



**CHILDREN'S HEALTH CARE**

Consolidated Financial Statements

December 31, 2019 and 2018

(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, 2019 and 2018, 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, 2019 and 2018, and the results of their operations and changes in net assets 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 on Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842). Our opinion is not modified with respect to this matter.

*Other Matter*

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The 2019 supplemental consolidating financial information 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 23, 2020

**CHILDREN'S HEALTH CARE**  
Consolidated Statements of Financial Position  
December 31, 2019 and 2018  
(In thousands)

<b>Assets</b>	<b>2019</b>	<b>2018</b>
Current assets:		
Cash and cash equivalents	\$ 19,106	12,834
Short-term investments	9,263	23,043
Short-term investments, board-designated	133	78
Funds held by trustee	3,131	3,083
Patient accounts receivable	154,783	166,286
Prepaid expenses and other current assets	46,418	39,242
Total current assets	232,834	244,566
Long-term investments	738,223	597,560
Board-designated investments	117,638	107,953
Operating lease right of use assets, net	39,470	—
Other assets	76,648	75,669
Land, buildings, and equipment – net	328,160	342,531
Total	\$ 1,532,973	1,368,279
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Current maturities of long-term debt	\$ 9,657	9,297
Current portion of operating lease liabilities	5,267	—
Accounts payable and accrued expenses	47,850	40,942
Accrued salaries, wages, and benefits	69,112	68,364
Other current liabilities	11,545	12,091
Total current liabilities	143,431	130,694
Fair value of interest rate swaps	25,883	20,748
Other long-term liabilities	17,352	27,332
Long-term portion of operating lease liabilities	44,704	—
Long-term debt – excluding current maturities	163,081	173,083
Total liabilities	394,451	351,857
Net assets:		
Net assets without donor restrictions	1,064,323	944,912
Net assets with donor restrictions	74,199	71,510
Total net assets	1,138,522	1,016,422
Total	\$ 1,532,973	1,368,279

See accompanying notes to the consolidated financial statements.

**CHILDREN'S HEALTH CARE**

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2019 and 2018

(In thousands)

	<b>2019</b>	<b>2018</b>
Revenue:		
Patient service revenue	\$ 922,840	900,261
Net assets released from restrictions for operations	10,890	10,033
Other	42,357	39,438
Total revenue	976,087	949,732
Expenses:		
Salaries, wages, and employee benefits	553,991	527,715
Professional fees and purchased services	129,736	120,944
Supplies	107,268	100,625
Facilities	17,257	17,196
Depreciation and amortization	44,990	44,969
Financing costs	7,586	8,360
Health services taxes	28,317	28,012
Other	54,495	50,478
Total expenses	943,640	898,299
Operating income	32,447	51,433
Nonoperating gains (losses):		
Investment income and realized gains	33,811	33,416
Income on investments accounted for under the equity method	2,646	3,431
Net unrealized gains (losses) on investments	55,607	(33,406)
Change in fair value of interest rate swaps	(5,135)	4,985
Other components of net periodic pension cost	(1,306)	(13,473)
Total nonoperating gains (losses)	85,623	(5,047)
Excess of revenue over expenses	118,070	46,386

See accompanying notes to the consolidated financial statements.

**CHILDREN'S HEALTH CARE**

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2019 and 2018

(In thousands)

	<b>2019</b>	<b>2018</b>
Net assets without donor restrictions:		
Excess of revenue over expenses	\$ 118,070	46,386
Net assets released from restrictions – capital acquisitions	1,165	1,136
RSVP plan-related changes other than net periodic plan expense	228	10,548
Other	(52)	—
	119,411	58,070
Net assets with donor restrictions:		
Contributions	8,450	13,298
Investment income	2,283	2,353
Net unrealized gains (losses) on investments	3,541	(2,382)
Net assets released from restrictions – operations	(10,890)	(10,033)
Net assets released from restrictions – capital acquisitions	(1,165)	(1,136)
Change in value of perpetual trusts held by others	470	(647)
	2,689	1,453
Increase in net assets with donor restrictions	2,689	1,453
Increase in net assets	122,100	59,523
Net assets – beginning of year	1,016,422	956,899
Net assets – end of year	\$ 1,138,522	1,016,422

See accompanying notes to the consolidated financial statements.

**CHILDREN'S HEALTH CARE**  
Consolidated Statements of Cash Flows  
Years ended December 31, 2019 and 2018  
(In thousands)

	<u>2019</u>	<u>2018</u>
Cash flows from operating activities:		
Increase in net assets	\$ 122,100	59,523
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	44,990	44,969
Net unrealized (gains) losses on investments	(59,148)	35,789
Net realized gains on investments	(5,764)	(10,592)
RSVP plan-related changes other than net periodic plan expense	(228)	(10,548)
Change in fair value of interest rate swaps	5,135	(4,985)
Contributions restricted for long-lived purposes	(31)	(140)
Income on investments accounted for under the equity method	(2,646)	(3,431)
Other	(734)	(3,270)
Changes in assets and liabilities:		
Patient accounts receivable	11,503	(53,303)
Prepaid expenses and other current assets	(2,259)	(1,418)
Other assets	5,809	168
Accounts payable and accrued expenses	7,924	2,405
Accrued salaries, wages, and benefits	748	3,837
Other liabilities	(9,709)	(857)
Net cash provided by operating activities	<u>117,690</u>	<u>58,147</u>
Cash flows from investing activities:		
Distributions received from joint ventures	2,309	3,838
Purchase of land, buildings, and equipment	(30,430)	(22,638)
Purchase of investments and funds held by trustee	(293,959)	(437,350)
Cash paid in acquisitions, net	(3,900)	—
Proceeds from sale and maturities of investments and funds held by trustee	<u>223,726</u>	<u>394,023</u>
Net cash used in investing activities	<u>(102,254)</u>	<u>(62,127)</u>
Cash flows from financing activities:		
Principal payments on long-term debt	(9,545)	(9,195)
Contributions restricted for long-lived purposes	<u>381</u>	<u>1,093</u>
Net cash used in financing activities	<u>(9,164)</u>	<u>(8,102)</u>
Net increase (decrease) in cash and cash equivalents	6,272	(12,082)
Cash and cash equivalents – beginning of year	<u>12,834</u>	<u>24,916</u>
Cash and cash equivalents – end of year	<u>\$ 19,106</u>	<u>12,834</u>
Supplemental cash flow disclosures:		
Cash paid for interest	\$ 4,305	4,653
Noncash gifts of property and equipment, and investments	1,146	673

See accompanying notes to the consolidated financial statements.

## CHILDREN'S HEALTH CARE

Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

### (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 three affiliate organizations, Children's Health Insurance Network, Ltd. (CHIN), which handles professional liability claims (note 6), Children's Clinic Network, which owns and operates community-based clinics, and Children's Minnesota Home Medical Equipment (CHME), which provides home medical equipment services. Children's is also the sole corporate and nonvoting member of Children's Health Network (CHN), a clinically integrated network created by Children's 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. Children's expects CHME will become a member of the Obligated Group after it commences operations in 2020.

#### (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 (Allina), a Minnesota not-for-profit 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 \$10,980 and \$17,242 for the years ended December 31, 2019 and 2018, respectively. The amount due to Allina was \$4,500 and \$5,430 at December 31, 2019 and 2018, respectively, which is included in accounts payable and accrued expenses in the consolidated statements of financial position.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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.

#### **(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 explicit and implicit price concessions, and valuation of alternative investments.

#### **(f) Subsequent Events**

Children's has evaluated all events or transactions that occurred after December 31, 2019 through April 23, 2020, 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 consolidated financial statements, other than the following:

On January 15, 2020, Children's issued \$214,095 of Taxable Bonds, Series 2020 (Series 2020 Bonds), due August 15, 2049, bearing a fixed interest rate of 3.448%. The proceeds of the Series 2020 Bonds were applied, in part, to refund the following outstanding bonds issued by the City of Minneapolis, Minnesota and the Housing and Redevelopment Authority of the City of St. Paul, acting jointly: (i) \$10,000 outstanding aggregate principal amount of Health Care Revenue Bonds (Children's Health Care), Series 1995B; (ii) \$17,025 outstanding aggregate principal amount of Variable Rate Revenue Bonds (Children's Hospitals and Clinics), Series 2004A; (iii) \$15,850 outstanding aggregate principal amount of Health Care Facilities Revenue Bonds (Children's Hospitals and Clinics), Series 2004A-1; (iv) \$19,500 outstanding aggregate principal amount of Variable Rate Revenue Bonds (Children's Hospitals and Clinics), Series 2004B; and (v) \$26,295 outstanding aggregate principal amount of Health Care Facilities Revenue Bonds (Children's Health Care), Series 2010A. A remaining balance of approximately \$125,425 is available for strategic investments and other general corporate purposes, including payment of costs of issuance of the Series 2020 Bonds and the cost of retiring the fixed payor swap arrangements related to the Series 2004A and B Bonds.

On January 30, 2020, the World Health Organization declared the outbreak of COVID-19 as a "public health emergency of international concern," and on March 13, 2020, the President of the United States declared a state of national emergency. As a result of the outbreak, there has been instability in the capital markets. The ultimate impact of the COVID-19 outbreak is highly uncertain, but Children's anticipates a substantial decrease in 2020 revenues and higher costs associated with COVID-19 preparedness. In response, Children's will be implementing a number of cost-saving measures within the next several weeks. These measures will include employee related actions, such as tiered rate reductions and a furlough of low need employees, postponement of capital and other strategic spending, and an overall reduction in most other expense categories. Children's is also focused on

## CHILDREN'S HEALTH CARE

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contingency planning should more severe operational, financial market or economic disruption continue for an extended period of time.

Financial markets have experienced unprecedented turbulence since mid-February of 2020 attributable to: (i) the potential impact of COVID-19 on world economies; (ii) oil prices; and (iii) the possibility of an economic recession in the United States. This turbulence has affected the performance of Children's investments. As of March 31, 2020, Children's investment portfolio has lost approximately (\$83,000) (unaudited) from ending fair market value investment balances reported as of December 31, 2019. Children's anticipates continued market volatility throughout the remainder of 2020.

#### **(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**

Effective January 1, 2019, Children's adopted Accounting Standards Codification (ASC) 842 - *Leases*. ASC 842 expands qualitative and quantitative disclosure requirements around leasing transactions while also requiring lessees to recognize most leases on the consolidated statements of financial position. See note 1(y) and note 13 for further discussion.

Effective January 1, 2019 Children's adopted ASU 2018-08 – Clarifying the Scope and Accounting for Contributions Received and Made. ASU 2018-08 clarifies and improves the scope and the accounting guidance to determine when a transaction should be accounted for as an exchange transaction or a contribution and how to determine whether a contribution is conditional. The adoption of ASU 2018-08 did not have a material effect on the consolidated financial statements.

Effective December 31, 2019, Children's adopted ASU 2016-18, *Restricted Cash*. ASU 2016-18 addresses classification and presentation of changes in restricted cash on the consolidated statement of cash flows and requires an entity's reconciliation of the beginning-of-period and end-of-period total amounts shown on the consolidated statement of cash flows to include in cash and cash equivalents amounts generally described as restricted cash. The adoption of ASU 2016-18 did not have a material effect on the consolidated financial statements.

#### **(i) Recently Issued Accounting Standards**

In August 2016, the FASB issued ASU 2018-15, *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*. ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The provisions of ASU 2018-15 are effective for annual periods beginning after December 31, 2019. Children's does not believe the new guidance will have a material impact on the consolidated financial statements.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

#### **(j) Patient Service Revenue**

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 payors (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 payors 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 and outpatient 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 payors 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 uses a portfolio approach to apply the new model to classes of payors with similar characteristics and analyzes 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 payors, 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

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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

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

- Government payors: Reimbursement for government payors is generally paid based upon established fee schedules. Outpatient services are paid using prospectively determined rates.
- Other third-party payors, 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 2019, the top four third-party payors accounted for 26%, 26%, 21%, and 17% of patient service revenue. In 2018, the top four third-party payors accounted for 29%, 23%, 20%, and 13% of patient service revenue.

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, 2019 and 2018 was as follows:

	2019	2018
Government payors	18 %	27 %
Other third-party payors	66	57
Patients	16	16
	100 %	100 %

Patient service revenue recognized for the years ended December 31, 2019 and 2018, by major payor source, was as follows:

	2019		2018	
	Inpatient	Outpatient	Inpatient	Outpatient
Government payors	\$ 162,638	78,814	183,338	77,656
Other third-party payors	411,319	251,751	377,227	234,281
Self-pay	4,212	14,106	10,971	16,788
Patient service revenue	\$ 578,169	344,671	571,536	328,725

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,

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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 payors also provide for retroactive audit and review of claims.

Settlements with third-party payors 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 payor, correspondence from the payor 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, 2019 and 2018.

Generally, patients who are covered by third-party payors 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.

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.

#### **(k) Investments**

Investments are carried at fair value, which generally are based on quoted market prices at December 31, 2019 and 2018. Certain investments are valued at net asset value of the underlying fund

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### Notes to the Consolidated Financial Statements

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as a practical expedient to fair value. Funds held by trustee are held under bond indenture agreements for debt service payments. The estimated values as determined by the respective funds' general partner or investment manager may differ significantly from the values that would have been used had ready markets existed. A portion of investments are not intended to be used for current operations and, therefore, is classified as noncurrent assets. Realized gains and losses on sales of securities are recognized using the average cost basis.

Children's classifies its investments as trading securities. Children's invests in various securities, including corporate equities, corporate bonds, municipal bonds, 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.

#### **(l) 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.

#### **(m) 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.

#### **(n) 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.

#### **(o) MNCare Tax**

Children's pays a state tax of 2% on receipts other than Medicare receipts. Children's recognized \$17,149 and \$16,991 as MNCare tax in health services taxes expense on the consolidated statements of operations for the years ended December 31, 2019 and 2018, respectively.

#### **(p) 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.

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Notes to the Consolidated Financial Statements

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### **(q) 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 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.

### **(r) 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 \$6,141 and \$1,794 for the years ended December 31, 2019 and 2018, respectively. Total direct and indirect costs related to these forgone charges were \$2,420 and \$727, respectively, based on an average ratio of cost to gross charges.

### **(s) 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.

### **(t) Pledges Receivable**

Children's 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 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.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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Pledges receivable at December 31, 2019 and 2018 were as follows:

	2019	2018
Pledges due:		
In less than one year	\$ 4,520	5,139
In one to five years	3,947	6,150
More than five years	3,613	4,278
Total pledges due	12,080	15,567
Less discount	(1,220)	(1,452)
Less allowance for uncollectible pledges	(412)	(501)
Pledges receivable – net	\$ 10,448	13,614
Classified as:		
Prepaid expenses and other current assets	\$ 4,336	4,954
Other assets	6,112	8,660
Pledges receivable – net	\$ 10,448	13,614

**(u) Concentration of Risk**

At December 31, 2019, Children's had 38.3% of its employee population covered under labor contracts. Of those employees, 25.0% are covered under labor contracts that are set to expire the last day of February 2021, and 75.0% are covered under labor contracts that are set to expire on the last day of May 2022. 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 patient service revenue.

**(v) 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 operations and changes in net assets.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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

From time to time, Children's makes use of certain exchange-traded options and futures contracts to manage its overall equity exposure, which 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.

#### **(x) Liquidity and Availability**

As of December 31, 2019, Children's has working capital of \$89,403 and average days cash on hand of 331. As of December 31, 2018, Children's had working capital of \$113,872 and average days cash on hand of 290.

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

Financial assets at year-end:	<b>2019</b>	<b>2018</b>
Cash and cash equivalents	\$ 19,106	\$ 12,834
Short-term investments	9,263	23,043
Short-term investments, board-designated	133	78
Patient accounts receivable	154,783	166,286
Funds held by trustee	3,131	3,083
Long-term investments	738,223	597,560
Board-designated investments	117,638	107,953
Total financial assets	1,042,277	910,837
Less amounts not available to be used within one year:		
Funds held by trustee	(3,131)	(3,083)
Long-term investments with certain contractual restrictions	(186,041)	(126,284)
Long-term investments with donor restrictions	(63,253)	(56,930)
Financial assets not available to be used within one year	(252,425)	(186,297)
Financial assets available to meet general expenditures within one year	\$ 789,852	\$ 724,540

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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, 2019, no amounts were drawn on the line of credit.

As of December 31, 2019, Children's was in compliance with all financial covenants required by its bond insurer, as more fully described in note 4.

#### **(y) Leases**

Children's adopted ASC 842, effective January 1, 2019 using a modified retrospective transition approach, without adjustment to the prior period comparative financial information. Accordingly, the 2018 presentation is in accordance with the previous accounting guidance. ASC 842 requires lessees to recognize leases on the consolidated balance sheet and disclose key information about leasing arrangements. The new standard establishes a right-of-use (ROU) model that requires a lessee to recognize an ROU asset and lease liability on the consolidated balance sheet for all leases with a term longer than 12 months. Leases are classified as finance or operating, with classification affecting the pattern and classification of the expense recognition in the consolidated statement of operations and changes in net assets. In adopting and applying the standard, Children's elected to adopt the package of practical expedients, including not reassessing past lease accounting, not separating lease components from nonlease components, and not reassessing previously capitalized initial direct costs. As of January 1, 2019, Children's recorded ROU assets of \$43,000 and a corresponding leasing obligation of the same amount.

Children's determines if an arrangement is or contains a lease at contract inception. Children's recognizes an ROU asset and a lease liability at the lease commencement date if the lease period exceeds one year. Leases less than one year are expensed monthly as incurred.

For operating leases, the lease liability is initially and subsequently measured at the present value of the unpaid lease payments at the lease commencement date. For finance leases, the lease liability is initially measured in the same manner and date as for operating leases and is subsequently measured at amortized cost using the effective-interest method.

Key estimates and judgments include how Children's determines (1) the discount rate it uses to discount the unpaid lease payments to present value, (2) lease term, and (3) lease payments.

ASC 842 requires a lessee to discount its unpaid lease payments using the interest rate implicit in the lease or, if that rate cannot be readily determined, its incremental borrowing rate. Children's uses its incremental borrowing rate as the discount rate for the leases.

The lease term for all of Children's leases includes the noncancelable period of the lease plus any additional periods covered by either a Children's option to extend (or not to terminate) the lease that Children's is reasonably certain to exercise or an option to extend (or not to terminate) the lease controlled by the lessor.

Lease payments included in the measurement of the lease liability comprise the following:

- Fixed payments
- Variable lease payments that depend on an index or rate

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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- Amounts expected to be payable under a Children's provided residual value guarantee
- The exercise price of a Children's option to purchase the underlying asset if Children's is reasonably certain to exercise the option

The ROU asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for lease payments made at or before the lease commencement date, plus any initial direct costs incurred less any lease incentives received.

For operating leases, the ROU asset is subsequently measured throughout the lease term at the carrying amount of the lease liability, plus initial direct costs, plus (minus) any prepaid (accrued) lease payments, less the unamortized balance of lease incentives received. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

Children's monitors for events or changes in circumstances that require a reassessment of one of its leases. When a reassessment results in the remeasurement of a lease liability, a corresponding adjustment is made to the carrying amount of the corresponding ROU asset unless doing so would reduce the carrying amount of the ROU asset to an amount less than zero. In that case, the amount of the adjustment that would result in a negative ROU asset balance is recorded in profit or loss.

Operating lease ROU assets are presented as operating lease right of use assets on the consolidated statement of financial position. The current portion and long-term portion of operating lease liabilities are presented separately as operating lease liabilities on the consolidated statement of financial position.

#### **(z) Reclassifications**

Certain 2018 amounts have been reclassified to conform to 2019 presentation.

**CHILDREN'S HEALTH CARE**

Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

**(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, 2019 and 2018 is shown below:

	<b>2019</b>	<b>2018</b>
Fixed income securities	\$ 162,771	158,481
Corporate equities	117,926	84,533
Foreign investments	140,095	103,909
Investments measured at net asset value	442,869	380,494
Perpetual trusts held by others	4,295	3,825
Interest and dividends receivable	432	475
Total	\$ 868,388	731,717
Investments are reported as:		
Short-term investments	\$ 9,263	23,043
Short-term investments, board-designated	133	78
Funds held by trustee	3,131	3,083
Long-term investments	738,223	597,560
Board-designated investments	117,638	107,953
Total	\$ 868,388	731,717

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

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

As of December 31, 2019 and 2018, the following schedule summarizes the investment gains (losses) and its classification in the consolidated statements of operations and changes in net assets:

	2019	2018
Investment earnings in net assets without donor restrictions:		
Interest and dividend income	\$ 37,219	29,461
Net realized (losses) gains on investments	(3,252)	4,039
Net unrealized gains (losses) on investments	55,607	(33,406)
Total	89,574	94
Investment earnings in net assets with donor restrictions:		
Interest and dividend income	2,566	2,130
Net realized (losses) gains on investments	(461)	40
Net unrealized gains (losses) on investments	4,189	(2,846)
Total	6,294	(676)
Total investment gains (losses)	\$ 95,868	(582)
Reported within:		
Other operating revenue	\$ 156	84
Investment income and realized gains	33,811	33,416
Net unrealized (losses) gains on investments	55,607	(33,406)
Changes in net assets with donor restrictions	6,294	(676)
Total investment gains (losses)	\$ 95,868	(582)

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.

#### **(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.

#### **(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 HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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 \$25,883 and \$20,748 as of December 31, 2019 and 2018, 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 (\$5,135) and \$4,985 for the years ended December 31, 2019 and 2018, respectively. Children's recognized \$2,688 and \$3,235 as interest costs in financing costs expense related to these swap agreements during the years ended December 31, 2019 and 2018, respectively.

The notional amounts and interest rates of the interest rate swaps at December 31, 2019 and 2018 are as follows:

<u>Swap agreement</u>	<u>Fair value</u>	<u>Change in fair value</u>	<u>Current notional amount</u>	<u>Rate paid</u>	<u>Rate received</u>
As of December 31, 2019:					
2004A	\$ (3,780)	(588)	17,025	4.127%	1.578%
2004B	(1,913)	84	19,500	4.266	1.578
2007A1	(10,093)	(2,315)	43,400	3.518	1.511
2007A2	(10,097)	(2,316)	43,425	3.518	1.511
	<u>\$ (25,883)</u>	<u>(5,135)</u>	<u>123,350</u>		
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>		

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

#### **(d) Fair Value of Financial Instruments**

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

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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.

Financial assets and liabilities measured at fair value on a recurring basis at December 31, 2019 and 2018 are summarized in the following tables by type of inputs applicable to the fair value measurements:

	Fair value			
	Level 1	Level 2	Level 3	Total
As of December 31, 2019:				
Cash and cash equivalents	19,106	—	—	19,106
Investments:				
Fixed-income securities:				
Money market and short-term bond funds	\$ 10,240	15,799	—	26,039
Municipal bond fund	19	—	—	19
Closed-end bond funds	—	86,002	—	86,002
Mortgage-backed securities	—	5	—	5
Investment grade corporate bonds	43,125	7,581	—	50,706
Total fixed-income securities	53,384	109,387	—	162,771
Corporate equities:				
Large cap	36	—	60	96
Mid cap	34,435	—	—	34,435
Small cap	24,042	—	—	24,042
Closed-end equity funds	54,162	—	—	54,162
Equity futures options	33	—	—	33
Equity index funds	—	5,158	—	5,158
Total corporate equities	112,708	5,158	60	117,926

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

	Fair value			
	Level 1	Level 2	Level 3	Total
Foreign investments:				
Foreign bonds	\$ —	11,135	—	11,135
Foreign equities	128,960	—	—	128,960
Total foreign investments	128,960	11,135	—	140,095
Total investments measured at net asset value*				442,869
Perpetual trusts held by others	—	4,295	—	4,295
Interest and dividends receivable	432	—	—	432
Total investments	\$ 295,484	129,975	60	868,388
Fair value of interest rate swaps liability	\$ —	25,883	—	25,883

  

	Fair value			
	Level 1	Level 2	Level 3	Total
As of December 31, 2018:				
Cash and cash equivalents	12,834	—	—	12,834
Investments:				
Fixed-income securities:				
Money market and short-term bond funds	\$ 15,037	25,120	—	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	61,997	96,484	—	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

**CHILDREN'S HEALTH CARE**

Notes to the Consolidated Financial Statements

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	Fair value			
	Level 1	Level 2	Level 3	Total
Foreign investments:				
Foreign bonds	\$ 592	5,357	—	5,949
Foreign equities	97,960	—	—	97,960
Total foreign investments	98,552	5,357	—	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	\$ 245,497	105,666	60	731,717
Fair value of interest rate swaps liability	\$ —	20,748	—	20,748

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

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.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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For certain investments, Children's utilizes net asset value as a practical expedient to fair value. Investments measured at net asset value at December 31, 2019 and 2018 are summarized in the following tables:

	<u>Net asset value</u>	<u>Redemption frequency</u>	<u>Redemption notice</u>	<u>Unfunded commitments</u>
As of December 31, 2019:				
Commingled funds (a)	\$ 87,281	Daily	10 Days	—
Limited partnerships (b)				
Private credit	46,021	None	None	48,709
	499	> 18 months	None	—
	21,693	Within 12 months	None	2,613
Private equity	111,015	None	None	35,729
			within 2	—
	20,259	Monthly (at discretion of Trust)	business days of month-end of repurchase date	
Multi-strategy mandate hedge fund (c)	39,046	Monthly	10 Days	—
	840	Quarterly	Quarterly in advance	—
	96,764	Monthly	Monthly	—
Single-strategy mandate hedge fund (d)	11,204	Quarterly	Quarterly	13,405
		3-year lock, then quarterly	90 day notice	—
	<u>8,247</u>			
	<u>\$ 442,869</u>			
	<u>Net asset value</u>	<u>Redemption frequency</u>	<u>Redemption notice</u>	<u>Unfunded commitments</u>
As of December 31, 2018:				
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 months	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-year lock	90 days	N/A
Single mandate hedge fund (d)	16,217	None	None	8,389
	<u>\$ 380,494</u>			

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

- (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. It is estimated that the underlying assets of these funds will be liquidated over the next 1 to 15 years.
- (c) Multi-strategy mandate 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.
- (d) Single-strategy mandate 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 2019 or 2018.

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

Land, buildings, and equipment at December 31, 2019 and 2018 consisted of the following:

	2019	2018
Land	\$ 13,999	14,001
Buildings and building improvements	484,301	479,463
Furniture, fixtures, and equipment	346,634	324,049
Construction in progress	117	1,048
Land, buildings, and equipment – gross	845,051	818,561
Less accumulated depreciation	(516,891)	(476,030)
Land, buildings, and equipment – net	\$ 328,160	342,531

The construction in progress at December 31, 2019 and 2018 relates to various equipment that has been received but not yet put into service and a large system implementation.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

There was no interest capitalized on construction for the years ended December 31, 2019 or 2018.

Depreciation expense for the years ended December 31, 2019 and 2018 was \$44,011 and \$43,959, respectively.

#### (4) Long-Term Debt

Long-term debt at December 31, 2019 and 2018 consisted of the following:

	2019	2018
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	\$ 10,000	11,400
Health Care Revenue Bonds, Series 2004A, interest rate at a variable rate, due through August 15, 2034 (average of 1.195% for 2019; 1.344% for 2018)	17,025	17,850
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	15,850	16,700
Health Care Revenue Bonds, Series 2004B, interest rate at a variable rate, due through August 15, 2025 (average of 1.228% for 2019; 1.354% for 2018)	19,500	22,275
Health Care Revenue Bonds, Series 2007A, interest rate at a variable rate, due through August 15, 2037 (average of 1.195% for 2019; 1.344% for 2018)	86,825	88,975
Health Care Revenue Bonds, Series 2010A, remaining fixed interest rate range from 4.0% to 5.25%, due in installments through August 15, 2035	26,295	27,840
Total long-term debt	175,495	185,040
Less:		
Unamortized bond premiums and discounts	(317)	(317)
Unamortized bond issuance costs	(2,440)	(2,343)
Current maturities	(9,657)	(9,297)
Long-term portion	\$ 163,081	173,083

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

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

Guaranty Ltd., which is currently rated AA with a stable outlook by Standard & Poor's and A2 with a stable outlook by Moody's Investors Service.

The Obligated Group must meet certain financial covenants required by the bond insurer and is limited in the amount of additional variable-rate indebtedness that can be incurred under Supplemental Indenture No. 7, dated March 1, 2010, to the Master Trust Indenture. The financial covenants include debt service coverage ratios, liquidity ratios, and capitalization ratios. The Obligated Group was in compliance with all covenants at December 31, 2019 and 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, 2021 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, 2019 and 2018, were as follows:

	<u>2019</u>	<u>2018</u>
Bond interest fund	\$ 1,055	1,082
Bond principal fund	<u>2,076</u>	<u>2,001</u>
Funds held by trustee	<u>\$ 3,131</u>	<u>3,083</u>

The funds are available to meet debt service.

**CHILDREN'S HEALTH CARE**

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Aggregate annual maturities of long-term debt for each of the five years as of December 31, 2019 and thereafter, are as follows:

Year ending December 31:		
2020	\$	9,905
2021		10,310
2022		10,720
2023		11,135
2024		11,580
Thereafter		<u>121,845</u>
Total	\$	<u><u>175,495</u></u>

**(5) Net Assets With Donor Restrictions**

Net assets with donor restrictions are restricted for the following purposes and/or periods at December 31, 2019 and 2018:

	<b>2019</b>	<b>2018</b>
Donor-restricted endowments subject to spending policy and appropriation to support the following purposes:		
Program activities	\$ 26,298	23,252
Health education and research	20,128	16,742
Community service	<u>3,404</u>	<u>3,116</u>
	<u>49,830</u>	<u>43,110</u>
Perpetual trusts, distributions available to support the following purposes:		
Program activities	2,447	2,175
Health education and research	<u>1,848</u>	<u>1,650</u>
	<u>4,295</u>	<u>3,825</u>
Subject to expenditure for specified purpose:		
Program activities	12,786	15,744
Purchases of buildings and equipment	4,044	4,338
Health education and research	1,671	2,641
Community service	<u>1,573</u>	<u>1,852</u>
Total	<u>20,074</u>	<u>24,575</u>
Total net assets with donor restrictions	<u><u>\$ 74,199</u></u>	<u><u>71,510</u></u>

**CHILDREN'S HEALTH CARE**

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

	<u>2019</u>	<u>2018</u>
Quasi-endowment, subject to spending policy and appropriation to support the following purposes:		
Program activities	\$ <u>117,771</u>	<u>108,031</u>
	\$ <u>117,771</u>	<u>108,031</u>

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, 2019 and 2018 were released from donor restrictions by incurring expenses or by making capital expenditures satisfying the restricted purposes of the following:

	<u>2019</u>	<u>2018</u>
Department uses	\$ 7,256	7,408
Purchases of buildings and equipment	1,165	1,114
Health education and research	1,848	1,292
Community service	<u>1,786</u>	<u>1,355</u>
Total	\$ <u>12,055</u>	<u>11,169</u>

**(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

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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expenditure by Children's in a manner consistent with donor intent and the standard of prudence prescribed by UPMIFA.

	<b>Without donor restrictions</b>	<b>With donor restrictions</b>	<b>Total</b>
Year ended December 31, 2019:			
Endowment net assets – beginning of year	\$ 108,031	46,934	154,965
Investment returns:			
Investment gains (losses)	5,801	2,283	8,084
Net unrealized (losses) gains	8,435	3,541	11,976
Change in value of perpetual trusts held by others	—	470	470
Total investment returns	14,236	6,294	20,530
Contributions	—	2,538	2,538
Appropriations of endowment assets for expenditure	(4,496)	(1,641)	(6,137)
Endowment net assets – end of year	\$ 117,771	54,125	171,896
	<b>Without donor restrictions</b>	<b>With donor restrictions</b>	<b>Total</b>
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)
Contributions	—	2,683	2,683
Appropriations of endowment assets for expenditure	(4,296)	(1,595)	(5,891)
Endowment net assets – end of year	\$ 108,031	46,934	154,965

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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**(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, 2019 and 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 this amount. In 2019 and 2018, 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 2019 and 2018 were \$4,716 and \$4,571, respectively. CHIN insures Children's for hospital professional liability for \$1,000 for each claim and \$4,000 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 \$3,747 and \$3,570 at December 31, 2019 and 2018, 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 HEALTH CARE

### Notes to the Consolidated Financial Statements

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

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

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

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

The Children's Health Care RSVP Retirement Plan (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.

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, 2019 were \$3,752, 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 \$717 for the year ended December 31, 2019, 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 the Consolidated Financial Statements

December 31, 2019 and 2018

The information for the defined-benefit pension plan as of and for the years ended December 31, 2019 and 2018 is as follows:

	<b>RSVP Plan</b>	<b>RSVP II Plan</b>	<b>RSVP Plan</b>	<b>RSVP II Plan</b>
	<b>Jan. 1, 2019–</b>	<b>Jan. 1, 2019–</b>	<b>Jan. 1, 2018–</b>	<b>Nov. 1, 2018–</b>
	<b>Dec. 31, 2019</b>	<b>Dec. 31, 2019</b>	<b>Dec. 31, 2018</b>	<b>Dec. 31, 2018</b>
Change in benefit obligation:				
Obligation – beginning of year	\$ 1,059	32,868	94,322	—
Interest cost	—	1,273	2,891	239
Plan settlements	(1,020)	(2,732)	(61,841)	—
Actuarial (gain) loss	(15)	990	(1,426)	306
Benefit payments	(24)	(646)	(463)	(101)
Plan asset transfer (out) in	—	—	(32,424)	32,424
Obligation – end of year	\$ —	31,753	1,059	32,868
	<b>RSVP Plan</b>	<b>RSVP II Plan</b>	<b>RSVP Plan</b>	<b>RSVP II Plan</b>
	<b>Jan. 1, 2019–</b>	<b>Jan. 1, 2019–</b>	<b>Jan. 1, 2018–</b>	<b>Nov. 1, 2018–</b>
	<b>Dec. 31, 2019</b>	<b>Dec. 31, 2019</b>	<b>Dec. 31, 2018</b>	<b>Dec. 31, 2018</b>
Change in plan assets:				
Fair value of plan assets – beginning of year	\$ 886	31,149	79,864	—
Employer contributions	200	2,300	14,762	—
Plan settlements	(1,020)	(2,732)	(61,841)	—
Benefit payments	(24)	(646)	(463)	(101)
Actual return on plan assets	(42)	1,398	(155)	(31)
Plan asset transfer (out) in	—	—	(31,281)	31,281
Fair value of plan assets – end of year	—	31,469	886	31,149
Net amount recognized:				
Current portion (included in accrued salaries, wages, and benefits)	—	—	—	—
Long-term portion (included in other long-term liabilities)	—	(284)	(173)	(1,719)
Funded status – end of year	—	(284)	(173)	(1,719)
Accumulated benefit obligation	\$ —	31,753	1,059	32,868

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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Components of net periodic benefit cost for the plan for 2019 and 2018 are as follows:

	<b>RSVP Plan Jan. 1, 2019– Dec. 31, 2019</b>	<b>RSVP II Plan Jan. 1, 2019– Dec. 31, 2019</b>	<b>RSVP Plan Jan. 1, 2018– Dec. 31, 2018</b>	<b>RSVP II Plan Nov. 1, 2018– Dec. 31, 2018</b>
Interest cost	—	1,273	2,891	239
Expected return on plan assets	—	(904)	(2,090)	(155)
Settlement loss	231	486	11,663	—
Amortization of loss	—	34	189	8
Net periodic pension cost	<u>231</u>	<u>889</u>	<u>12,653</u>	<u>92</u>

Components of RSVP plan related changes other than net periodic plan expense for 2019 and 2018 are as follows:

	<b>RSVP Plan Jan. 1, 2019 – Dec. 31, 2019</b>	<b>RSVP II Plan Jan. 1, 2019 – Dec. 31, 2019</b>	<b>RSVP Plan Jan. 1, 2018 – Dec. 31, 2018</b>	<b>RSVP II Plan Nov. 1, 2018 – Dec. 31, 2018</b>
Net (loss) gain arising during year	\$ (27)	(497)	323	(1,635)
Amortization of loss	231	521	11,852	8
Impact of spin termination on allocations	—	—	3,730	(3,730)
Total	<u>\$ 204</u>	<u>24</u>	<u>15,905</u>	<u>(5,357)</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, 2019 and 2018 is as follows:

	<b>RSVP Plan Jan. 1, 2019– Dec. 31, 2019</b>	<b>RSVP II Plan Jan. 1, 2019– Dec. 31, 2019</b>	<b>RSVP Plan Jan. 1, 2018– Dec. 31, 2018</b>	<b>RSVP II Plan Nov. 1, 2018– Dec. 31, 2018</b>
Amortization of loss	\$ —	(5,333)	(204)	(5,357)

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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Weighted average assumptions used to determine the benefit obligations and net periodic benefit costs at December 31, 2019 and 2018 are as follows:

	<b>RSVP Plan</b> <b>Jan. 1, 2019–</b> <b>Dec. 31, 2019</b>	<b>RSVP II Plan</b> <b>Jan. 1, 2019–</b> <b>Dec. 31, 2019</b>	<b>RSVP Plan</b> <b>Jan. 1, 2018–</b> <b>Dec. 31, 2018</b>	<b>RSVP II Plan</b> <b>Nov. 1, 2018–</b> <b>Dec. 31, 2018</b>
Discount rate – benefit obligation	N/A	3.29%	N/A	4.28%
Discount rate – net periodic benefit cost	N/A	4.28	3.55/4.43%	4.43
Rate of compensation increase	N/A	N/A	N/A	N/A
Expected return on plan assets	N/A	3.00	3.00	3.00

Children's pension plan asset allocation at December 31, 2019 and 2018 by asset category is as follows:

	<b>Plan assets</b>	
	<b>2019</b>	<b>2018</b>
Cash and cash equivalents	10 %	24 %
Synthetic equity strategy investments	—	—
Fixed income investments	90	76
Mutual funds	—	—
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 the Consolidated Financial Statements

December 31, 2019 and 2018

Children's pension plan investments measured at fair value on a recurring basis at December 31, 2019 and 2018 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, 2019:			
Cash, cash equivalents, and accrued interest	\$ 3,207	—	3,207
Fixed income investments:			
Investment grade	—	—	—
U.S. government agency and municipal issues	—	28,262	28,262
Total fixed income investments	—	28,262	28,262
Total pension plan investments	\$ 3,207	28,262	31,469
	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

See note 2 for discussion over the fair value hierarchy, fair value inputs, and valuation methodologies used at December 31, 2019 and 2018.

Children's made no transfers between levels during 2019 or 2018.

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### Notes to the Consolidated Financial Statements

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Benefits expected to be paid through the defined-benefit pension plans, by year, as of December 31, 2019 are as follows:

2020	\$	2,734
2021		2,618
2022		2,023
2023		2,110
2024		2,124
Subsequent five years		8,367

Children's does not expect to make a contribution to the RSVP II Plan during 2020. The estimated net actuarial loss for the plan that will be amortized from unrestricted net assets into net periodic benefit cost during 2020 is \$72.

The long-term rate of return on assets reflected in the 2019 expense was 3.0%. The rate is determined based on Children's asset allocation during 2019 of 10.0% cash and cash equivalents and 90.0% 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, 2019 is outlined in the table below. The "EIN/Pension Plan Number" column provides the Employee Identification Number (EIN) and the three-digit plan number. The zone status is based on information that Children's received from the plan and is certified by the plan's actuary. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are less than 80% funded, and plans in the green zone are at least 80% funded. The "FIP/RP Status Pending/Implemented" column indicates plans for which a financial improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented. The last column lists the expiration date of the collective bargaining agreement to which

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

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the plans are subject. There have been no significant changes that affect the comparability of 2019 and 2018 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			
		2019	2018		2019	2018		
Twin City Hospitals – Minnesota Nurses Association Pension Plan	41-6184922/001	Green	Green	Implemented	\$ 11,996	13,985	No	5/31/2022
Other funds	—	—	—	—	663	648	—	—
Total contributions					\$ 12,659	14,633		

(a) The plan's funding level on January 1, 2019 is determined based on the actual December 31, 2018 asset values and projected liabilities as of January 1, 2019 that are a rollforward of liabilities from the previous valuation date of January 1, 2018, assuming no actuarial gains/losses occur during the period.

In January 2020, Children's contributed \$14,091 to the Twin City Hospitals – Minnesota Nurses Association Pension Plan, which is Children's proportionate share of the minimum 2020 contribution requirement according to the collective bargaining agreement. Children's expects to make an additional contribution of approximately \$1,000 during 2020.

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, 2019 and 2018. At the date the consolidated financial statements were issued, Form 5500 was not available for the plan year ended in 2019.

#### (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, 2019 and 2018 are as follows:

	2019	2018
Change in benefit obligations:		
Obligation – beginning of year	\$ 2,530	3,810
Service cost	98	162
Interest cost	106	133
Net loss (gain)	538	(1,369)
Benefit payments	(150)	(206)
Obligation included in other long-term liabilities – end of year	\$ 3,122	2,530

For the 2019 postretirement benefit obligation, certain actuarial assumptions were changed from 2018, including the discount rate, mortality assumptions, retirement rates, and termination rates. Children's recognizes these gains and losses in the year the assumptions are changed.

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### Notes to the Consolidated Financial Statements

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The discount rate used in determining the accrued postretirement liability was 3.2% for 2019 and 4.2% for 2018. For measurement purposes, a 6.5% annual rate increase in the cost of covered healthcare benefits was assumed for 2019; the rate was assumed to decrease by 0.5% per year for three years beginning in 2023, reaching 5.0% in 2025 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	\$ 400	(338)
Sum of service cost and interest cost	35	(29)

#### **(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 \$15,248 and \$15,077 for the 12 months ended December 31, 2019 and 2018, 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, 2019, there were 14 executives and 152 employed physicians active in the plan. The liability for these plans at December 31, 2019 and 2018 was \$7,341 and \$6,710, respectively, of which \$4,785 and \$4,063 were included in other long-term liabilities and \$2,556 and \$2,646 were included in accrued salaries, wages, and benefits in the consolidated statements of financial position.

## CHILDREN'S HEALTH CARE

Notes to the Consolidated Financial Statements

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### (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, 2019 and 2018 are as follows:

	Year ended December 31, 2019			
	Program	G&A	Fundraising	Total
Salaries, wages, and employee benefits	\$ 480,759	70,063	3,169	553,991
Professional fees and purchased services	97,973	30,664	1,099	129,736
Supplies	106,312	908	48	107,268
Facilities	15,631	1,626	—	17,257
Depreciation and amortization	34,939	9,949	102	44,990
Financing costs	7,586	—	—	7,586
Health services taxes	28,308	—	9	28,317
Other	36,321	13,023	5,151	54,495
Total expenses	<u>\$ 807,829</u>	<u>126,233</u>	<u>9,578</u>	<u>943,640</u>

	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	<u>\$ 776,244</u>	<u>113,393</u>	<u>8,662</u>	<u>898,299</u>

### (9) Income Taxes

The IRS has determined that Children's and its subsidiaries, except for CHN and CHME, which are taxable not-for-profit corporations under the Minnesota Not-for-profit 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 ASC Subtopic 740-10, *Income Taxes – Overall*, Children's recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements December 31, 2019 and 2018

Management determined there were no material income tax positions for the years ended December 31, 2019 or 2018. Children's is not subject to an income tax examination for years before 2015.

#### (10) Other Assets

Other assets for the years ended December 31, 2019 and 2018 consist of the following:

	<b>2019</b>	<b>2018</b>
Investments in unconsolidated joint ventures	\$ 46,631	45,810
Deferred compensation	7,341	6,710
Foundation long-term pledges receivable – restricted	6,112	8,660
Other	16,564	14,489
Total other assets	\$ 76,648	75,669

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:

	<b>Percentage ownership</b>	<b>Equity investment</b>		<b>Share of net earnings (loss)</b>	
		<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
HealthEast Woodwinds Hospital Diagnostic Treatment Center	20 %	10,299	9,820	3,352	4,630
Critical Care Services, Inc. (d/b/a Life Link III)	10	4,204	3,695	509	66
Health System Cooperative Laundries	6	749	745	4	(31)
Mother Baby Pavilion, LLC	50	22,822	24,050	(1,228)	(1,234)
Other	Various	509	500	9	—
		<b>38,583</b>	<b>38,810</b>	<b>2,646</b>	<b>3,431</b>

Children's received \$2,309 and \$3,838 in distributions from joint ventures for the years ended December 31, 2019 and 2018, respectively.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

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	
	2019	2018
Total assets	\$ 130,503	124,103
Total liabilities	22,630	24,302
Total net assets	107,873	99,801
Total revenue	182,629	175,369
Total operating expenses	162,442	153,897
Excess of revenues over expenses	20,187	21,472

Investments accounted for under the cost method were \$8,048 and \$7,000 at December 31, 2019 and 2018, respectively, 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 \$3,547. As of December 31, 2019, Children's has a letter of credit in the amount \$3,974 to meet this requirement.

##### (d) *Other Contractual Commitments*

Children's maintains various long-term, noncancelable contractual commitments with certain vendors for ongoing system maintenance and general business support. As of December 31, 2019 and 2018, commitments under these arrangements were \$35,861 and \$43,092, respectively.

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

#### (12) Other Long-Term Liabilities

Other long-term liabilities for the years ended December 31, 2019 and 2018 consist of the following:

	2019	2018
RSVP retirement plan	\$ 284	1,892
Other benefit plans	8,012	6,728
Self insured reserves	5,164	4,813
Deferred revenue	2,820	12,693
Other	1,072	1,206
Total other long-term liabilities	\$ 17,352	27,332

#### (13) 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.

The weighted average terms of operating leases were 9.4 years for the year ended December 31, 2019. The weighted average discount rate of operating leases was 3.5% for the year ended December 31, 2019.

Children's incurred operating lease expense of \$6,955 and \$8,610 for the years ended December 31, 2019 and 2018, respectively. Short-term lease cost for the year ended December 31, 2019 was \$171. Operating cash flows from operating leases were \$7,198 for the year ended December 31, 2019. Sublease rental income for the year-ended December 31, 2019 was \$1,695.

Maturities of operating lease liabilities as of December 31, 2019 are as follows:

2020	\$	6,917
2021		6,792
2022		6,857
2023		6,570
2024		6,016
Thereafter		26,203
Total future minimum lease payments		59,355
Less imputed interest		(9,384)
Total lease liabilities	\$	49,971

## CHILDREN'S HEALTH CARE

### Notes to the Consolidated Financial Statements

December 31, 2019 and 2018

Future minimum lease payments to be received as lessor under sublease arrangements as of December 31, 2019 are as follows:

2020	\$	1,603
2021		1,520
2022		1,308
2023		1,032
2024		637
Thereafter		<u>530</u>
	\$	<u><u>6,630</u></u>

Prior to the adoption of ASC 842, aggregate future minimum lease payments required under operating lease agreements in effect on December 31, 2018 were as follows:

	<b>Future minimum lease payments</b>	
	<b>As lessee</b>	<b>As lessor</b>
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><u>65,597</u></u>	<u><u>6,847</u></u>

## **ADDITIONAL INFORMATION**

**CHILDREN'S HEALTH CARE**

Consolidating Schedule of Statement of Financial Position

December 31, 2019

(In thousands)

<b>Assets</b>	<b>Obligated group total</b>	<b>Children's Health Insurance Network, Ltd</b>	<b>Children's Health Network</b>	<b>Children's Home Medical Equipment</b>	<b>Eliminating entries</b>	<b>Consolidated total</b>
<b>Current assets:</b>						
Cash and cash equivalents	\$ 18,875	231	—	—	—	19,106
Short-term investments	9,263	—	—	—	—	9,263
Short-term investments, board-designated	133	—	—	—	—	133
Funds held by trustee	3,131	—	—	—	—	3,131
Patient accounts receivable	154,783	—	—	—	—	154,783
Prepaid expenses and other current assets	55,644	2,237	166	—	(11,629)	46,418
<b>Total current assets</b>	<b>241,829</b>	<b>2,468</b>	<b>166</b>	<b>—</b>	<b>(11,629)</b>	<b>232,834</b>
Long-term investments	725,484	12,739	—	—	—	738,223
Board-designated investments	117,638	—	—	—	—	117,638
Operating lease right of use assets, net	39,411	—	59	—	—	39,470
Other assets	76,898	—	—	—	(250)	76,648
Land, buildings, and equipment – net	328,076	—	40	44	—	328,160
<b>Total</b>	<b>\$ 1,529,336</b>	<b>15,207</b>	<b>265</b>	<b>44</b>	<b>(11,879)</b>	<b>1,532,973</b>
<b>Liabilities and Net Assets</b>						
<b>Current liabilities:</b>						
Current maturities of long-term debt	\$ 9,657	—	—	—	—	9,657
Current portion of operating lease liabilities	5,226	—	41	—	—	5,267
Accounts payable and accrued expenses	50,856	8,622	1	—	(11,629)	47,850
Accrued salaries, wages, and benefits	69,112	—	—	—	—	69,112
Other current liabilities	10,855	690	—	—	—	11,545
<b>Total current liabilities</b>	<b>145,706</b>	<b>9,312</b>	<b>42</b>	<b>—</b>	<b>(11,629)</b>	<b>143,431</b>
Intercompany accounts	3,056	—	(3,140)	84	—	—
Fair value of interest rate swaps	25,883	—	—	—	—	25,883
Other long-term liabilities	14,295	3,057	—	—	—	17,352
Long-term portion of operating lease liabilities	44,686	—	18	—	—	44,704
Long-term debt – excluding current maturities	163,081	—	—	—	—	163,081
<b>Total liabilities</b>	<b>396,707</b>	<b>12,369</b>	<b>(3,080)</b>	<b>84</b>	<b>(11,629)</b>	<b>394,451</b>
<b>Net assets:</b>						
Net assets without donor restrictions	1,058,430	2,838	3,345	(40)	(250)	1,064,323
Net assets with donor restrictions	74,199	—	—	—	—	74,199
<b>Total net assets</b>	<b>1,132,629</b>	<b>2,838</b>	<b>3,345</b>	<b>(40)</b>	<b>(250)</b>	<b>1,138,522</b>
<b>Total</b>	<b>\$ 1,529,336</b>	<b>15,207</b>	<b>265</b>	<b>44</b>	<b>(11,879)</b>	<b>1,532,973</b>

See notes to the consolidating schedules of financial statements information.

**CHILDREN'S HEALTH CARE**

Consolidating Schedule of Statement of Operations

Year ended December 31, 2019

(In thousands)

	<u>Obligated group total</u>	<u>Children's Health Insurance Network, Ltd</u>	<u>Children's Health Network</u>	<u>Children's Home Medical Equipment</u>	<u>Eliminating entries</u>	<u>Consolidated total</u>
Revenue:						
Patient service revenue	\$ 922,240	—	—	—	600	922,840
Net assets released from restrictions for operations	10,890	—	—	—	—	10,890
Other	38,002	4,716	7,261	—	(7,622)	42,357
Total revenue	<u>971,132</u>	<u>4,716</u>	<u>7,261</u>	<u>—</u>	<u>(7,022)</u>	<u>976,087</u>
Expenses:						
Salaries, wages, and employee benefits	549,525	—	4,466	—	—	553,991
Professional fees and purchased services	131,404	152	188	9	(2,017)	129,736
Supplies	107,216	—	52	—	—	107,268
Facilities	17,094	—	163	—	—	17,257
Depreciation and amortization	44,990	—	(1)	1	—	44,990
Financing costs	7,690	—	—	—	(104)	7,586
Health services taxes	28,286	—	31	—	—	28,317
Other	51,964	5,794	1,712	30	(5,005)	54,495
Total expenses	<u>938,169</u>	<u>5,946</u>	<u>6,611</u>	<u>40</u>	<u>(7,126)</u>	<u>943,640</u>
Operating income (losses)	<u>32,963</u>	<u>(1,230)</u>	<u>650</u>	<u>(40)</u>	<u>104</u>	<u>32,447</u>
Nonoperating gains (losses):						
Investment income and realized gains	33,709	102	104	—	(104)	33,811
Income on investments accounted for under the equity method	2,646	—	—	—	—	2,646
Net unrealized gains on investments	54,109	1,498	—	—	—	55,607
Change in fair value of interest rate swaps	(5,135)	—	—	—	—	(5,135)
Other components of net periodic pension cost	(1,306)	—	—	—	—	(1,306)
Total nonoperating gains	<u>84,023</u>	<u>1,600</u>	<u>104</u>	<u>—</u>	<u>(104)</u>	<u>85,623</u>
Excess (deficiency) of revenue over expenses	<u>116,986</u>	<u>370</u>	<u>754</u>	<u>(40)</u>	<u>—</u>	<u>118,070</u>
Other changes in net assets without donor restrictions:						
Net assets released from restrictions – capital acquisitions	1,165	—	—	—	—	1,165
RSVP plan-related changes other than net periodic plan expense	228	—	—	—	—	228
Other	(52)	—	—	—	—	(52)
Increase (decrease) in net assets without donor restrictions	<u>\$ 118,327</u>	<u>370</u>	<u>754</u>	<u>(40)</u>	<u>—</u>	<u>119,411</u>

See notes to the consolidating schedules of financial statements information.

## CHILDREN'S HEALTH CARE

Notes to the Consolidating Schedules of Financial Statements Information

December 31, 2019

### (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 not-for-profit corporation that is a wholly controlled affiliate; Children's Health Care Services, Inc., d/b/a Children's – Minnetonka, a Minnesota not-for-profit 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 fundraising functions and endowment management. Children's Health Insurance Network, Ltd., a Cayman Island domiciled insurance entity and Children's Minnesota Home Medical Equipment (CHME), which provides home medical equipment services, are wholly controlled affiliates of Children's and are not currently members 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 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.