements of Financial Position

December 31, 2018 and 2017

(In thousands)

Assets	2018	2017
Current assets:		
Cash and cash equivalents	\$ 12,834	24,916
Short-term investments	23,043	9,130
Short-term investments, board-designated	78	165
Funds held by trustee	3,083	3,037
Patient accounts receivable, less allowance for uncollectible accounts of \$9,790 at December 31, 2017	166,286	112,983
Prepaid expenses and other current assets	39,242	38,777
Total current assets	244,566	189,008
Long-term investments	597,560	589,620
Board-designated investments	107,953	112,181
Other assets	75,669	77,254
Land, buildings, and equipment – net	342,531	362,339
Total	\$ 1,368,279	1,330,402
Liabilities and Net Assets		
Current liabilities:		
Current maturities of long-term debt	\$ 9,297	8,947
Accounts payable and accrued expenses	40,942	40,903
Accrued salaries, wages, and benefits	68,364	64,527
Other current liabilities	12,091	8,191
Total current liabilities	130,694	122,568
Fair value of interest rate swaps	20,748	25,733
Other long-term liabilities	27,332	42,723
Long-term debt – excluding current maturities	173,083	182,479
Total liabilities	351,857	373,503
Net assets:		
Net assets without donor restrictions	944,912	886,842
Net assets with donor restrictions	71,510	70,057
Total net assets	1,016,422	956,899
Total	\$ 1,368,279	1,330,402

See accompanying notes to consolidated financial statements.

CHILDREN'S HEALTH CARE

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2018 and 2017

(In thousands)

	2018	2017
Revenue:		
Net patient service revenue	\$ 900,261	854,790
Provision for uncollectible accounts	—	(10,969)
Net patient service revenue less provision for uncollectible accounts	900,261	843,821
Net assets released from restrictions for operations	10,033	13,313
Other	39,438	38,229
Total revenue	949,732	895,363
Expenses:		
Salaries, wages, and employee benefits	527,715	509,597
Professional fees and purchased services	120,944	120,951
Supplies	100,625	88,810
Facilities	17,196	17,440
Depreciation and amortization	44,969	46,522
Financing costs	8,360	8,994
Health services taxes	28,012	26,496
Other	50,478	50,580
Total expenses	898,299	869,390
Operating income	51,433	25,973
Nonoperating gains (losses):		
Investment income and realized gains	33,416	56,551
Income on investments accounted for under the equity method	3,431	2,749
Net unrealized (losses) gains on investments	(33,406)	13,257
Change in fair value of interest rate swaps	4,985	2,995
Other components of net periodic pension cost	(13,473)	(2,471)
Total nonoperating (losses) gains	(5,047)	73,081
Excess of revenue over expenses	46,386	99,054

CHILDREN'S HEALTH CARE

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2018 and 2017

(In thousands)

	2018	2017
Net assets without donor restrictions:		
Excess of revenue over expenses	\$ 46,386	99,054
Net assets released from restrictions – capital acquisitions	1,136	3,848
RSVP plan-related changes other than net periodic plan expense	10,548	(458)
Increase in net assets without donor restrictions	58,070	102,444
Net assets with donor restrictions:		
Contributions	13,298	11,641
Investment income	2,353	4,821
Net unrealized (losses) gains on investments	(2,382)	632
Net assets released from restrictions – operations	(10,033)	(13,313)
Net assets released from restrictions – capital acquisitions	(1,136)	(3,848)
Change in value of perpetual trusts held by others	(647)	465
Increase in net assets with donor restrictions	1,453	398
Increase in net assets	59,523	102,842
Net assets – beginning of year	956,899	854,057
Net assets – end of year	\$ 1,016,422	956,899

See accompanying notes to consolidated financial statements.

CHILDREN'S HEALTH CARE

Consolidated Statements of Cash Flows

Years ended December 31, 2018 and 2017

(In thousands)

	2018	2017
Cash flows from operating activities:		
Increase in net assets	\$ 59,523	102,842
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	44,969	46,522
Net unrealized losses (gains) on investments	35,789	(13,889)
Net realized gains on investments	(10,592)	(50,442)
RSVP plan-related changes other than net periodic plan expense	(10,548)	458
Change in fair value of interest rate swaps	(4,985)	(2,995)
Contributions restricted for long-lived purposes	(140)	(935)
Income on investments accounted for under the equity method	(3,431)	(2,749)
Provision for uncollectible accounts	—	10,969
Other	(3,270)	(817)
Changes in assets and liabilities:		
Patient accounts receivable	(53,303)	(18,697)
Prepaid expenses and other current assets	(1,418)	(2,331)
Other assets	168	1,014
Accounts payable and accrued expenses	2,405	(232)
Accrued salaries, wages, and benefits	3,837	477
Other liabilities	(857)	(2,487)
Net cash provided by operating activities	58,147	66,708
Cash flows from investing activities:		
Distributions received from joint ventures	3,838	2,736
Purchase of land, buildings, and equipment	(22,638)	(24,164)
Purchase of investments and funds held by trustee	(437,350)	(507,003)
Proceeds from sale and maturities of investments and funds held by trustee	394,023	479,709
Net cash used in investing activities	(62,127)	(48,722)
Cash flows from financing activities:		
Principal payments on long-term debt	(9,195)	(8,850)
Contributions restricted for long-lived purposes	1,093	2,703
Net cash used in financing activities	(8,102)	(6,147)
Net (decrease) increase in cash and cash equivalents	(12,082)	11,839
Cash and cash equivalents – beginning of year	24,916	13,077
Cash and cash equivalents – end of year	\$ 12,834	24,916
Supplemental cash flow disclosures:		
Cash paid for interest	\$ 4,653	4,056
Noncash gifts of property and equipment, and investments	673	2,297

See accompanying notes to consolidated financial statements.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(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) 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. 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 \$17,242 and \$16,577 for the years ended December 31, 2018 and 2017, respectively. The amount due to Allina was \$5,430 and \$4,052 at December 31, 2018 and 2017, respectively, which is included in accounts payable and accrued expenses in the consolidated statements of financial position.

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(In thousands)

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.

(e) 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 contractual allowances, allowance for uncollectible accounts receivable and pledges, and valuation of alternative investments.

(f) Subsequent Events

Children's has evaluated all events or transactions that occurred after December 31, 2018 through April 19, 2019, 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 2018 consolidated financial statements.

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Notes to Consolidated Financial Statements

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(In thousands)

(g) 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.

(h) Recently Adopted Accounting Standards

In May of 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. In August of 2015, the FASB amended the guidance to defer the effective date of this standard by one year. ASU 2014-09 affects any 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.

Effective January 1, 2018, Children's adopted ASU 2014-09 using a modified retrospective method of application to all contracts existing on January 1, 2018. For Children's hospital operations and ambulatory care segments, the adoption of ASU 2014-09 resulted in changes to our presentation for and disclosure of revenue primarily related to uninsured or underinsured patients. Prior to the adoption of ASU 2014-09, a significant portion of our provision for uncollectible accounts related to self-pay patients, as well as co-pays, co-insurance amounts and deductibles owed to us by patients with insurance. Under ASU 2014-09, the estimated uncollectible amounts due from these patients are generally considered implicit price concessions that are a direct reduction to net patient service revenue, with a corresponding reduction in the amounts presented separately as provision for uncollectible accounts. For the year ended December 31, 2018, Children's recorded approximately \$23,574 of implicit price concessions as a direct reduction of net patient service revenue that would have been recorded as provision for uncollectible accounts prior to the adoption of ASU 2014-09.

In August 2016, the FASB issued ASU No. 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-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 was effective for Children's beginning January 1, 2018. As a result of adopting this standard, 2017 temporarily restricted net assets of \$38,123 and permanently restricted net assets of \$31,934 have been combined for presentation in 2018 as net assets with donor restrictions. The adoption of the new standard did not have a material effect on the consolidated financial statements other than the additional disclosure required by the standard.

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(In thousands)

(i) **Net Patient Service Revenue**

Net patient service revenue is reported at the amount that reflects the consideration to which Children's expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payers (including health insurers and government programs), and others and includes variable consideration for retroactive revenue adjustments due to settlement of audits, reviews, and investigations. Generally, Children's bills the patients and third-party payers several days after the services are performed and/or the patient is discharged from the facility. Revenue is recognized as performance obligations are satisfied.

Performance obligations are determined based on the nature of the services provided by Children's. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred in relation to total expected (or actual) charges. Children's believes that this method provides a faithful depiction of the transfer of services over the term of the performance obligation based on the inputs needed to satisfy the obligation. Generally, performance obligations satisfied over time relate to patients in Children's hospitals receiving inpatient acute care services. Children's measures the performance obligation from admission into the hospital to the point when it is no longer required to provide services to that patient, which is generally at the time of discharge. Revenue for performance obligations satisfied at a point in time is recognized when goods or services are provided and Children's does not believe it is required to provide additional goods or services to the patient. Because all of its performance obligations relate to contracts with a duration of less than one year, Children's has elected to apply the optional exemption provided in FASB ASC 606-10-50-14(a) and, therefore, is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The unsatisfied or partially unsatisfied performance obligations referred to above are primarily related to inpatient acute care services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period.

As provided for under the guidance, Children's does not adjust the promised amount of consideration from patients and third-party payers for the effects of a significant financing component due to the expectation that the period between the time the service is provided to a patient and the time that the patient or a third-party payor pays for that service will be one year or less.

Children's 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 payor. Children's also completed an initial 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 Children's historical accounting practices.

Children's determines the transaction price based on standard charges for goods and services provided, reduced by contractual adjustments provided to third-party payers, discounts provided to uninsured patients in accordance with Children's policies, and/or implicit price concessions provided to uninsured patients. Children's determines its estimates of contractual adjustments and discounts based on contractual agreements, its discount policies, and historical experience. Children's determines its

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(In thousands)

estimate of implicit price concessions based on its historical collection experience with this class of patients.

Agreements with third-party payers typically provide for payments at amounts less than established charges. A summary of the payment arrangements with major third-party payers follows:

- Government payers: Reimbursement for government payers is generally paid based upon established fee schedules. Outpatient services are paid using prospectively determined rates.
- Other third-party payers, including commercial: Payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations provide for payment using prospectively determined rates per discharge, discounts with established charges, and prospectively determined daily rates.

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 2018, the top four third-party payors accounted for 29%, 23%, 20%, and 13% of net patient service revenue. In 2017, the top four third-party payors accounted for 30%, 26%, 18%, and 11% of net patient service revenue.

Net patient service revenue recognized for the years ended December 31, 2018 and 2017, by major payor source, was as follows:

	2018		2017	
	Inpatient	Outpatient	Inpatient	Outpatient
Government payors	\$ 183,338	77,656	171,155	86,232
Other third-party payors	377,227	234,281	335,018	217,510
Self-pay	10,971	16,788	24,068	20,807
Net patient service revenue	\$ 571,536	328,725	530,241	324,549

Laws and regulations concerning government programs, including Medicare and Medicaid, are complex and subject to varying interpretation. As a result of investigations by governmental agencies, various health care organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and potential exclusion from the related programs. There can be no assurance that regulatory authorities will not challenge Children's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon Children's. In addition, the contracts Children's has with commercial payers also provide for retroactive audit and review of claims.

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(In thousands)

Settlements with third-party payers for retroactive adjustments due to audits, reviews or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payer, correspondence from the payer and Children's historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known (that is, new information becomes available), or as years are settled or are no longer subject to such audits, reviews, and investigations. Adjustments arising from a change in the transaction price were not significant for the years ended December 31, 2018 and 2017.

Generally patients who are covered by third-party payers are responsible for related deductibles and coinsurance, which vary in amount. Children's also provides services to uninsured patients, and offers those uninsured patients a discount, either by policy or law, from standard charges. Children's estimates the transaction price for patients with deductibles and coinsurance and from those who are uninsured based on historical experience and current market conditions. The initial estimate of the transaction price is determined by reducing the standard charge by any contractual adjustments, discounts, and implicit price concessions. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change. Subsequent changes that are determined to be the result of an adverse change in the patient's ability to pay are recorded as provision for uncollectible accounts. Provision for uncollectible accounts for the years ended December 31, 2018 and 2017 was \$0 and \$10,969, respectively.

Consistent with Children's mission, care is provided to patients regardless of their ability to pay. Therefore, Children's has determined it has provided implicit price concessions to uninsured patients and patients with other uninsured balances (for example, copays and deductibles). The implicit price concessions included in estimating the transaction price represent the difference between amounts billed to patients and the amounts Children's expects to collect based on its collection history with those patients.

Patients who meet Children's criteria for charity care are provided care without charge or at amounts less than established rates. Such amounts determined to qualify as charity care are not reported as revenue.

(j) Investments

Investments are carried at fair value, which generally are based on quoted market price at December 31, 2018 and 2017. 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.

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(In thousands)

Children's classifies its investments as trading securities. Children's invests in various securities, including corporate equities, corporate bonds, municipal 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 under capital leases is 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 \$16,991 and \$15,993 as MNCare tax in health services taxes expense for the years ended December 31, 2018 and 2017, respectively.

(o) Net Assets With Donor Restrictions

Net assets with donor restrictions include those whose use at Children's has been limited by donors to a specific time period or purpose, or 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 net assets with donor restrictions 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, net assets with donor restrictions

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(In thousands)

are reclassified as net assets without donor restrictions 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 net assets without donor restrictions. Children's accounts for net assets with donor restrictions where the time or purpose restriction has been satisfied during the year as net assets with donor restrictions 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 \$1,794 and \$2,333 for the years ended December 31, 2018 and 2017, respectively. Total direct and indirect costs related to these forgone charges were \$727 and \$951, respectively, based on an average ratio of cost to gross charges.

(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) Pledges Receivable

The Foundation records pledges receivable at the time an unconditional pledge agreement is signed. All pledges receivable are classified as net assets with donor restrictions 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.

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(In thousands)

Pledges receivable at December 31, 2018 and 2017 were as follows:

	2018	2017
Pledges due:		
In less than one year	\$ 5,139	6,871
In one to five years	6,150	6,222
More than five years	4,278	4,807
Total pledges due	15,567	17,900
Less discount	(1,452)	(1,584)
Less allowance for uncollectible pledges	(501)	(2,567)
Pledges receivable – net	\$ 13,614	13,749
Classified as:		
Prepaid expenses and other current assets	\$ 4,954	5,275
Other assets	8,660	8,474
Pledges receivable – net	\$ 13,614	13,749

(t) Concentration of Risk

At December 31, 2018, Children's had 38.4% of its employee population covered under labor contracts. Of those employees, 24.4% are covered under labor contracts that are set to expire the last day of February 2021, and 75.6% 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.

(u) Excess of Revenue over Expenses

Children's consolidated results of operations include excess revenue over expenses. Consistent with industry practice, changes in net assets without donor restrictions that are excluded from excess revenue over expense include net assets released from restriction for capital acquisitions and RSVP plan-related changes other than net periodic plan expense. Investment gains and losses on investments without donor restrictions, income and losses from investments accounted for under the equity method, unrealized gains or losses on investments, the change in fair value of interest rate swaps, and other components of net periodic pension cost are included in excess of revenues over expenses. Transactions related to net assets with donor restrictions are recorded as additions or deductions to net assets with donor restrictions and reflected in the consolidated statements of changes in net assets.

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(v) *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 is 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.

(w) *Liquidity and Availability*

As of December 31, 2018, Children's has working capital of \$113,872 and average days cash on hand of 290.

Financial assets available for general expenditure within one year of the balance sheet date consist of the following:

Financial assets at year-end:

Cash and cash equivalents	\$ 12,834
Short term investments	23,043
Short term investments, board-designated	78
Funds held by trustee	3,083
Long-term investments	597,560
Board-designated investments	107,953
Total financial assets	<u>744,551</u>

Less amounts not available to be used within one year:

Funds held by trustee	(3,083)
Long-term investments with certain contractual restrictions	(126,284)
Long-term investments with donor restrictions	<u>(56,930)</u>
Financial assets not available to be used within one year	<u>(186,297)</u>
Financial assets available to meet general expenditures within one year	<u>\$ 558,254</u>

As part of Children's liquidity management plan, cash in excess of daily requirements is invested in short-term investments and money market funds. Additionally, Children's maintains a \$20,000 line of credit with US Bank. As of December 31, 2018, no amounts were drawn on the line of credit.

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As of December 31, 2018, Children's was in compliance with all financial covenants required by its bond insurer, as more fully described in note 4.

(x) Recently Issued Accounting Standards

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.

(y) Reclassifications

Certain 2017 amounts have been reclassified to conform to 2018 presentation.

(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, 2018 and 2017 is shown below:

	2018	2017
Fixed income securities	\$ 158,481	165,195
Corporate equities	84,533	119,831
Foreign investments	103,909	117,856
Investments measured at net asset value	380,494	266,354
Pending purchases	—	40,000
Perpetual trusts held by others	3,825	4,473
Interest and dividends receivable	475	424
Total	\$ 731,717	714,133
Investments are reported as:		
Short-term investments	\$ 23,043	9,130
Short-term investments, board-designated	78	165
Funds held by trustee	3,083	3,037
Long-term investments	597,560	589,620
Board-designated investments	107,953	112,181
Total	\$ 731,717	714,133

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.

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As of December 31, 2018 and 2017, the following schedule summarizes the investment gains (losses) and its classification in the consolidated statements of operations and changes in net assets:

	2018	2017
Investment earnings in net assets without donor restrictions:		
Interest and dividend income	\$ 29,461	15,587
Net realized gains on investments	4,039	40,995
Net unrealized (losses) gains on investments	(33,406)	13,257
Total	94	69,839
Investment earnings in net assets with donor restrictions:		
Interest and dividend income	2,130	1,170
Net realized gains on investments	40	3,496
Net unrealized (losses) gains on investments	(2,846)	1,252
Total	(676)	5,918
Total investment gains	\$ (582)	75,757
Reported within:		
Other operating revenue	\$ 84	31
Investment income and realized gains	33,416	56,551
Net unrealized (losses) gains on investments	(33,406)	13,257
Changes in net assets with donor restrictions	(676)	5,918
Total investment gains	\$ (582)	75,757

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 investment gains (losses) in the consolidated statements of operations and changes in net assets. Children's held long derivative positions valued at \$2,025 and \$0 and short derivative positions valued at \$0 and \$366 as of December 31, 2018 and December 31, 2017, respectively. These contracts are set to expire in 2019 and were held at fair value as of December 31, 2018.

(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.

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(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 position and were a liability of \$20,748 and \$25,733 as of December 31, 2018 and 2017, 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 \$4,985 and \$2,995 for the years ended December 31, 2018 and 2017, respectively. Children's recognized \$3,235 and \$4,132 as interest costs in financing costs expense related to these swap agreements during the years ended December 31, 2018 and 2017, respectively.

The notional amounts and interest rates of the interest rate swaps at December 31, 2018 and 2017 are as follows:

Swap agreement	Fair value	Change in fair value	Current notional amount	Rate paid	Rate received
As of December 31, 2018:					
2004A	\$ (3,192)	(726)	17,850	4.127%	1.436%
2004B	(1,997)	(812)	22,275	4.266	1.436
2007A1	(7,778)	(1,723)	44,475	3.518	1.375
2007A2	(7,781)	(1,724)	44,500	3.518	1.375
	<u>\$ (20,748)</u>	<u>(4,985)</u>	<u>129,100</u>		
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>		

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

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(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 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.

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Financial assets and liabilities measured at fair value on a recurring basis at December 31, 2018 and 2017 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, 2018:				
Investments:				
Fixed-income securities:				
Money market and short-term bond funds	\$ 40,157	—	—	40,157
Municipal bond fund	19	—	—	19
Closed-end bond funds	—	62,719	—	62,719
Mortgage-backed securities	—	5	—	5
Investment grade corporate bonds	46,941	8,640	—	55,581
Total fixed-income securities	87,117	71,364	—	158,481
Corporate equities:				
Large cap	36	—	60	96
Mid cap	14,629	—	—	14,629
Small cap	17,318	—	—	17,318
Closed-end equity funds	50,465	—	—	50,465
Equity futures options	2,025	—	—	2,025
Total corporate equities	84,473	—	60	84,533
Foreign investments:				
Foreign bonds	5,949	—	—	5,949
Foreign equities	97,960	—	—	97,960
Total foreign investments	103,909	—	—	103,909
Total investments measured at net asset value*				380,494
Perpetual trusts held by others	—	3,825	—	3,825
Interest and dividends receivable	475	—	—	475
Total investments	\$ 275,974	75,189	60	731,717
Fair value of interest rate swaps liability	\$ —	20,748	—	20,748

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	Fair value			
	Level 1	Level 2	Level 3	Total
As of December 31, 2017:				
Investments:				
Fixed-income securities:				
Money market and short-term bond funds	\$ 62,858	—	—	62,858
U.S. government and U.S. government 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
Foreign investments:				
Foreign bonds	—	9,638	—	9,638
Foreign 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

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

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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, 2018:

	<u>Net asset value</u>	<u>Redemption frequency</u>	<u>Redemption notice</u>	<u>Unfunded commitments</u>
Commingled funds (a)	\$ 92,247	Daily	10 Days	N/A
Limited partnerships (b)				
Private credit	33,663	None	None	25,561
	46,343	Within 12 mo	None	—
Private equity	86,040	None	None	53,921
Multi-strategy mandate hedge fund (c)	32,905	Monthly	10 Days	N/A
	64,858	Monthly	Monthly	N/A
	1,640	Quarterly	Quarterly	N/A
	6,581	3 yr lock	90 days	N/A
Single mandate hedge fund (d)	<u>16,217</u>	None	None	8,389
	<u>\$ 380,494</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 limited partnerships with monthly or quarterly liquidity that have broad investment mandates across geographic, public and private markets, and equity or fixed income markets.

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(d) Single strategy hedge fund – this category includes limited partnerships with monthly or quarterly liquidity that have a specific strategy within a specific market.

Children's made no level transfers during 2018 or 2017.

(3) Land, Buildings, and Equipment

Land, buildings, and equipment at December 31, 2018 and 2017 consisted of the following:

	<u>2018</u>	<u>2017</u>
Land	\$ 14,001	15,936
Buildings and building improvements	479,463	476,377
Furniture, fixtures, and equipment	324,049	297,745
Construction in progress	<u>1,048</u>	<u>8,314</u>
Land, buildings, and equipment – gross	818,561	798,372
Less accumulated depreciation	<u>(476,030)</u>	<u>(436,033)</u>
Land, buildings, and equipment – net	<u>\$ 342,531</u>	<u>362,339</u>

The construction in progress at December 31, 2018 and 2017 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, 2018 or 2017.

Depreciation expense for the years ended December 31, 2018 and 2017 was \$43,959 and \$45,211, respectively.

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(4) Long-Term Debt

Long-term debt at December 31, 2018 and 2017 consisted of the following:

	2018	2017
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	\$ 11,400	12,700
Health Care Revenue Bonds, Series 2004A, interest rate at a variable rate, due through August 15, 2034 (average of 1.344% for 2018; 0.770% for 2017)	17,850	18,575
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	16,700	17,500
Health Care Revenue Bonds, Series 2004B, interest rate at a variable rate, due through August 15, 2025 (average of 1.354% for 2018; 0.762% for 2017)	22,275	24,950
Health Care Revenue Bonds, Series 2007A, interest rate at a variable rate, due through August 15, 2037 (average of 1.344% for 2018; 0.770% for 2017)	88,975	91,200
Health Care Revenue Bonds, Series 2010A, remaining fixed interest rate range from 4.0% to 5.25%, due in installments through August 15, 2035	27,840	29,310
Total long-term debt	185,040	194,235
Less:		
Unamortized bond premiums and discounts	(317)	(316)
Unamortized bond issuance costs	(2,343)	(2,493)
Current maturities	(9,297)	(8,947)
Long-term portion	\$ 173,083	182,479

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.

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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, 2018. 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 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, 2020 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, 2018 and 2017, were as follows:

	2018	2017
Bond interest fund	\$ 1,082	1,105
Bond principal fund	2,001	1,932
Funds held by trustee	\$ 3,083	3,037

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, 2018 and thereafter, are as follows:

Year ending December 31:	
2019	\$ 9,545
2020	9,905
2021	10,310
2022	10,720
2023	11,135
Thereafter	133,425
Total	\$ 185,040

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(5) Net Assets With Donor Restrictions

Net assets with donor restrictions are restricted for the following purposes and/or periods at December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Donor restricted endowments subject to spending policy and appropriation to support the following purposes:		
Program activities	\$ 23,252	23,931
Health education and research	16,742	14,880
Community service	<u>3,116</u>	<u>3,246</u>
	<u>43,110</u>	<u>42,057</u>
Perpetual trusts, distributions available to support the following purposes:		
Program activities	2,175	2,561
Health education and research	<u>1,650</u>	<u>1,912</u>
	<u>3,825</u>	<u>4,473</u>
Subject to expenditure for specified purpose:		
Program activities	15,745	14,718
Purchases of buildings and equipment	4,338	5,124
Health education and research	2,641	2,186
Community service	<u>1,852</u>	<u>1,499</u>
Total	<u>24,576</u>	<u>23,527</u>
Total net assets with donor restrictions	\$ <u>71,511</u>	\$ <u>70,057</u>

Children's governing board has designated net assets without donor restrictions for the following purposes:

	<u>2018</u>	<u>2017</u>
Quasi-endowment, subject to spending policy and appropriation to support the following purposes:		
Program activities	\$ <u>108,031</u>	<u>112,181</u>
	\$ <u>108,031</u>	\$ <u>112,181</u>

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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, 2018 and 2017 were released from donor restrictions by incurring expenses or by making capital expenditures satisfying the restricted purposes of the following:

	2018	2017
Department uses	\$ 7,408	10,637
Purchases of buildings and equipment	1,114	4,087
Health education and research	1,292	1,216
Community service	1,355	1,221
Total	\$ 11,169	17,161

(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 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.

	Without donor restrictions	With donor restrictions	Total
Year ended December 31, 2018:			
Endowment net assets – beginning of year	\$ 112,181	46,531	158,712
Investment returns:			
Investment gains (losses)	5,886	2,344	8,230
Net unrealized (losses) gains	(5,740)	(2,382)	(8,122)
Change in value of perpetual trusts held by others	—	(647)	(647)
Total investment returns	146	(685)	(539)

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	Without donor restrictions	With donor restrictions	Total
Contributions	\$ —	2,683	2,683
Appropriations of endowment assets for expenditure	(4,297)	(1,595)	(5,892)
Endowment net assets – end of year	\$ 108,030	46,934	154,964

	Without donor restrictions	With donor restrictions	Total
Year ended December 31, 2017:			
Endowment net assets – beginning of year	\$ 103,192	41,573	144,765
Investment returns:			
Investment gains (losses)	12,090	4,821	16,911
Net unrealized (losses) gains	1,759	632	2,391
Change in value of perpetual trusts held by others	—	465	465
Total investment returns	13,849	5,918	19,767
Contributions	—	934	934
Appropriations of endowment assets for expenditure	(4,860)	(1,894)	(6,754)
Endowment net assets – end of year	\$ 112,181	46,531	158,712

(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, 2018.

(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

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(In thousands)

this amount. In 2018 and 2017, 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).

(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 2018 and 2017 were \$4,571 and \$3,970, 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 \$3,570 and \$3,655 at December 31, 2018 and 2017, 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.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

(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 (the Legacy Plan) was terminated on October 31, 2018. The Legacy Plan provided benefits to eligible noncontract employees based on final average salary and accumulated pension credits, which, in turn, were based on years of service. Benefit accruals under the Legacy Plan have been frozen since January 1, 2013.

A new plan was established, effective October 30, 2018, to assume Children's obligations under the Legacy Plan for certain specified participants. The new plan is called the Children's RSVP Retirement Plan II (the RSVP Plan II) and provides essentially the same benefits as were provided under the Legacy Plan to the individuals designated to participate in it. Children's determined who was eligible to participate in the RSVP Plan II based on certain criteria that it had established, including participant preference. The plan assets and liabilities of the individuals designated to participate in the RSVP Plan II have been transferred to the RSVP Plan II and are administered according to the terms of that plan.

In connection with the termination of the Legacy Plan, its assets were dispersed to participants as required by the plan document and applicable law. Accordingly, the accounts of participants under the terminating Legacy Plan were distributed to participants in that plan in the form of a lump sum payment (subject to applicable rollover and distribution rules) or an annuity.

A contribution of \$10,300 for the plan year 2017 was made for the Legacy Plan on September 13, 2018. The final contribution of \$4,500 for the plan year 2018 was made for the Legacy Plan on December 28, 2018. A total of \$32,424 in assets was transferred from the Legacy Plan to the RSVP Plan II in connection with the transfer described above to fund the benefits to be provided under the RSVP Plan II. At present the assets of the RSVP Plan II are invested solely in fixed income investments

Total plan settlements for the year ended December 31, 2018 were \$61,841, 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 \$11,663 for the year ended December 31, 2018, which is included in other components of net periodic pension cost within the consolidated statements of operations and changes in net assets.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

The information for the defined-benefit pension plan as of and for the years ended December 31, 2018 and 2017 is as follows:

	RSVP Plan	RSVP II Plan	RSVP Plan
	Jan. 1, 2018–	Nov. 1, 2018–	2017
	Dec. 31, 2018	Dec. 31, 2018	2017
	<u> </u>	<u> </u>	<u> </u>
Change in benefit obligation:			
Obligation – beginning of year	\$ 94,322	—	94,332
Interest cost	2,891	239	3,542
Plan settlements	(61,841)	—	(5,676)
Actuarial (gain) loss	(1,426)	306	2,614
Benefit payments	(463)	(101)	(490)
Plan asset transfer (out) in	(32,424)	32,424	—
	<u> </u>	<u> </u>	<u> </u>
Obligation – end of year	\$ <u>1,059</u>	<u>32,868</u>	<u>94,322</u>
	RSVP Plan	RSVP II Plan	RSVP Plan
	Jan. 1, 2018–	Nov. 1, 2018–	2017
	Dec. 31, 2018	Dec. 31, 2018	2017
	<u> </u>	<u> </u>	<u> </u>
Change in plan assets:			
Fair value of plan assets – beginning of year	\$ 79,864	—	80,604
Employer contributions	14,762	—	2,200
Plan settlements	(61,841)	—	(5,676)
Benefit payments	(463)	(101)	(490)
Actual return on plan assets	(155)	(31)	3,226
Plan asset transfer (out) in	(31,281)	31,281	—
	<u> </u>	<u> </u>	<u> </u>
Fair value of plan assets – end of year	<u>886</u>	<u>31,149</u>	<u>79,864</u>
Net amount recognized:			
Current portion (included in accrued salaries, wages, and benefits)	—	—	—
Long-term portion (included in other long-term liabilities)	(173)	(1,719)	(14,458)
	<u> </u>	<u> </u>	<u> </u>
Funded status – end of year	<u>(173)</u>	<u>(1,719)</u>	<u>(14,458)</u>
Accumulated benefit obligation	\$ <u>1,059</u>	<u>32,868</u>	<u>94,322</u>

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

Components of net periodic benefit cost for the plan for 2018 and 2017 are as follows:

	RSVP Plan Jan. 1, 2018– Dec. 31, 2018	RSVP II Plan Nov. 1, 2018– Dec. 31, 2018	RSVP Plan 2017
Interest cost	2,891	239	3,542
Expected return on plan assets	(2,090)	(155)	(2,262)
Settlement loss	11,663	—	1,017
Amortization of loss	189	8	174
Net periodic pension cost	<u>12,653</u>	<u>92</u>	<u>2,471</u>

Components of RSVP plan related changes other than net periodic plan expense for 2018 and 2017 are as follows:

	RSVP Plan Jan. 1, 2018 – Dec. 31, 2018	RSVP II Plan Nov. 1, 2018 – Dec. 31, 2018	RSVP Plan 2017
Net gain (loss) arising during year	\$ 323	(1,635)	(1,649)
Amortization of loss	11,852	8	1,191
Impact of spin termination on allocations	3,730	(3,730)	—
Total	<u>\$ 15,905</u>	<u>(5,357)</u>	<u>(458)</u>

Amount recognized in net assets without donor restrictions but not yet recognized as a component of net periodic benefit cost for the plan at December 31, 2018 and 2017 is as follows:

	RSVP Plan Jan. 1, 2018– Dec. 31, 2018	RSVP II Plan Nov. 1, 2018– Dec. 31, 2018	RSVP Plan 2017
Amortization of loss	\$ (204)	(5,357)	(16,110)

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

Weighted average assumptions used to determine the benefit obligations and net periodic benefit costs at December 31, 2018 and 2017 are as follows:

	RSVP Plan Jan. 1, 2018– Dec. 31, 2018	RSVP II Plan Nov. 1, 2018– Dec. 31, 2018	RSVP Plan 2017
Discount rate – benefit obligation	N/A	4.28 %	3.55 %
Discount rate – net periodic benefit cost	3.55/4.43%	4.43	4.00
Rate of compensation increase	N/A	N/A	N/A
Expected return on plan assets	3.00	3.00	3.00

Children's pension plan asset allocation at December 31, 2018 and 2017 by asset category is as follows:

	Plan assets	
	2018	2017
Cash and cash equivalents	24 %	12 %
Synthetic equity strategy investments	—	15
Fixed income investments	76	45
Mutual funds	—	28
Total	<u>100 %</u>	<u>100 %</u>

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

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

Children's pension plan investments measured at fair value on a recurring basis at December 31, 2018 and 2017 are summarized in the following tables by type of inputs applicable to the fair value measurements of the RSVP and RSVP II Plans:

	Fair value		
	Level 1	Level 2	Total
December 31, 2018:			
Cash, cash equivalents, and accrued interest	\$ 7,843	—	7,843
Fixed income investments:			
Investment grade	—	14,854	14,854
U.S. government agency and municipal issues	—	9,338	9,338
Total fixed income investments	—	24,192	24,192
Total pension plan investments	\$ 7,843	24,192	32,035

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

	Fair value		
	Level 1	Level 2	Total
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
Mutual funds	—	—	—
Asset-backed securities	—	1,893	1,893
Investment grade securities	—	1,673	1,673
Collateralized mortgage obligations	—	7,522	7,522
Total synthetic equity strategy investments	332	11,945	12,277
Fixed income investments:			
Investment grade	—	18,907	18,907
High yield	—	225	225
Closed end funds	3,539	—	3,539
U.S. government agency and municipal issues	—	12,493	12,493
Asset-backed securities	—	369	369
Collateralized mortgage obligations	—	306	306
Total fixed income investments	3,539	32,300	35,839
Mutual funds:			
Fixed-income funds	21,868	—	21,868
Total mutual funds	21,868	—	21,868
Total pension plan investments	\$ 35,619	44,245	79,864

See note 2 for discussion over the fair value hierarchy, fair value inputs, and valuation methodologies used at December 31, 2018 and 2017.

Children's made no transfers between levels during 2018 or 2017.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

Benefits expected to be paid through the defined-benefit pension plans, by year, as of December 31, 2018 are as follows:

2019	\$	6,394
2020		3,285
2021		2,864
2022		2,265
2023		2,201
Subsequent five years		8,732

Children's expects to make a contribution of \$173 to the RSVP II Plan during 2019. The estimated net actuarial loss for the plan that will be amortized from unrestricted net assets into net periodic benefit cost during 2019 is \$64 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 2018 expense was 3.0%. The rate is determined based on Children's asset allocation during 2018 of 24.0% cash and cash equivalents and 76.0% 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, 2018 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

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

implemented. 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 2018 and 2017 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			
		2018	2017		2018	2017		
Twin City Hospitals – Minnesota Nurses Association Pension Plan	41-6184922/001	Green	Green	Implemented	\$ 13,985	13,020	No	5/31/2019
Other funds	—	—	—	—	648	620	—	—
Total contributions					\$ 14,633	13,640		

(a) The plan's funding level on January 1, 2018 is determined based on the actual December 31, 2017 asset values and projected liabilities as of January 1, 2018 that are a rollforward of liabilities from the previous valuation date of January 1, 2017, assuming no actuarial gains/losses occur during the period.

In January 2019, Children's contributed \$11,996 to the Twin City Hospitals – Minnesota Nurses Association Pension Plan, which is Children's proportionate share of the minimum 2019 contribution requirement according to the collective bargaining agreement. Children's does not expect to make further contributions during 2019.

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, 2018 and 2017. At the date the consolidated financial statements were issued, Form 5500 was not available for the plan year ended in 2018.

(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 and the amounts recognized in the consolidated financial statements as of and for the years ended December 31, 2018 and 2017 are as follows:

	2018	2017
Change in benefit obligations:		
Obligation – beginning of year	\$ 3,810	3,469
Service cost	162	134
Interest cost	133	135
Net loss	(1,369)	245
Benefit payments	(206)	(173)
Obligation included in other long-term liabilities – end of year	\$ 2,530	3,810

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

For the 2018 postretirement benefit obligation, certain actuarial assumptions were changed from 2017, 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 4.2% for 2018 and 3.5% for 2017. For measurement purposes, a 6.5% annual rate increase in the cost of covered healthcare benefits was assumed for 2018; the rate was assumed to decrease by 0.5% per year for three 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:

		<u>1% Increase</u>	<u>1% Decrease</u>
Accrued postretirement benefit liability	\$	300	(256)
Sum of service cost and interest cost		53	(43)

(d) Defined-Contribution Plan

Children's has a defined contribution plan, covering substantially all employees. In conjunction with the Legacy RSVP plan amendment effective December 31, 2012, to freeze benefits for plan participants, Children's enhanced the defined contribution plan for noncontract participants. 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. Effective January 1, 2018, Children's adopted an IRS Safe Harbor plan whereby all employer contribution match is vested immediately. The amount expensed to the consolidated statements of operations and changes in net assets was \$15,077 and \$14,332 for the twelve months ended December 31, 2018 and 2017, respectively.

Effective January 1, 2018, the defined contribution plan removed an auto-escalation feature that increased participant contributions by 1% annually up to 6%. Deferral adjustments are now solely a participant directed activity.

(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, 2018, there were 7 executives and 153 employed physicians active in the plan. The liability for these plans at December 31, 2018 and 2017 was \$6,710 and \$7,311, respectively, of which \$4,063 and \$4,904 were included in other long-term liabilities and \$2,646 and \$2,407 were included in accrued salaries, wages, and benefits in the consolidated statements of financial position.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

(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, 2018 and 2017 are as follows:

	Year ended December 31, 2018			
	Program	G&A	Fundraising	Total
Salaries, wages, and employee benefits	\$ 459,970	64,135	3,610	527,715
Professional fees and purchased services	91,559	29,245	140	120,944
Supplies	99,652	886	87	100,625
Facilities	15,632	1,564	—	17,196
Depreciation and amortization	34,903	9,964	102	44,969
Financing costs	8,360	—	—	8,360
Health services taxes	28,012	—	—	28,012
Other	38,156	7,599	4,723	50,478
Total expenses	\$ 776,244	113,393	8,662	898,299

	Year ended December 31, 2017			
	Program	G&A	Fundraising	Total
Salaries, wages, and employee benefits	\$ 440,730	64,449	4,418	509,597
Professional fees and purchased services	91,042	28,466	1,443	120,951
Supplies	87,780	954	76	88,810
Facilities	15,811	1,629	—	17,440
Depreciation and amortization	33,021	13,399	102	46,522
Financing costs	8,994	—	—	8,994
Health services taxes	26,496	—	—	26,496
Other	39,174	7,872	3,534	50,580
Total expenses	\$ 743,048	116,769	9,573	869,390

(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.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

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, 2018 or 2017. Children's is not subject to an income tax examination for years before 2014.

(10) Other Assets

Other assets for the years ended December 31, 2018 and 2017 consist of the following:

	2018	2017
Investments in unconsolidated joint ventures	\$ 45,810	46,223
Deferred compensation	6,710	7,311
Foundation long-term pledges receivable – restricted	8,660	8,474
Other	14,489	15,246
Total other assets	\$ 75,669	77,254

Investments held under deferred compensation arrangements are considered Level 1 investments. 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:

	Percentage ownership	Equity investment		Share of net earnings (loss)	
		2018	2017	2018	2017
HealthEast Woodwinds Hospital Diagnostic Treatment Center	20 %	9,820	9,028	4,630	3,703
Critical Care Services, Inc. (d/b/a Life Link III)	10	3,695	3,628	66	329
Health System Cooperative Laundries	6	745	783	(31)	25
Mother Baby Pavilion, LLC	50	24,050	25,284	(1,234)	(1,286)
Other	Various	500	500	—	(22)
		38,810	39,223	3,431	2,749

Children's received \$3,838 and \$2,736 in distributions from joint ventures for the years ended December 31, 2018 and 2017, respectively.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

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:

	Unaudited	
	2018	2017
Total assets	\$ 124,103	118,785
Total liabilities	24,302	24,579
Total net assets	99,801	94,206
Total revenue	175,369	167,467
Total operating expenses	153,897	147,544
Excess of revenues over expenses	21,472	19,923

Investments accounted for under the cost method were \$7,000 at December 31, 2018 and 2017 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 \$3,278. As of December 31, 2018, Children's has a letter of credit in the amount \$4,493 to meet this requirement.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

(12) Other Long-Term Liabilities

Other long-term liabilities for the years ended December 31, 2018 and 2017 consist of the following:

	<u>2018</u>	<u>2017</u>
RSVP retirement plan	\$ 1,892	14,458
Other benefit plans	6,728	8,792
Self insured reserves	4,813	5,378
Deferred revenue	12,693	12,771
Other	1,206	1,324
Total other long-term liabilities	<u>\$ 27,332</u>	<u>42,723</u>

(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, 2018 and 2017 was as follows:

	<u>2018</u>	<u>2017</u>
Government payors	27 %	33 %
Other third-party payors	57	55
Patients	16	12
	<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, 2018 and 2017 included in facilities expenses, including allocated common costs, was approximately \$12,671 and \$14,026, respectively. Children's subleases portions of its medical office facilities. Total sublease rental income included in other revenue was \$2,487 and \$2,398 for the years ended December 31, 2018 and 2017, respectively.

CHILDREN'S HEALTH CARE

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(In thousands)

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:

	Future minimum lease payments	
	As lessee	As lessor
2019	\$ 7,251	1,514
2020	6,912	1,328
2021	6,787	1,268
2022	6,834	1,071
2023	6,496	831
Thereafter	<u>31,317</u>	<u>835</u>
	<u>\$ 65,597</u>	<u>6,847</u>

ADDITIONAL INFORMATION

CHILDREN'S HEALTH CARE

Consolidating Schedule of Statement of Financial Position

December 31, 2018

(In thousands)

Assets	Obligated group total	Children's Health Insurance Network, Ltd	Children's Health Network	Eliminating entries	Consolidated total
Current assets:					
Cash and cash equivalents	\$ 11,689	1,145	—	—	12,834
Short-term investments	23,043	—	—	—	23,043
Short-term investments, board-designated	78	—	—	—	78
Funds held by trustee	3,083	—	—	—	3,083
Patient accounts receivable – net	166,286	—	—	—	166,286
Prepaid expenses and other current assets	46,532	2,113	128	(9,531)	39,242
Total current assets	250,711	3,258	128	(9,531)	244,566
Long-term investments	588,920	8,640	—	—	597,560
Board-designated investments	107,953	—	—	—	107,953
Other assets	75,919	—	—	(250)	75,669
Land, buildings, and equipment – net	342,492	—	39	—	342,531
Total	\$ 1,365,995	11,898	167	(9,781)	1,368,279
Liabilities and Net Assets					
Current liabilities:					
Current maturities of long-term debt	\$ 9,297	—	—	—	9,297
Accounts payable and accrued expenses	44,609	5,860	4	(9,531)	40,942
Accrued salaries, wages, and benefits	68,364	—	—	—	68,364
Other current liabilities	11,465	626	—	—	12,091
Total current liabilities	133,735	6,486	4	(9,531)	130,694
Intercompany accounts	2,428	—	(2,428)	—	—
Fair value of interest rate swaps	20,748	—	—	—	20,748
Other long-term liabilities	24,388	2,944	—	—	27,332
Long-term debt – excluding current maturities	173,083	—	—	—	173,083
Total liabilities	354,382	9,430	(2,424)	(9,531)	351,857
Net assets:					
Net assets without donor restrictions	940,103	2,468	2,591	(250)	944,912
Net assets with donor restrictions	71,510	—	—	—	71,510
Total net assets	1,011,613	2,468	2,591	(250)	1,016,422
Total	\$ 1,365,995	11,898	167	(9,781)	1,368,279

See notes to consolidating schedules of financial statements information.

CHILDREN'S HEALTH CARE

Consolidating Schedule of Statement of Operations

Year ended December 31, 2018

(In thousands)

	Obligated group total	Children's Health Insurance Network, Ltd	Children's Health Network	Eliminating entries	Consolidated total
Revenue:					
Net patient service revenue	\$ 899,861	—	—	400	900,261
Net assets released from restrictions for operations	10,033	—	—	—	10,033
Other	37,024	4,573	5,029	(7,188)	39,438
Total revenue	946,918	4,573	5,029	(6,788)	949,732
Expenses:					
Salaries, wages, and employee benefits	523,718	—	3,997	—	527,715
Professional fees and purchased services	122,619	103	145	(1,923)	120,944
Supplies	100,565	—	60	—	100,625
Facilities	17,049	—	147	—	17,196
Depreciation and amortization	44,965	—	4	—	44,969
Financing costs	8,401	—	—	(41)	8,360
Health services taxes	27,993	—	19	—	28,012
Other	49,931	4,547	865	(4,865)	50,478
Total expenses	895,241	4,650	5,237	(6,829)	898,299
Operating income (losses)	51,677	(77)	(208)	41	51,433
Nonoperating gains (losses):					
Investment income and realized gains	33,416	—	41	(41)	33,416
Income on investments accounted for under the equity method	3,431	—	—	—	3,431
Net unrealized losses on investments	(32,866)	(540)	—	—	(33,406)
Change in fair value of interest rate swaps	4,985	—	—	—	4,985
Other components of net periodic pension cost	(13,473)	—	—	—	(13,473)
Total nonoperating (losses) gains	(4,507)	(540)	41	(41)	(5,047)
Excess (deficiency) of revenue over expenses	47,170	(617)	(167)	—	46,386
Other changes in net assets without donor restrictions:					
Net assets released from restrictions – capital acquisitions	1,136	—	—	—	1,136
RSVP plan-related changes other than net periodic plan expense	10,548	—	—	—	10,548
Increase (decrease) in net assets without donor restrictions	\$ 58,854	(617)	(167)	—	58,070

See notes to consolidating schedules of financial statements information.

CHILDREN'S HEALTH CARE

Notes to Consolidating Schedules of Financial Statements Information

December 31, 2018

(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.