



Consolidated Financial Statements as of and for the
Years Ended December 31, 2017 and 2016, and
Independent Auditors' Report



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INDEPENDENT AUDITORS' REPORT

To the Audit Committee of the Board of Trustees
Henry Ford Health System
Detroit, Michigan

We have audited the accompanying consolidated financial statements of Henry Ford Health System and affiliates (the "System"), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; 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 auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company'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 Company'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 the System as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

April 9, 2018



**CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2017 AND 2016
(In thousands)**

	<u>2017</u>	<u>2016</u>
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 774,534	\$ 828,444
Short-term investments	546	272
Patient care receivables—net of allowances of \$95,521 and \$124,399 in 2017 and 2016, respectively	334,926	279,232
Health care premium receivables	41,485	45,313
Due from third-party payors	55,815	18,657
Other current assets	217,338	212,881
Current portion of assets limited as to use	<u>45,509</u>	<u>47,822</u>
Total current assets	1,470,153	1,432,621
LONG-TERM INVESTMENTS	445,500	325,123
ASSETS LIMITED AS TO USE	1,009,027	988,664
JOINT VENTURE INVESTMENTS	24,854	23,487
INTANGIBLE AND OTHER ASSETS—Net	46,810	47,383
GOODWILL—Net of accumulated amortization of \$28,577 in 2017 and \$28,606 in 2016	14,029	14,199
PROPERTY, PLANT, AND EQUIPMENT—Net	<u>1,448,566</u>	<u>1,426,699</u>
TOTAL ASSETS	<u>\$4,458,939</u>	<u>\$4,258,176</u>

(Continued)



**CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2017 AND 2016
(In thousands)**

	<u>2017</u>	<u>2016</u>
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Short-term borrowings	\$ -	\$ 24,167
Accounts payable	267,163	236,159
Due to third-party payors	37,523	32,059
Medical claims liability	197,124	194,324
Other liabilities and accrued expenses	345,456	300,736
Current portion of capital lease payable	175	8
Current portion of long-term obligations	17,383	15,967
Current portion of malpractice and general liability	<u>37,465</u>	<u>37,261</u>
Total current liabilities	902,289	840,681
MALPRACTICE AND GENERAL LIABILITY	88,049	95,246
DEFERRED COMPENSATION, POSTRETIREMENT, AND OTHER LIABILITIES	408,885	448,522
LONG-TERM OBLIGATIONS	1,006,805	1,029,037
LONG-TERM CAPITAL LEASE PAYABLE	<u>9,517</u>	<u>4,308</u>
Total liabilities	<u>2,415,545</u>	<u>2,417,794</u>
NET ASSETS:		
Unrestricted		
Henry Ford Health System	1,785,322	1,593,299
Noncontrolling interests	<u>3,331</u>	<u>3,135</u>
Total unrestricted net assets	1,788,653	1,596,434
Temporarily restricted	140,618	137,884
Permanently restricted	<u>114,123</u>	<u>106,064</u>
Total net assets	<u>2,043,394</u>	<u>1,840,382</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$4,458,939</u>	<u>\$4,258,176</u>

See notes to consolidated financial statements.

(Concluded)



**CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016
(In thousands)**

	<u>2017</u>	<u>2016</u>
UNRESTRICTED REVENUE:		
Patient service revenue	\$3,374,869	\$3,020,851
Less provision for bad debts	<u>(99,815)</u>	<u>(69,585)</u>
Net patient service revenue	3,275,054	2,951,266
Health care premiums	2,296,229	2,413,214
Investment income	95,751	47,356
Other income	<u>309,972</u>	<u>291,453</u>
Total unrestricted revenue	<u>5,977,006</u>	<u>5,703,289</u>
EXPENSES:		
Salaries, wages, and employee benefits	2,421,415	2,232,350
Health care provider expense	1,350,827	1,445,234
Supplies	944,101	846,826
Depreciation and amortization	189,017	173,122
General and other administrative	359,267	386,452
Other contracted services	315,429	288,161
Malpractice	36,187	29,656
Plant operations	56,223	53,583
Interest expense	32,932	38,541
Repairs and maintenance	71,803	64,980
Rent and lease	<u>53,285</u>	<u>49,287</u>
Total expenses	<u>5,830,486</u>	<u>5,608,192</u>
EXCESS OF REVENUE OVER EXPENSES BEFORE UNUSUAL ITEMS	<u>146,520</u>	<u>95,097</u>
UNUSUAL ITEMS:		
Net cumulative unrealized gains transferred to trading securities (Note 1)	59,216	-
Inherent contribution of acquired net assets (Note 1)	-	240,269
Gain on sale of Midwest assets (Note 1)	-	1,696
Loss on refinancing (Note 12)	<u>-</u>	<u>(58,742)</u>
Total unusual items	<u>59,216</u>	<u>183,223</u>
EXCESS OF REVENUE OVER EXPENSES FROM CONSOLIDATED OPERATIONS	205,736	278,320
LESS EXCESS OF REVENUE OVER EXPENSES ATTRIBUTABLE TO NONCONTROLLING INTERESTS	<u>2,057</u>	<u>2,715</u>
EXCESS OF REVENUE OVER EXPENSES ATTRIBUTABLE TO HENRY FORD HEALTH SYSTEM	<u>203,679</u>	<u>275,605</u>

(Continued)



**CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016
(In thousands)**

	<u>2017</u>	<u>2016</u>
UNRESTRICTED NET ASSETS:		
Excess of revenue over expenses from consolidated operations	\$ 205,736	\$ 278,320
Net cumulative unrealized gains transferred to trading securities (Note 1)	(59,216)	-
Change in net unrealized gains and losses on investments (Note 1)	22,558	9,202
Net assets released from restrictions for capital	8,862	6,395
Acquisition of noncontrolling interest (Note 1)	-	(27,724)
Distributions to noncontrolling interests	(1,861)	(3,858)
Pension and other postretirement net adjustments	<u>16,140</u>	<u>(10,094)</u>
Increase in unrestricted net assets	<u>192,219</u>	<u>252,241</u>
TEMPORARILY RESTRICTED NET ASSETS:		
Income on restricted investments	2,470	2,449
Contributions and grants	39,371	62,126
Net cumulative unrealized gains transferred to trading securities (Note 1)	(1,395)	-
Change in net unrealized gains and losses on investments (Note 1)	6,952	3,451
Net assets released from restrictions for operations	(40,599)	(34,214)
Net assets released from restrictions for capital	(8,862)	(6,395)
Inherent contribution of acquired net assets	-	1,012
Annual spending appropriation	<u>4,797</u>	<u>4,665</u>
Increase in temporarily restricted net assets	<u>2,734</u>	<u>33,094</u>
PERMANENTLY RESTRICTED NET ASSETS:		
Income on restricted investments	9,479	3,503
Contributions and other	3,377	7,908
Inherent contribution of acquired net assets	-	721
Annual spending appropriation	<u>(4,797)</u>	<u>(4,665)</u>
Increase in permanently restricted net assets	<u>8,059</u>	<u>7,467</u>
TOTAL INCREASE IN NET ASSETS	203,012	292,802
TOTAL NET ASSETS—Beginning of year	<u>1,840,382</u>	<u>1,547,580</u>
TOTAL NET ASSETS—End of year	<u>\$ 2,043,394</u>	<u>\$ 1,840,382</u>

See notes to consolidated financial statements.

(Concluded)



**CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016
(In thousands)**

	<u>2017</u>	<u>2016</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Increase in net assets	\$ 203,012	\$ 292,802
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Provision for bad debts	99,815	69,585
Depreciation and amortization	189,017	173,122
Pension and other postretirement net adjustments	(16,140)	10,094
Curtailed gain	(13,742)	-
Amortization of bond premium and financing costs	(4,840)	-
Inherent contribution of net assets	-	(240,269)
Inherent contribution of restricted assets	-	(1,733)
Loss on refinancing	-	58,742
Gain on sale of Midwest assets	-	(1,696)
Loss (gain) on sale or disposal of assets	3,620	(471)
Goodwill impairment	170	-
Income on restricted investments	(11,949)	(5,952)
Restricted contributions and grants	(42,748)	(70,034)
Net realized and unrealized gains on investments—other than trading securities	(46,533)	(15,073)
Net realized and unrealized gains on investments—trading	(33,972)	(11,568)
Acquisition of noncontrolling interest	-	27,724
Distributions to noncontrolling interests	1,861	3,858
Change in assets and liabilities:		
Patient and health care premium receivables	(151,681)	(66,467)
Other current assets	543	4,668
Trading securities	-	(4,052)
Assets limited as to use	(28,606)	-
Joint venture investments	(1,367)	(2,566)
Other assets	(2,635)	41
Accounts payable	23,511	(1,658)
Other liabilities	36,418	15,247
Due to/from third-party payors	(31,694)	(15,090)
Medical claims liability	2,800	(47,134)
Malpractice and general liability	(6,993)	(3,838)
Net cash provided by operating activities	<u>167,867</u>	<u>168,282</u>

(Continued)



**CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016
(In thousands)**

	<u>2017</u>	<u>2016</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property	\$ (203,258)	\$ (176,555)
Proceeds from the sale or maturity of available-for-sale investments	215,115	445,319
Purchase of available-for-sale investments	(254,257)	(359,410)
Proceeds from the sale or maturity of trading securities	162,360	65,827
Purchase of trading securities	(154,261)	(35,317)
Cash acquired from business combinations	<u>-</u>	<u>41,234</u>
Net cash used in investing activities	<u>(234,301)</u>	<u>(18,902)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term obligations	-	1,003,714
Redemption of long-term obligations	-	(1,025,180)
Payments of financing costs	-	(6,678)
Proceeds from short-term borrowings	-	2,000
Payments on short-term borrowings	(24,167)	(21,698)
Payments of long-term obligations	(15,976)	(19,040)
Payments of capital lease payable	(169)	(60)
Acquisition of noncontrolling interests	-	(15,000)
Distributions to noncontrolling interests	(1,861)	(3,858)
Income on restricted investments	11,949	5,952
Restricted contributions and grants	<u>42,748</u>	<u>70,034</u>
Net cash provided by (used in) financing activities	<u>12,524</u>	<u>(9,814)</u>
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(53,910)	139,566
CASH AND CASH EQUIVALENTS—Beginning of year	<u>828,444</u>	<u>688,878</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 774,534</u>	<u>\$ 828,444</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the year for interest, including amounts capitalized of \$2,594 and \$1,059 in 2017 and 2016, respectively	<u>\$ 43,041</u>	<u>\$ 30,071</u>
Amounts accrued in property, plant, and equipment—net	<u>\$ 19,320</u>	<u>\$ 11,828</u>
Unsettled investment trades	<u>\$ 996</u>	<u>\$ 1,642</u>
Unsettled investment purchases	<u>\$ 3,020</u>	<u>\$ 2,999</u>
Cash paid for taxes	<u>\$ 6,209</u>	<u>\$ 16,645</u>
New capital lease obligation for building	<u>\$ 5,545</u>	<u>\$ -</u>

See notes to consolidated financial statements.

(Concluded)



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016**

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Organization—Henry Ford Health System (the “Corporation”) and its affiliates (collectively, the “System”) constitute a comprehensive health care system offering health care to the people of southeastern and south-central Michigan. The System provides medical, surgical, psychiatric, and rehabilitative services in inpatient and outpatient settings; conducts research activities; and engages in the education and training of residents, nurses, and allied health professionals. The System includes one of the nation’s largest employed physician group practices. A significant portion of the System’s revenues is derived through its health maintenance organization (HMO) and its subsidiaries.

The Corporation is a Michigan not-for-profit corporation that operates Henry Ford Hospital, Henry Ford Medical Group, Henry Ford West Bloomfield Hospital, Henry Ford Kingswood Hospital, and Community Care Services, each of which is an operating division of the Corporation that is not separately incorporated.

The Corporation is the parent and sole member or shareholder of Henry Ford Wyandotte Hospital (“Wyandotte”); Henry Ford Macomb Hospital Corporation (“Macomb”); Henry Ford Allegiance Health Group and Affiliates (“Allegiance Health Group and Affiliates”); Health Alliance Plan of Michigan (HAP); Henry Ford Health System Foundation (the “Foundation”); Henry Ford OptimEyes; Henry Ford Physician Network (HFPN); Henry Ford Physicians Accountable Care Organization, L.L.C.; HFHS-SCA Holdings, L.L.C.; Henry Ford Innovation Institute; Henry Ford Health System Government Affairs Services (HFGA); Onika Insurance Company Ltd. (“Onika”); Sha Realty; and Neighborhood Development, L.L.C.

HAP has the following wholly owned subsidiaries: HAP Preferred Incorporated (HPI); Alliance Health and Life Insurance Company (AHLIC); HAP Midwest Health Plan, Inc. (MHP); and Administration Systems Research Corporation (ASR).

Allegiance Health Group and Affiliates has the following wholly owned subsidiaries: W.A. Foote Memorial Hospital d.b.a. Henry Ford Allegiance Health (“Allegiance Health”); CareLink of Jackson, a Community-Owned Specialty Hospital d.b.a. Henry Ford Allegiance Specialty Hospital; Allegiance Health Foundation d.b.a. Henry Ford Allegiance Health Foundation; and Healthlink, Inc. and its subsidiary, Hospice of Jackson d.b.a. Henry Ford Allegiance Hospice. Allegiance Health has the following wholly owned subsidiaries: Jackson Community Medical Record, L3C; Physicians Choice Network, L.L.C.; and Jackson Health Network, L3C.

Joint ventures include Foote Health Center Associates (62% ownership), Northwest Detroit Dialysis Centers (56.25% ownership), and Macomb Regional Dialysis Centers, L.L.C. (60% ownership), which are consolidated.

On October 13, 2015, MHP was notified by the State of Michigan that effective January 1, 2016, they would no longer be a participating Medicaid plan for two key regions, 9 and 10, that represented 91.7% of MHP's membership. On November 23, 2015, the System entered into an agreement to transfer certain assets of MHP. This transaction was completed on January 1, 2016, and resulted in a gain of \$1,696,000.

On February 1, 2016, HAP completed the merger, which was accounted for as an acquisition, with HealthPlus of Michigan (HPM) pursuant to the Agreement and Plan of Merger dated October 30, 2015, and the order approving acquisitions as approved by the State of Michigan Department of Insurance and Financial Services. The fair value of the assets acquired exceeded the liabilities assumed resulting in an inherent contribution of \$18,459,000, which was recorded during the year ended December 31, 2016.

Summarized consolidated opening balance sheet information for HPM as of the acquisition date is shown below (in thousands):

Cash and cash equivalents	\$ 27,576	Accounts payable	\$ 23,808
Health care premium receivables	5,907	Medical claims liability	68,041
Other current assets	25,373	Other liabilities and	
Long-term investments	26,638	accrued expenses	9,950
Assets limited to use	1,000	Deferred compensation,	
Intangible and other assets	27,950	postretirement, and	
Property, plant, and equipment	<u>7,098</u>	other liabilities	<u>1,284</u>
Total assets acquired	<u>\$ 121,542</u>	Total liabilities assumed	<u>\$ 103,083</u>

The operating results of HPM for the period February 1, 2016, through December 31, 2016, included total unrestricted revenue of \$331,675,000, the majority of which is health care premiums, and excess of revenue over expenses before unusual items of \$6,897,000.

On April 1, 2016, Allegiance Health Group and Affiliates merged with the System, which was accounted for as an acquisition. Allegiance Health Group and Affiliates, headquartered in Jackson, Michigan, operates an acute care facility and has more than 40 sites offering a wide array of primary and specialty care and represents a significant geographic expansion of the System's health care provider operations beyond southeastern Michigan. The fair value of the assets acquired exceeded the liabilities assumed resulting in an inherent contribution of \$221,810,000, which was recorded during the year ended December 31, 2016.

Summarized consolidated opening balance sheet information for Allegiance Health Group and Affiliates as of the acquisition date is shown below (in thousands):

Cash and cash equivalents	\$ 13,658	Short-term borrowings	\$ 14,698
Patient care receivables	46,431	Accounts payable	15,540
Other current assets	22,819	Due to third-party payors	4,694
Current portion of assets limited as to use	3,132	Other liabilities and accrued expenses	42,797
Assets limited as to use	270,941	Current portion of long-term obligations	5,209
Joint venture investments	5,601	Current portion of malpractice and general liability	3,132
Intangible and other assets	1,183	Malpractice and general liability	8,145
Property, plant, and equipment	161,018	Deferred compensation, postretirement, and other liabilities	53,098
		Long-term obligations	<u>153,927</u>
Total assets acquired	<u>\$ 524,783</u>	Total liabilities assumed	<u>\$ 301,240</u>
		Temporarily restricted net assets	\$ 1,012
		Permanently restricted net assets	<u>721</u>
		Total restricted net assets acquired	<u>\$ 1,733</u>

The operating results of Allegiance Health Group and Affiliates for the period April 1, 2016, through December 31, 2016, included total unrestricted revenue of \$414,789,000, the majority of which is patient service revenue, and excess of revenue over expenses before unusual items of \$2,492,000.

In connection with HAP's acquisition of ASR, ASR initially entered into an employment and stock transfer and redemption agreement (the "Agreement") with a 33% non-controlling interest (NCI) holder. Under the terms of the Agreement, the NCI holder had the right to require ASR to purchase the NCI holder's interest based upon a methodology measuring the growth in ASR related business over a three-year look back period (the "Put Option"). The Agreement obligates HAP as guarantor for ASR. On April 1, 2016, the NCI holder exercised the Put Option and HAP recorded a \$27,724,000 liability based on its calculation of the Put Option. In consideration for extending the negotiation period, HAP transferred \$15,000,000 to the NCI holder and the remaining outstanding amount owing to the NCI holder of \$12,724,000 is reflected in accounts payable in the consolidated balance sheets. The NCI holder has filed litigation against ASR and HAP disputing the value of the Put Option. (Refer to Note 14).

Basis of Presentation—The consolidated financial statements include the accounts of the System members as described above. The accounting and reporting policies of the System conform to accounting principles generally accepted in the United States of America (GAAP). All intercompany transactions have been eliminated. The preparation of the consolidated financial statements in conformity with GAAP requires that management make estimates and assumptions that affect the reported amounts. Actual results could differ from those estimates.

In connection with the Series 2016 bond issuance, the System amended and restated its 2006 Master Indenture. The Amended and Restated Master Trust Indenture (the "2016 Master Indenture") created the Henry Ford Health System Credit Group (the "Credit Group"). The Credit Group is comprised of the Henry Ford Health System Obligated Group (the "Obligated Group"), Henry Ford Health System Designated Affiliates (the "Designated Affiliates"), and Henry Ford Health System Limited Designated Affiliates (the "Limited Designated Affiliates"). The Corporation, Wyandotte, Macomb, and Allegiance Health are members of the Obligated Group. HAP (excluding its subsidiaries HPI, AHLIC, MHP, and

ASR) and the Foundation are Designated Affiliates. There are currently no Limited Designated Affiliates.

Net Patient Service Revenue, Patient Care Receivables, and Allowance for Doubtful Accounts—

Net patient service revenue is reported at the estimated net realizable amounts. Net patient service revenue associated with services provided to patients who have third-party payor coverage is reported on the basis of contractual rates for the services rendered. Reimbursement from most payors for acute inpatient and outpatient services vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Reimbursements for services to certain patients include prospectively determined per diem rates, fee schedules, and discounts from established charges. Medicare, Medicaid, and Blue Cross have cost-reimbursed items and tentative rates with final settlement determined after submission of annual cost reports and a subsequent audit or review process, and represent the major payors included in patient care receivables at December 31, 2017 and 2016. Revenues associated with health care services provided by the System to members of its HMO are included in health care premiums in the consolidated statements of operations and changes in net assets.

In evaluating the collectability of accounts receivable, the System analyzes its history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts. For receivables associated with self-pay patients (which include both patients without insurance and patients with deductible and co-payment balances due for which third-party coverage exists for a portion of the bill), the System records a provision for bad debts in the period of service on the basis of its experience. At such point in time that a billed service is believed to be uncollectible, the related receivable is written off against the allowance for doubtful accounts. Estimates of retroactive adjustments under reimbursement agreements with third-party payors are accrued in the period the related services are rendered and adjusted in future periods as final settlements are received.

The System administers a patient financial assistance policy designed to provide financial assistance for uninsured patients as well as for insured patients with limited resources. For uninsured patients who meet the qualifications stipulated in the System's patient financial assistance policy, emergency and other medically necessary inpatient and outpatient services are provided at no cost. For uninsured patients that do not qualify for financial assistance, the System offers a discount off standard rates for services provided that result in net charges that do not exceed 115% of Medicare payment rates. The accounts receivable from self-pay patients represented 12% of total accounts receivable at December 31, 2017 and 2016. Insured patients with limited financial resources may qualify for a discount on self-pay balances. The System's allowances, which are primarily related to self-pay patients, were \$95,521,000 and \$124,399,000 at December 31, 2017 and 2016, respectively. These allowances include estimates related to both presumptive eligibility for charity of \$15,993,000 and \$32,294,000 and bad debts of \$79,528,000 and \$92,105,000 at December 31, 2017 and 2016, respectively. In 2017, the System enhanced its collection policies increasing collections on previously reserved accounts, which resulted in a decrease in the allowance in the current year. The December 31, 2017 allowance reflects this improved collection experience combined with favorable payer mix in year-end patient care receivables.

Health Care Premiums—Premiums received in advance of the respective period of coverage are credited to income ratably over the period of coverage. A significant portion of HAP's customer base is concentrated in companies that are part of the automotive manufacturing industry. HAP also has a significant portion of its customer base concentrated in Medicare beneficiaries.

Contributions—Unrestricted contributions are included in the consolidated statements of operations and changes in net assets when received. Gifts of cash and other assets are reported as restricted contributions if they are received with donor stipulations that limit the use of the assets. When the restrictions expire or the purpose of the restriction is accomplished, temporarily restricted assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as other income or net assets released from restrictions for capital.

Other Income—Other income consists of assets released from restrictions, income from grants, income from contract pharmacy arrangements, administrative fees earned from HAP self-insured products, joint venture income, gift shop and cafeteria sales, parking garage fees, and other miscellaneous sources.

Performance Indicator—The consolidated statements of operations and changes in net assets include the excess of revenue over expenses from consolidated operations. Changes in unrestricted net assets, which are excluded from the excess of revenue over expenses from consolidated operations, consistent with industry practice, include net cumulative unrealized gains transferred to trading securities, change in net unrealized gains and losses on investments, net assets released from restrictions for capital, acquisition of noncontrolling interest, distributions to noncontrolling interest, and pension and other postretirement net adjustments. Certain income and expenses that are included in the performance indicator are separately presented as unusual items.

Cash and Cash Equivalents—Cash and cash equivalents consist of cash and highly liquid short-term investments (e.g., money market funds) with an original maturity of 90 days or less. Cash equivalents are stated at fair value, which approximates cost.

Short-Term Investments—Short-term investments consist primarily of fixed-income instruments with original maturities greater than 90 days and less than one year. Short-term investments are stated at fair value, which approximates cost.

Other Current Assets—Other current assets consist primarily of inventories, which are stated at the lower of cost (first-in, first-out) or market, prepaid expenses, and miscellaneous receivables.

Assets Limited as to Use—Assets limited as to use are reported at their estimated fair value or cost and include resources for which the board of trustees of the System has designated specific future uses; donor-restricted funds that arise through specific contributions to the System; loan funds held by a trustee; funds held under the bond indenture agreements; and statutory reserve requirements. The dollar amount of these assets, which are to be used to satisfy current liabilities, has been classified as a current asset.

Investments and Investment Income—Investments, inclusive of invested assets limited as to use, include marketable debt and equity securities. Investments in debt securities and investments in equity securities with readily determinable fair values are measured at fair value in the consolidated balance sheets. The System has classified all investments as trading. Hedge funds, commingled funds, and other investments structured as limited liability corporations and partnerships are valued at net asset value (NAV), which is calculated using the most recent financial statements. Private equities are accounted for on the cost basis (except for pension assets, which are recorded at fair value).

Investment income includes interest, dividends, realized gains and losses, and unrealized gains and losses. Realized gains and losses on sales of investments are computed on the specific-identification method and the average cost method and are included in investment income or income on restricted investments. Unrealized gains and losses on investments are included in investment income or income on restricted investments.

During 2016, the System acquired Allegiance Health whose investments were classified as trading securities and the System initiated an asset liability management (ALM) analysis to determine its optimal investment allocation. The ALM analysis, completed in 2017, resulted in the System shifting its investment allocation strategy away from minimally traded cash or similar safe-harbor investments toward a broadly diverse, actively managed investment structure with reasonable risk parameters. As a result of this change, effective October 1, 2017, the System elected to transfer its investments previously accounted for as available-for-sale securities to trading securities. The System determined that the trading securities category is more appropriate based on its new investment strategies and policies and all System assets will now be accounted for as trading securities. As a result, all unrealized gains and losses will be included in the excess of revenue over expenses from consolidated operations.

This change resulted in the reclassification of net cumulative unrealized gains on investments previously classified as available-for-sale securities of \$59,216,000 from the statement of changes in net assets into the consolidated statements of operations as an unusual item. This amount includes net cumulative unrealized gains on investments as of December 31, 2016, of \$36,658,000 and unrealized gains on investments for the nine-month period ended September 30, 2017, of \$22,558,000. This change also resulted in the reclassification of restricted net cumulative unrealized gains on investments previously classified as available-for-sale securities of \$1,395,000 to income on restricted investments. This amount includes net cumulative unrealized losses on investments as of December 31, 2016, of \$5,557,000 and unrealized gains on investments for the period ended September 30, 2017, of \$6,952,000.

Investment Risks—Investment securities are exposed to various risks, such as interest rate, market, and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in values in the near term could materially affect the amounts reported in the accompanying consolidated financial statements.

Fair Value of Financial Instruments—Fair value of financial instruments has been determined using available information and appropriate valuation methodologies. The fair value of assets is based on quoted market prices, dealer quotes, and prices obtained from independent sources. The fair value of liabilities is based on a discounted cash flows analysis, using interest rates currently available for the issuance of debt with similar terms and remaining maturities. Considerable judgment is required in certain circumstances to develop the estimates of fair value, and they may not be indicative of the amounts, which could be realized in a current market exchange.

Derivative Financial Instruments—The System periodically utilizes various financial instruments (e.g., options and swaps) to limit interest rate risk and guarantee income. The System's policies generally prohibit trading in derivative financial instruments on a leveraged basis.

Intangible and Other Assets—Intangible and other assets for the years ended December 31, 2017 and 2016, consisted of the following (dollars in thousands):

	<u>Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>	<u>Useful Life (Years)</u>
December 31, 2017				
Definite-lived intangible assets:				
Customer relationships	\$ 15,660	\$ 5,073	\$ 10,587	8–22
Provider relations	22,164	4,115	18,049	10–25
Reinsurance escrow	13,063	-	13,063	
Other	<u>7,298</u>	<u>2,187</u>	<u>5,111</u>	
Total	<u>\$ 58,185</u>	<u>\$ 11,375</u>	<u>\$ 46,810</u>	
December 31, 2016				
Definite-lived intangible assets:				
Customer relationships	\$ 15,660	\$ 3,468	\$ 12,192	8–22
Provider relations	22,164	2,976	19,188	10–25
Reinsurance escrow	7,178	-	7,178	
Other	<u>10,549</u>	<u>1,724</u>	<u>8,825</u>	
Total	<u>\$ 55,551</u>	<u>\$ 8,168</u>	<u>\$ 47,383</u>	

Amortization expense on intangible assets was \$3,208,000 and \$3,094,000 for the years ended December 31, 2017 and 2016, respectively.

Estimated amortization expense on intangible assets for the next five years and thereafter is as follows: \$3,076,000 in 2018, \$2,830,000 in 2019, \$2,781,000 in 2020, \$2,571,000 in 2021, \$2,359,000 in 2022, and \$16,129,000 thereafter.

Goodwill—The System evaluates goodwill for impairment as of September 30 of each year, unless conditions arise that would require a more frequent evaluation. In assessing the recoverability of goodwill, management performs a qualitative or quantitative assessment to test for impairment annually. If it is determined, on the basis of qualitative factors, that a quantitative impairment test is required, estimated future cash flows and other factors are made to determine the fair value of the respective reporting unit. If these estimates or related projections change in the future, the System may be required to record impairment charges for goodwill at that time. Impairments, if any, are charged to earnings.

Information on changes in the carrying amounts of goodwill as of December 31, 2017 and 2016, is as follows (in thousands):

	<u>2017</u>	<u>2016</u>
As of January 1:		
Goodwill	\$ 45,451	\$ 45,380
Accumulated impairment loss	<u>(31,252)</u>	<u>(31,252)</u>
Total	14,199	14,128
Goodwill acquired during the year	-	71
Impairment loss	<u>(170)</u>	<u>-</u>
Total	<u>\$ 14,029</u>	<u>\$ 14,199</u>
As of December 31:		
Goodwill	\$ 45,451	\$ 45,451
Accumulated impairment loss	<u>(31,422)</u>	<u>(31,252)</u>
Total	<u>\$ 14,029</u>	<u>\$ 14,199</u>

Impairment—The System periodically evaluates the carrying value of its long-lived assets for impairment. This evaluation is based principally on the projected, undiscounted cash flows generated by the related assets.

Property, Plant, and Equipment—Property, plant, and equipment, which includes capitalized internal-use software, is recorded at cost or fair value at the date of acquisition. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Estimated useful lives used in computing depreciation are generally 10 years for land improvements, 15 to 40 years for buildings and building improvements, and three to 15 years for equipment.

Expenditures for maintenance and repairs are charged against operations. Expenditures for betterment and major renewals that extend the useful life of an asset are capitalized and depreciated.

Medical Claims Liability—Medical claims liability consists of unpaid medical claims and other obligations resulting from the provision of health care services. It includes claims reported as of the consolidated balance sheets date and estimates, based upon historical claims experience, for claims incurred but not reported (IBNR).

Management estimates the amount of the IBNR using standard actuarial developmental methodologies based upon, but not limited to, historical data, including the period between the date services are rendered and the date claims are received and paid, as well as denied claim activity, expected medical cost inflation, seasonality patterns, and changes in membership. Management's IBNR best estimate also includes a provision for adverse deviation, which is an estimate for known environmental factors that are reasonably likely to affect the required level of IBNR reserves. This provision for adverse deviation is intended to capture the potential adverse development from known environmental factors, such as changes in current payment patterns versus historical payment patterns; potential unknown high-cost cases; providers incurring increased operating income pressure and looking to increase their net revenue

within commercial populations; increased usage of higher cost services resulting from advances in technology and pharmacologic treatments; accelerated utilization of services due to increased prevalence of high-deductible, consumer-based health plans and the general concern by covered members relating to the potential loss of health care coverage in the near future; and/or exceptional situations that require judgmental adjustments in setting the reserves for claims. There were no material changes in the amount of these reserves, or as a percent of reserve for claims and other settlements, between December 31, 2017 and 2016.

The IBNR estimation methodology has been consistently applied from period to period. Management's IBNR best estimate is made on an accrual basis and adjusted in future periods as required. Any adjustments to the prior-period estimates are included in the current period. As additional information becomes known to management, it adjusts its assumptions accordingly to change its estimate of IBNR. Therefore, if moderately adverse conditions do not occur, evidenced by more complete claims information in the following period, then management's prior-period estimates will be revised downward, resulting in favorable development. However, any favorable prior-period reserve development would increase current-period excess of revenue over expenses only to the extent that the current-period provision for adverse deviation is less than the benefit recognized from the prior-period favorable development. If moderately adverse conditions occur and are more acute than management estimated, then its prior-period estimates will be revised upward, resulting in unfavorable development, which would decrease current-period excess of revenue over expenses.

The majority of the IBNR reserve balance held at the end of each year is associated with the most recent months' incurred services, as these are the services for which the fewest claims have been paid. The degree of uncertainty in the estimates of incurred claims is greater for the most recent months' incurred services. Revised estimates for prior periods are determined each year based on the most recent updates of paid claims for prior periods. Estimates for IBNR service costs are subject to the impact of changes in the regulatory environment, economic conditions, changes in claims trends, and numerous other factors. Given the inherent variability of such estimates, the actual liability could differ significantly from the amounts estimated.

Deferred Compensation—Certain employees of the System participate in deferred compensation plans. The System has chosen to fund this liability using mutual funds and annuity or insurance contracts solely owned by the System, but accruing to vested employees. These amounts are subject to the claims of the System's general creditors. Earnings related to the deferred compensation assets, including unrealized appreciation or depreciation, are included in investment income and changes in the corresponding liability are included in salaries, wages, and employee benefits in the consolidated statements of operations and changes in net assets. The asset and liability are recorded at fair market value. The System recorded a charge to salaries, wages, and employee benefits expense of \$17,436,000 and \$7,458,000 in 2017 and 2016, respectively, related to earnings from the deferred compensation assets.

Temporarily and Permanently Restricted Net Assets—Temporarily restricted net assets are those whose use by the System has been limited by donors to a specific time or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the System in perpetuity.

Tax Status—The System, except for HAP and its subsidiaries, HFPN, HFGA, and Onika, consists of entities described under Internal Revenue Service Code Section 501(c)(3) and, as such, are exempt from federal income taxes under Internal Revenue Code Section 501(a) and do not have private foundation status under Internal Revenue Code Sections 509(a)(1), 509(a)(2), or 509(a)(3). HAP and HFGA are entities described under Internal Revenue Code Section 501(c)(4) and, as such, are exempt from federal income taxes. HFPN and the HAP subsidiaries are taxable entities. Approximately \$4,687,000 and

\$1,751,000 in related tax expense was recorded in general and other administrative expense in 2017 and 2016, respectively. The System's wholly owned insurance captive, Onika, operates in the Cayman Islands and is currently not subject to income taxes. The System does not have any material uncertain tax positions as of December 31, 2017 and 2016.

Reclassifications—Certain amounts in prior periods' financial statements have been reclassified to conform to the current-year presentation. In the System's consolidated balance sheet as of December 31, 2016, \$1,947,000 was reclassified from deferred tax asset to intangible and other assets—net to conform to the current-year presentation. Also, in the System's consolidated statement of cash flows for the year ended December 31, 2016, \$(235,000) was reclassified from deferred tax asset to other assets to conform to the current-year presentation.

Adoption of New Accounting Standards—In January 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-04, *Intangibles—Goodwill and Other: Simplifying the Test for Goodwill Impairment*. This guidance simplifies the subsequent measurement of goodwill by eliminating Step 2 of the goodwill impairment test. If a reporting unit fails Step 1 of the goodwill impairment test, entities are no longer required to compute the implied fair value of goodwill following the same procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, the guidance requires an entity to perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and to recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The new guidance is effective for the System for periods beginning after December 15, 2021. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. ASU No. 2017-04 was adopted in 2017 and it did not have a material impact on the System's consolidated financial position or results of operations.

Forthcoming Accounting Standards—In March 2017, the FASB issued ASU No. 2017-07, *Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This ASU requires the service cost component of net periodic benefit cost related to defined benefit pension and postretirement benefit plans to be reported in the same financial statement line as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented separately from service costs and outside of operating income in the consolidated statements of operations. Only the service cost component of net periodic benefit cost will be eligible for capitalization in assets. This guidance is effective for the System for periods beginning after December 15, 2018. The System is evaluating the impact this guidance may have on the consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, *Restricted Cash*, which adds and clarifies guidance in the presentation of changes in restricted cash on the statement of cash flows requiring restricted cash to be included with cash and cash equivalents in the consolidated statements of cash flows. This guidance does not provide a definition of restricted cash. This guidance is effective for the System for periods beginning July 1, 2020. The System is evaluating the impact this guidance may have on the consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. This guidance adds or clarifies guidance on the classification of certain cash receipts and payments in the consolidated statements of cash flows. This guidance is effective for the System for periods beginning after December 15, 2018. The System is evaluating the impact this guidance may have on the consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-For-Profit Entities*. This guidance simplifies and improves how not-for-profit entities classify net assets as well as the information presented in financial statements and notes about liquidity, financial performance, and cash flows. This guidance is effective for the System for periods beginning after December 15, 2017. The System is evaluating the impact this guidance may have on the consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*, which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance, and requires significantly expanded disclosures about revenue recognition. The core principal of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The guidance may be adopted using either a full or modified retrospective approach.

The System has evaluated the requirements of the new standard to ensure the processes, systems, and internal controls are in place to collect the necessary information to implement the standard, which will be effective January 1, 2018. The System will use the modified retrospective approach to adopt this ASU.

The System utilized the portfolio approach practical expedient to analyze contracts within its core service lines. The practical expedient allows the System to evaluate the criteria for revenue recognition over a portfolio of similar contracts as opposed to evaluating each individual contract. A significant component of the adoption of this ASU is grouping patient accounts into portfolios of similar characteristics that will result in materially consistent revenue when compared to the revenue that would have been recognized if each patient account was evaluated individually.

The System has determined that there will be no significant impact to revenue recognized upon the adoption of this ASU.

The adoption of this ASU will result in significant changes to the presentation of financial information within the consolidated statements of operations and changes in unrestricted net assets, as well as expanded disclosures within the notes to the consolidated financial statements. The primary change will be a change in the presentation of the provision for bad debts, which relates to self-pay patients and amounts due from patients with insurance for co-pays and deductibles. Under the ASU, the amounts will be a direct deduction to patient service revenue.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This guidance retains a distinction between operating leases and financing leases and the classification criteria is substantially similar to previous lease guidance. The main change in the new guidance is the requirement for all leases to be recognized on the balance sheet at the present value of lease payments. This guidance is effective for the System in periods beginning after December 15, 2018. The System is evaluating the impact this guidance may have on the consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This guidance revises accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. It also amends certain disclosure requirement associated with

the fair value of financial instruments. This guidance is effective for the System in periods beginning after December 15, 2018. The System is evaluating the impact this guidance may have on the consolidated financial statements.

2. NET PATIENT SERVICE REVENUE

A substantial portion of net patient service revenue was paid primarily by Medicare, Medicaid, and Blue Cross based upon contracted rates or under cost-reimbursement agreements in 2017 and 2016. Provisions for estimated retroactive adjustments under these agreements for current and prior years have been reflected in the accounts based upon the most current information available. Net patient service revenue of \$16,348,000 and \$23,667,000 related to prior-year settlements was recorded in 2017 and 2016, respectively. Patient service revenue (before the provision for bad debts), recognized from these major sources, as of December 31, 2017 and 2016, is as follows (dollars in thousands):

	2017		2016	
Medicare	\$ 1,425,488	42 %	\$ 1,239,320	41 %
Medicaid	560,457	17	546,240	18
Blue Cross	830,612	25	720,924	24
Self-pay	117,445	3	130,009	4
Commercial and other	<u>440,867</u>	<u>13</u>	<u>384,358</u>	<u>13</u>
Total	<u>\$ 3,374,869</u>	<u>100 %</u>	<u>\$ 3,020,851</u>	<u>100 %</u>

Letters of final settlements have not been received from Medicare for 2012 through 2017, from Medicaid for 2014 through 2017, or from Blue Cross for 2016 through 2017. The System is appealing various elements of Medicare final settlements dating back to 1999.

3. UNCOMPENSATED CARE AND COMMUNITY BENEFIT

The System provided health care services without charge or at amounts less than its established rates to patients who met the criteria of its charity care policy. Charity care is reported on the basis of cost, as computed using a cost-to-charge ratio methodology. In addition to charity care, the System provided services to Medicare, Medicaid, and other public programs for which the payments received were less than the cost of providing services. The unpaid costs attributed to providing services under these programs are considered a community benefit. The System also provided research and community health services, such as community education and outreach in the form of free or low-cost clinics; health education; donations for the community; multiple health promotion and wellness programs, such as health screening; and various community projects and support groups.

Additionally, the System demonstrates its exempt purpose to benefit the community by operating emergency rooms and other clinical services open to the public 24 hours a day, seven days a week; providing facilities for the education and training of health care professionals; and maintaining research facilities for the study of new drugs and medical devices that offer the promise of improving health care.

The quantifiable costs of the System's community benefit for the years ended December 31, 2017 and 2016, were as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Charity care at cost	\$ 11,081	\$ 43,605
Unpaid cost of Medicare, Medicaid, and other public programs	346,216	289,065
Bad debt at estimated cost	<u>85,923</u>	<u>58,538</u>
 Total cost of uncompensated care	 443,220	 391,208
 Research	 59,293	 54,420
Health professional education	80,610	82,626
Community health services and building activities	21,928	23,985
Subsidized health services	5,494	8,744
Community benefit operations and financial donations	<u>3,494</u>	<u>3,010</u>
 Total community benefit	 <u>\$ 614,039</u>	 <u>\$ 563,993</u>

The Internal Revenue Service requires community benefit activities to be offset by external funding received. The System received \$40,771,000 and \$40,449,000 of external funding for research and \$4,751,000 and \$6,334,000 of external funding for community health services and building activities during the years ended December 31, 2017 and 2016, respectively.

The improvements in the cash collections in 2017 combined with an increase in previously reserved for insured patients resulted in a decrease in charity care at cost. The System's total cost of uncompensated care as a proportion of consolidated net patient revenue approximated 13.5% and 13.3% at December 31, 2017 and December 31, 2016, respectively.

4. INVESTMENTS AND FAIR VALUE MEASUREMENTS

The System assesses the inputs used to measure fair value using a three-level hierarchy based on the extent to which inputs used in measuring fair value are observable in the market. The fair value hierarchy is as follows:

Level 1—Quoted (unadjusted) prices for identical assets in active markets

Level 2—Other observable inputs, either directly or indirectly, including:

- Quoted prices for similar assets in active markets
- Quoted prices for identical or similar assets in nonactive markets (few transactions, limited information, noncurrent prices, high variability over time, etc.)
- Inputs other than quoted prices that are observable for the asset (interest rates, yield curves, volatilities, default rates, etc.)
- Inputs that are derived principally from or corroborated by other observable market data

Level 3—Unobservable inputs that cannot be corroborated by observable market data

Fair values of securities are based on quoted market prices, where available. The System obtains one price for each security, primarily from a third-party pricing service (“pricing service”), which generally uses Level 1 or Level 2 inputs for the determination of fair value. The pricing service normally derives the security prices through recently reported trades for identical or similar securities, making adjustments through the reporting date based upon available observable market information. For securities not actively traded, the pricing service may use quoted market prices of comparable instruments or discounted cash flow analyses, incorporating inputs that are currently observable in the markets for similar securities. Inputs that are often used in the valuation methodologies include, but are not limited to, nonbinding broker quotes, benchmark yields, credit spreads, default rates, and prepayment speeds. As the System is responsible for the determination of fair value, it performs quarterly analyses on the prices received from the pricing service to determine whether the prices are reasonable estimates of fair value. As a result of these reviews, the System has not historically adjusted the prices obtained from the pricing service.

Instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest-level input that is significant to the fair value measurement in its entirety. The System’s assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Cash Equivalents—The carrying value of cash equivalents approximates fair value as maturities are less than three months. Cash equivalents, comprised primarily of money markets, are classified as Level 1.

Debt Securities—The estimated fair values of debt securities are based on quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices. Due to the nature of pricing fixed-income securities, management has classified the majority of debt securities as Level 2 investments.

Equity Securities—The estimated fair values of equity securities and collective funds, including mutual funds, that are publicly traded are based on quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices. Nonpublicly traded securities, which are primarily collective funds, are recorded at fair value based on NAV, which is calculated using the most recent fund financial statements. The funds in this class include bonds and other fixed-income instruments.

Hedge Funds—Underlying in these funds may include equity and debt securities, commodities, currencies, and derivatives. These funds are valued at NAV, which is calculated using the most recent fund financial statements.

Derivatives—The estimated fair values of derivative financial instruments, including treasury notes, are based on quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices.

Grants and Pledges Receivable—The fair value of grant and pledges receivable has been estimated by management using the discounted cash flows method.

Private Equities—The estimated fair values of investments in private equity are based on the most current financial statements issued by each fund adjusted for cash flows to and from the fund subsequent to the financial statement reporting date.

Long-Term Obligations—The carrying value of the System’s variable-rate bonds and other obligations approximates the fair value. The fair value of the System’s fixed-rate bonds is estimated based upon prices obtained from a third-party service routinely relied upon by securities professionals to provide an approximate fair value of these types of securities.

The System’s policy is to recognize transfers between all levels as of the beginning of the reporting period. There were no significant transfers between Levels 1, 2, and 3 during the years ended December 31, 2017 and 2016.

Effective October 1, 2017, the System elected to transfer its investments previously accounted for as available-for-sale securities to trading securities. (Refer to Note 1.)

Information about the fair value of the System's financial assets and liabilities, according to the valuation techniques the System used to determine its fair values, as of December 31, 2017 and 2016, is as follows (in thousands):

	2017			
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Assets at fair value:				
Cash equivalents	\$ 878,387	\$ 878,387	\$ -	\$ -
Common stock	35,941	35,941	-	-
Collective equity funds:				
Asset allocation	200,204	200,204	-	-
Common stock	163,540	163,540	-	-
Debt securities	212,939	212,939	-	-
Fixed income	18,155	18,155	-	-
Debt securities:				
Asset-backed securities	37,649	-	37,649	-
Corporate debt securities	74,300	-	74,300	-
Government and agency debt securities	111,144	-	111,144	-
Nonagency mortgage-backed securities	6,263	-	6,263	-
Other debt securities	7,764	-	7,764	-
Derivative—asset	10,272	10,272	-	-
Grants and pledges receivable at fair value	<u>12,643</u>	<u>-</u>	<u>12,643</u>	<u>-</u>
Subtotal—assets at fair value	<u>1,769,201</u>	<u>1,519,438</u>	<u>249,763</u>	<u>-</u>
Cash	9,979			
Investments measured at NAV	440,462			
Private equities at cost	39,041			
Other	<u>16,433</u>			
Subtotal—assets recorded at cost or NAV	<u>505,915</u>			
Total	<u>\$2,275,116</u>			
Asset classifications:				
Cash and cash equivalents	\$ 774,534			
Short-term investments	546			
Assets limited as to use	1,054,536			
Long-term investments	<u>445,500</u>			
Total	<u>\$2,275,116</u>			
Derivative—liability at fair value	<u>\$ 10,256</u>	<u>\$ 10,256</u>		
Financial instruments disclosed but not measured at fair value:				
Private equity	<u>\$ 39,041</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$39,041</u>
Long-term obligations	<u>\$1,107,646</u>	<u>\$ -</u>	<u>\$1,107,646</u>	<u>\$ -</u>

	2016			
	Total	Level 1	Level 2	Level 3
Description:				
Trading securities:				
Cash equivalents	\$ 27,414	\$ 27,414	\$ -	\$ -
Debt securities:				
Asset-backed securities	777	-	777	-
Corporate debt securities	5,970	-	5,910	60
Government and agency debt securities	8,483	-	8,483	-
Nonagency mortgage-backed securities	-	-	-	-
Other debt securities	974	-	974	-
Equity securities:				
Collective funds—asset allocation	117,076	117,076	-	-
Collective funds—common stock	131,124	131,124	-	-
Collective funds—debt securities	88,105	88,105	-	-
Subtotal—trading securities	<u>379,923</u>	<u>363,719</u>	<u>16,144</u>	<u>60</u>
Available-for-sale securities:				
Cash equivalents	900,096	900,096	-	-
Debt securities:				
Short-term investments	272	-	272	-
Asset-backed securities	35,959	-	35,959	-
Corporate debt securities	59,691	-	59,691	-
Government and agency debt securities	101,884	-	101,884	-
Nonagency mortgage-backed securities	9,565	-	9,565	-
Other debt securities	6,877	-	6,877	-
Equity securities:				
Collective funds—asset allocation	94,598	94,598	-	-
Collective funds—common stock	42,809	42,809	-	-
Collective funds—debt securities	150,662	150,662	-	-
Common stock	22,994	22,994	-	-
Subtotal—available-for-sale securities	<u>1,425,407</u>	<u>1,211,159</u>	<u>214,248</u>	<u>-</u>
Derivative—asset	<u>11,283</u>	<u>11,283</u>	<u>-</u>	<u>-</u>
Subtotal—investments at fair value	<u>1,816,613</u>	<u>\$ 1,586,161</u>	<u>\$ 230,392</u>	<u>\$ 60</u>
Grants and pledges receivables at fair value	<u>22,718</u>	<u>\$ -</u>	<u>\$ 22,718</u>	<u>\$ -</u>
Cash	8,902			
Investments measured at NAV	179,853			
Equity method investments	116,727			
Hedge funds and private equities at cost	33,522			
Other	11,990			
Subtotal—investments recorded at cost, equity method or NAV	<u>350,994</u>			
Total	<u>\$ 2,190,325</u>			
Asset classifications:				
Cash and cash equivalents	\$ 828,444			
Short-term investments	272			
Assets limited as to use	1,036,486			
Long-term investments	<u>325,123</u>			
Total	<u>\$ 2,190,325</u>			
Derivative—liability at fair value	<u>\$ (11,266)</u>	<u>\$ (11,266)</u>	<u>\$ -</u>	<u>\$ -</u>
Financial instruments disclosed but not measured at fair value:				
Private equity and hedge funds	<u>\$ 33,637</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 33,637</u>
Long-term obligations	<u>\$ 1,077,386</u>	<u>\$ -</u>	<u>\$ 1,077,386</u>	<u>\$ -</u>

The fair value reconciliation of the Level 3 assets for the years ended December 31, 2017 and 2016, is as follows (in thousands):

	Corporate Debt Securities	Other Debt Securities	Total
Ending balance—December 31, 2015	\$ 95	\$ 122	\$ 217
Total realized and unrealized gains included in changes in net assets	<u>(35)</u>	<u>(122)</u>	<u>(157)</u>
Ending balance—December 31, 2016	60	-	60
Total realized and unrealized losses included in changes in net assets	<u>(60)</u>	<u>-</u>	<u>(60)</u>
Ending balance—December 31, 2017	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The following summarizes the effect the derivative financial instruments had on the System's consolidated balance sheets and consolidated statements of operations and changes in net assets (in thousands):

Description	Financial Statement Location	2017	2016
Consolidated balance sheets:			
Fixed-income derivatives	Long-term investments	<u>\$ 10,272</u>	<u>\$ 11,283</u>
Fixed-income derivatives	Deferred compensation, postretirement, and other liabilities	<u>\$ (10,256)</u>	<u>\$ (11,266)</u>
Consolidated statements of operations and changes in net assets:			
Fixed-income derivatives	Investment income	<u>\$ (83)</u>	<u>\$ (14)</u>

The effect of the derivative financial instruments reported on the consolidated statements of operations and changes in net assets is included in unrestricted net assets.

The total return on the investment portfolios for the years ended December 31, 2017 and 2016, consisted of the following (in thousands):

	<u>2017</u>	<u>2016</u>
Trading securities:		
Interest and dividend income	\$ 44,607	\$ 6,408
Realized gains	21,220	2,049
Unrealized gains	<u>12,752</u>	<u>9,519</u>
Subtotal—trading securities	<u>78,579</u>	<u>17,976</u>
Available-for-sale securities:		
Interest and dividend income	10,703	32,912
Realized gains	17,023	2,420
Change in unrealized gains	<u>29,510</u>	<u>12,653</u>
Subtotal—available-for-sale securities	<u>57,236</u>	<u>47,985</u>
Total investment return	<u>\$ 135,815</u>	<u>\$ 65,961</u>

Included in the above total return on investments are \$256,000 and \$1,967,000 of impairment losses deemed other than temporary for the years ended December 31, 2017 and 2016, respectively.

Effective October 1, 2017, the System elected to transfer its investments previously accounted for as available-for-sale securities to trading securities; therefore, total return on investments for 2017 for available-for-sale securities is for the nine months ended September 30, 2017.

Investment income for the years ended December 31, 2017 and 2016, consisted of the following (in thousands):

	<u>2017</u>	<u>2016</u>
The Foundation	\$ 31,754	\$ 12,622
Funds designated for malpractice and general liability	2,787	3,463
Funds designated for deferred compensation	17,436	7,458
Funds held under bond indenture agreements	3,004	1,573
Interest, dividends, and realized and unrealized gains from other unrestricted assets	<u>40,770</u>	<u>22,240</u>
Total investment income	<u>\$ 95,751</u>	<u>\$ 47,356</u>

The aggregate cost of the System's cost-method investments totaled \$39,041,000 and \$33,522,000 as of December 31, 2017 and 2016, respectively. Of the total cost-method investments, the System evaluated \$15,733,000 and \$19,292,000 of investments for impairment as the estimated cost of the investments exceeded the fair value as of December 31, 2017 and 2016, respectively. The System identified an unrealized loss of \$2,382,000 and \$1,438,000 as of December 31, 2017 and 2016, respectively. The System did not identify any events or changes in circumstances that may have had a significant adverse effect on the fair value of those investments. Based on the System's intent and ability to hold the

investments for reasonable periods of time sufficient for forecasted recovery of fair value, the System does not consider the investments to be other-than-temporarily impaired as of December 31, 2017.

The fair value measurements of certain investments calculated based on NAV held as of December 31, 2017 and 2016, are as follows (there were no unfunded commitments at year-end):

December 31, 2017	<u>Fair Value (in thousands)</u>	<u>Redemption Frequency</u>	<u>Redemption Notice Period</u>
Collective funds:			
Asset allocation ⁽¹⁾	\$ 18,864	Monthly	9–30 days
Common stock ⁽²⁾	148,912	Daily, monthly Daily, weekly,	2–30 days
Debt securities ⁽³⁾	165,910	semimonthly, monthly	0–30 days
Hedge funds ⁽⁴⁾	<u>106,776</u>	Quarterly, annually	3–90 days
Total	<u>\$ 440,462</u>		
	<u>Fair Value (in thousands)</u>	<u>Redemption Frequency</u>	<u>Redemption Notice Period</u>
December 31, 2016			
Collective funds:			
Asset allocation ⁽¹⁾	\$ 17,568	Monthly	9–30 days
Common stock ⁽²⁾	52,295	Daily, monthly Daily, weekly,	2–30 days
Debt securities ⁽³⁾	<u>109,990</u>	semimonthly, monthly	0–30 days
Total	<u>\$ 179,853</u>		

⁽¹⁾ Collective funds—asset allocation are investment funds that consist of diversified portfolios of debt, equity, and other assets often providing the money manager with discretion as to the allocation across the various assets.

⁽²⁾ Collective funds—common stock are investment funds that invest substantially all their assets in the equity securities of publicly traded companies in the United States, developed international markets, and emerging international markets.

⁽³⁾ Collective funds—debt securities are investment funds that invest substantially all their assets in debt securities, including government and corporate bonds, both domestic and foreign.

⁽⁴⁾ Hedge funds—are investments funds that have advanced investment strategies with long, short, and derivative positions in domestic and foreign markets. Certain funds have provisions that limit access to the invested funds. These provisions include lockup terms that range up to three years from the subscription date.

The bonds and notes are carried at fair value. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment

penalties. Holdings as of December 31, 2017, by contractual maturity, are listed as follows (in thousands):

Maturity	Estimated Fair Value	Book Value
Due in one year or less	\$ 2,100	\$ 2,100
Due in one year through five years	130,291	130,291
Due in five years through 10 years	43,441	43,441
Due after 10 years	<u>61,288</u>	<u>61,288</u>
 Total	 <u>\$ 237,120</u>	 <u>\$ 237,120</u>

5. ASSETS LIMITED AS TO USE

Assets limited as to use as of December 31, 2017 and 2016, consisted of the following (in thousands):

	2017	2016
Unrestricted assets limited as to use:		
The Foundation	\$ 336,193	\$ 303,730
Loan funds held by trustee	4,512	4,122
Funds designated for malpractice and general liability	85,581	81,051
Funds designated for deferred compensation	154,078	135,495
Funds held under bond indenture agreements	-	2,304
HAP statutory funds	14,336	14,337
Funds board designated for research, education, and other	<u>205,095</u>	<u>251,499</u>
 Total unrestricted assets limited as to use	 <u>799,795</u>	 <u>792,538</u>
Temporarily restricted assets:		
Grants and other funds	128,642	121,652
Grants and pledges receivable	<u>11,976</u>	<u>16,232</u>
 Total temporarily restricted assets	 <u>140,618</u>	 <u>137,884</u>
Permanently restricted assets:		
Grants and other funds	113,456	99,578
Grants and pledges receivable	<u>667</u>	<u>6,486</u>
 Total permanently restricted assets	 <u>114,123</u>	 <u>106,064</u>
 Total assets limited as to use	 1,054,536	 1,036,486
Less requirements for current liabilities	<u>45,509</u>	<u>47,822</u>
 Noncurrent assets limited as to use	 <u>\$ 1,009,027</u>	 <u>\$ 988,664</u>

Temporarily restricted and permanently restricted grants and pledges receivable consist of the following as of December 31, 2017: Amounts expected to be collected in 2018, \$8,045,000; amounts expected to

be collected in 2019 through 2022, \$4,960,000; amounts expected to be collected in 2023 and thereafter, \$172,000; and unamortized discount of \$(534,000). All pledges are deemed collectible.

Onika maintains a reserve deposit of \$11,292,000 and \$11,073,000 as of December 31, 2017 and 2016, respectively, under a reinsurance trust agreement and an agency agreement. These amounts are included above in funds designated for malpractice and general liability. The HAP statutory funds are required by regulatory requirements.

6. JOINT VENTURE INVESTMENTS

The System maintains investments in eight unconsolidated affiliates with ownership interests ranging from 20% to 55%. All unconsolidated affiliates are accounted for under the equity method.

The income related to the investments accounted for under the equity method, included in other income, was \$2,299,000 and \$2,628,000 for 2017 and 2016, respectively.

The summarized financial information for unconsolidated affiliates as of December 31, 2017 and 2016, consisted of the following (in thousands):

	<u>2017</u>	<u>2016</u>
Net revenues	\$ 123,570	\$ 110,832
Net income	4,757	4,769
Total assets	60,697	65,851
Net assets	44,538	44,180

7. PROPERTY, PLANT, AND EQUIPMENT

Property, plant, and equipment as of December 31, 2017 and 2016, consisted of the following (in thousands):

	<u>2017</u>	<u>2016</u>
Land and improvements	\$ 86,832	\$ 81,823
Building and improvements	1,529,649	1,504,524
Equipment	1,439,682	1,358,185
Construction in progress	<u>91,828</u>	<u>81,758</u>
Total	3,147,991	3,026,290
Less accumulated depreciation	<u>1,699,425</u>	<u>1,599,591</u>
Property, plant, and equipment—net	<u>\$ 1,448,566</u>	<u>\$ 1,426,699</u>

As of December 31, 2017, the following assets recorded under capital leases are included above: Land and improvements of \$614,000 with accumulated amortization of \$233,000; building and improvements of \$13,296,000 with accumulated amortization of \$5,287,000.

As of December 31, 2016, the following assets recorded under capital leases are included above: Land and improvements of \$614,000 with accumulated amortization of \$233,000; building and improvements of \$7,751,000 with accumulated amortization of \$4,675,000.

Internal-use software is included above in equipment and construction in progress. The net book value was \$201,858,000 and \$213,640,000 at December 31, 2017 and 2016, respectively.

8. CREDIT AGREEMENTS

The Corporation has a credit agreement through which up to \$100,000,000 may be borrowed and committed at several interest rate options. The Corporation had no loan advances and had letters of credit commitments of \$8,128,000 and \$8,090,000 as of December 31, 2017 and 2016, respectively. This credit agreement expires on April 26, 2018. The Corporation has a commitment agreement and is finalizing a renewal under similar terms.

The Corporation has a credit agreement through which up to \$50,000,000 may be borrowed and committed at several interest rate options. The Corporation had no loan advances or letters of credit commitments as of December 31, 2017 and 2016. This credit agreement expires on April 30, 2020, but the Corporation has a commitment agreement to extend the expiration date to April 30, 2021.

The Corporation has a credit agreement through which up to \$75,000,000 may be borrowed and committed at several interest rate options. The Corporation had loan advances outstanding of \$0 and \$24,167,000 and no letters of credit commitments as of December 31, 2017 and 2016, respectively. Loan advances are recorded in short-term borrowings in the consolidated balance sheets. This credit agreement expires on April 19, 2019, but the Corporation has a commitment agreement to extend the expiration date to April 19, 2020.

9. MEDICAL CLAIMS LIABILITY (REPORTED AND UNREPORTED)

Activity from HAP, AHLIC, and MHP, included in medical claims liability, is summarized as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Balance—beginning of year	\$ 222,110	\$ 211,934
Addition due to HPM acquisition	-	68,041
Incurred related to:		
Current year	2,049,434	1,816,623
Prior year	<u>(25,017)</u>	<u>(11,865)</u>
Total incurred	<u>2,024,417</u>	<u>1,804,758</u>
Paid related to:		
Current year	1,809,392	1,634,875
Prior year	<u>203,043</u>	<u>227,748</u>
Total paid	<u>2,012,435</u>	<u>1,862,623</u>
Balance—end of year	<u>\$ 234,092</u>	<u>\$ 222,110</u>

Changes in actuarial estimates of claims unpaid reported as “incurred related to prior year” in the schedule above reflect revisions in estimates of medical cost trends and changes in claims processing patterns. Given the inherent variability of such estimates, the actual liability could differ significantly from the amounts provided.

10. MALPRACTICE AND GENERAL LIABILITY

The System provides professional and general liability insurance through a combination of self-insurance, claims-made coverage reinsured through Onika, and excess coverage purchased from commercial carriers and Caymich Insurance Company, Ltd. (“Caymich”). Caymich is an offshore captive insurance company domiciled in the Cayman Islands that provides pooled-risk coverage to its members. The System is a 34.86% and 21.73% member in Caymich at December 31, 2017 and 2016, respectively.

The System estimates a range of loss for known claims and unreported incidents and has recorded a liability based on its assessment of the most likely amount of loss in the range. The liability of \$125,514,000 and \$132,507,000 as of December 31, 2017 and 2016, respectively, has been discounted using a discount factor of 4% as of December 31, 2017 and 2016. Segregated funds included in assets limited as to use have been established to settle claims subject to self-insurance. Earnings related to these assets of \$2,787,000 and \$3,463,000 are included in investment income in December 31, 2017 and 2016, respectively.

11. PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS

The System has qualified defined benefit pension plans covering certain employees. The funding policies are to contribute annually amounts necessary to meet or exceed the minimum funding requirements of the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

Effective December 31, 2010, the System permanently froze the Henry Ford Health System pension plan. Effective January 1, 2011, the System instituted a defined contribution supplemental retirement savings account for each participant in the frozen pension plan as well as employees hired after December 31, 2010. The System’s contribution to this plan is based on each participant’s age and years of service. Allegiance Health Group and Affiliates sponsor defined contribution plans that include nonelective and matching contributions. The expense related to these plans was approximately \$28,549,000 and \$24,570,000 in 2017 and 2016, respectively.

Effective June 30, 2017, the System permanently froze the Allegiance Health Group and Affiliates retirement plan, which resulted in a curtailment gain of \$8,408,000, which was recorded in salaries, wages, and employee benefits in the consolidated statements of operations and changes in net assets.

Effective July 1, 2017, the Allegiance Health Group and Affiliates 403(b) plan was amended to modify the employer-matching formula, add an employer annual contribution, and provide transitional contributions. The new matching formula will go into effect on the first pay of 2018 and the transitional contributions will end after the contribution for the 2020 plan year.

Effective December 31, 2011, HAP permanently froze the final average pay defined benefit formula for all nonrepresented participants in the HAP pension plan. Effective January 1, 2012, HAP instituted a cash balance defined benefit formula for all non-represented participants and also for the UAW Local 600 Union Office/Nonexempt Bargaining unit participants hired on or after January 1, 2012, and for the UAW Local 600 Union Sales and Labor unit participants hired on or after April 1, 2012.

Effective March 19, 2016, the cash balance benefit for those participants in UAW Local 600 Union Office/Nonexempt Bargaining was frozen and no additional pay credits will be credited. HAP also maintains a “safe-harbor” 401(k) plan that provides for up to a 3.5% matching employer contribution,

for those participants who defer at least 6% of their earnings to the plan. The HAP 401(k) plan also has a secondary account for certain bargaining unit groups that provides an annual employer contribution of 3% to 7% of eligible earnings.

Effective December 23, 2017, HAP permanently froze the cash balance plan for the non-represented active participants, which resulted in a curtailment gain of \$5,334,000, which was recorded in salaries, wages, and employee benefits in the consolidated statements of operations and changes in net assets.

All HAP non-represented participants who were active as of November 8, 2017, and age 50 or older with at least 10 years of service as of December 31, 2017, were included in a Special Voluntary Retirement Program (SVRP) offer that provided an additional pay credit based on the participant's years of service as of December 31, 2017, and plan compensation earned during 2017. As a result, the value of the additional pay credit for the employees that accepted the SVRP by the December 23, 2017, deadline is recognized as a special termination benefit as of December 31, 2017.

Effective January 1, 2018, HAP instituted a defined contribution supplemental retirement savings account for each nonunion and union participant who were formerly eligible for the cash balance formula in the frozen pension plan as well as employees hired after December 31, 2017. HAP's contribution to this plan is based on each participant's age and years of service.

The System has a retirement savings plan under which certain employees may make a onetime irrevocable election indicating whether or not they will participate. This plan requires employee and employer contributions of 2% and 2.5%, respectively, of base wages up to the social security wage limit. For wages in excess of the social security wage limit, contributions are 4% and 5% of base wages for the employee and employer, respectively. The retirement savings plan also has a secondary account that provides an annual employer contribution that ranges from 1.25% to 2.75% of eligible earnings to participants accounts. The expense related to this plan was approximately \$36,830,000 and \$36,344,000 in 2017 and 2016, respectively.

The System also provides postretirement health care and life insurance benefits to certain employees who met minimum age and years of service requirements as of December 31, 2006. These employees are also required to meet certain eligibility requirements at the time of retirement. Benefits to employees may require employee contributions or be provided in the form of a fixed-dollar subsidy.

In 1989, the System entered into a master retirement trust agreement. This master retirement trust agreement combined several trust agreements of the System's subsidiaries, including HAP, into a single trust agreement. All of the System's pension plan assets, excluding Allegiance Health Group and Affiliates, are held by the master trust fund.

The System's primary investment objective for the pension plans, excluding Allegiance Health Group and Affiliates, is to ensure sufficient funds are available to meet the plan's benefit and expense obligations and to maintain compliance with regulatory funding requirements. The plan is managed with a long-term duration and liability investment perspective with the goal to achieve risk-adjusted returns on plan assets and plan liabilities. The investment program shall be broadly diversified among asset classes and manager strategies with the total return for the overall plan exceeding the pension plan's investment policy index returns. The allocation percentages of the fair value of total plan assets held as of the measurement dates, December 31, 2017 and 2016, are shown below:

The System (excluding Allegiance Health Group and Affiliates)

	<u>Target</u>	<u>2017</u>	<u>2016</u>
Cash and cash equivalents	2 %	1 %	2 %
Global asset allocation	20	19	18
Stock and stock funds	42	45	45
Bonds and bond funds	33	34	34
Other	<u>3</u>	<u>1</u>	<u>1</u>
Total	<u>100 %</u>	<u>100 %</u>	<u>100 %</u>

The following tables present information about the fair value of the total plan assets as of December 31, 2017 and 2016, according to the valuation techniques the System used to determine its fair values as described in Note 4 (in thousands):

The System (excluding Allegiance Health Group and Affiliates)

	<u>2017</u>			<u>Total</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	
Investment class:				
Cash equivalents	\$ 4,014	\$ -	\$ -	\$ 4,014
Common stock	29,301	-	-	29,301
Collective equity funds:				
Asset allocation	92,884	-	-	92,884
Common stock	42,456	-	-	42,456
Debt securities	77,750	-	-	77,750
Private equity	-	-	5,346	5,346
Debt securities:				
Asset-backed securities	-	1,312	-	1,312
Corporate debt securities	-	4,043	-	4,043
Government and agency debt securities	-	4,454	-	4,454
Non-agency mortgage-backed securities	-	302	-	302
Other debt securities	<u>-</u>	<u>228</u>	<u>-</u>	<u>228</u>
Total investments measured at fair value	<u>\$ 246,405</u>	<u>\$ 10,339</u>	<u>\$ 5,346</u>	262,090
Investments measured at NAV				<u>226,979</u>
Total				<u>\$ 489,069</u>

The System (excluding Allegiance Health Group and Affiliates)

	2016			Total
	Level 1	Level 2	Level 3	
Investment class:				
Cash equivalents	\$ 9,339	\$ -	\$ -	\$ 9,339
Common stock	25,497	-	-	25,497
Collective equity funds:				
Asset allocation	60,152	-	-	60,152
Common stock	65,276	-	-	65,276
Debt securities	61,849	-	-	61,849
Private equity	-	-	7,375	7,375
Debt securities:				
Asset-backed securities	-	1,896	-	1,896
Corporate debt securities	-	4,012	-	4,012
Government and agency debt securities	-	3,465	-	3,465
Nonagency mortgage-backed securities	-	521	-	521
Other debt securities	-	348	-	348
Total investments measured at fair value	<u>\$ 222,113</u>	<u>\$ 10,242</u>	<u>\$ 7,375</u>	239,730
Investments measured at NAV				<u>218,584</u>
Total				<u>\$ 458,314</u>

There were no significant transfers between Levels 1, 2, and 3 during the years ended December 31, 2017 and 2016.

The fair value reconciliation of the Level 3 assets for the years ended December 31, 2017 and 2016, is as follows (in thousands):

The System (excluding Allegiance Health Group and Affiliates)

	Private Equity Funds
Ending balance—December 31, 2015	\$ 9,841
Total losses for the period included in changes in net assets	(96)
Purchases and settlements:	
Purchases	435
Settlements	<u>(2,805)</u>
Ending balance—December 31, 2016	7,375
Total gains for the period included in changes in net assets	490
Purchases and settlements:	
Purchases	245
Settlements	<u>(2,764)</u>
Ending balance—December 31, 2017	<u>\$ 5,346</u>

Allegiance Health Group and Affiliates invests the majority of the assets in the pension plan in a diversified portfolio consisting of asset classes that attempt to maximize returns while minimizing volatility. The allocation percentages of the fair value of total plan assets held as of the measurement dates, December 31, 2017 and 2016, are shown below:

Allegiance Health Group and Affiliates	Target	2017	2016
Stock and stock funds	44 %	45 %	44 %
Bond and bond funds	31	30	31
Other	<u>25</u>	<u>25</u>	<u>25</u>
Total	<u>100 %</u>	<u>100 %</u>	<u>100 %</u>

The following tables present information about the fair value of the total plan assets as of December 31, 2017 and 2016, according to the valuation techniques used to determine its fair values as described in Note 4 (in thousands):

Allegiance Health Group and Affiliates	2017			
	Level 1	Level 2	Level 3	Total
Investment class:				
Cash and cash equivalents	\$ 1,158	\$ -	\$ -	\$ 1,158
Collective equity funds:				
Asset allocation	11,216	-	-	11,216
Common stock	72,286	-	-	72,286
Debt securities	27,532	-	-	27,532
Fixed income	7,230	-	-	7,230
Private equity	<u>-</u>	<u>-</u>	<u>1,953</u>	<u>1,953</u>
Total investments measured at fair value	<u>\$ 119,422</u>	<u>\$ -</u>	<u>\$ 1,953</u>	121,375
Investments measured at NAV				<u>29,246</u>
Total				<u>\$ 150,621</u>

Allegiance Health Group and Affiliates	2016			
	Level 1	Level 2	Level 3	Total
Investment class—				
Collective equity funds:				
Asset allocation	\$ 19,793	\$ -	\$ -	\$ 19,793
Common stock	57,777	-	-	57,777
Debt securities	24,991	871	-	25,862
Private equity	<u>-</u>	<u>-</u>	<u>16,779</u>	<u>16,779</u>
Total investments measured at fair value	<u>\$ 102,561</u>	<u>\$ 871</u>	<u>\$ 16,779</u>	120,211
Investments measured at NAV				<u>12,642</u>
Total				<u>\$ 132,853</u>

There were no significant transfers between Levels 1, 2, and 3 during the year ended December 31, 2017.

The fair value reconciliation of the Level 3 assets for the years ended December 31, 2017 and 2016, is as follows (in thousands):

Allegiance Health Group and Affiliates	Private Equity Funds
Opening balance—April 1, 2016	\$ 14,858
Total gains for the period included in changes in net assets	1,243
Purchases and settlements:	
Purchases	1,014
Settlements	<u>(336)</u>
Ending balance—December 31, 2016	16,779
Total losses for the period included in changes in net assets	(44)
Transfer to investments measured at NAV	(13,593)
Purchases and settlements:	
Purchases	-
Settlements	<u>(1,189)</u>
Ending balance—December 31, 2017	<u>\$ 1,953</u>

The expected long-term rate of return on System plan assets is established based on management's expectations of asset returns for the investment mix in the plans, considering historical experience, current economic environment, and forecasted risk/reward assumptions. The expected returns of various asset categories are blended to derive one long-term assumption.

The System is expected to contribute \$21,334,000 to the pension plans in 2018.

The System is expected to make a \$4,403,000 contribution to the postretirement health care plans in 2018.

Information regarding the projected benefit obligation and assets of the pension and postretirement benefit plans for the System as of and for the years ended December 31, 2017 and 2016, is as follows (in thousands):

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Change in benefit obligation:				
Benefit obligation—beginning of year	\$ 794,841	\$ 612,945	\$ 65,871	\$ 66,457
Service cost	15,915	17,107	761	744
Interest cost	30,498	30,572	2,622	2,816
Actuarial loss (gain)	34,795	16,041	(446)	(165)
Benefits paid	(24,309)	(30,415)	(4,677)	(4,706)
Medicare Part D subsidy	-	-	703	725
Settlements	(43,058)	(26,465)	-	-
Curtailments	(8,575)	-	-	-
Acquisition of Allegiance Health Group and Affiliates	-	175,030	-	-
Special contractual termination benefits	650	-	-	-
Plan changes/other	-	26	3	-
	<u>800,757</u>	<u>794,841</u>	<u>64,837</u>	<u>65,871</u>
Change in plan assets:				
Fair value of assets—beginning of year	591,167	466,461	-	-
Actual return on assets	84,751	38,609	-	-
Employer contributions	31,139	11,444	4,678	4,706
Benefits paid	(24,309)	(30,415)	(4,678)	(4,706)
Settlements	(43,058)	(26,465)	-	-
Acquisition of Allegiance Health Group and Affiliates	-	131,533	-	-
	<u>639,690</u>	<u>591,167</u>	<u>-</u>	<u>-</u>
Amounts included in the consolidated balance sheets:				
Total accrued liability	<u>\$ 161,067</u>	<u>\$ 203,674</u>	<u>\$ 64,837</u>	<u>\$ 65,871</u>
Current liability	<u>\$ 1,482</u>	<u>\$ 3,015</u>	<u>\$ 4,327</u>	<u>\$ 4,583</u>
Long-term liability	<u>\$ 159,585</u>	<u>\$ 200,659</u>	<u>\$ 60,510</u>	<u>\$ 61,288</u>

Lump-sum settlements of \$43,058,000 and \$26,465,000 were made during the years ended December 31, 2017 and 2016, respectively. As a result of total lump-sum settlements exceeding the sum of service costs and interest costs, the System recognized a settlement loss of \$6,738,000 and \$7,095,000 during 2017 and 2016, respectively.

All previously unrecognized actuarial losses are reflected in the consolidated balance sheets. Pension and postretirement plan benefit items not yet recognized as a component of periodic pension and postretirement plan expense, but included within unrestricted net assets, as of and for the years ended December 31, 2017 and 2016, are as follows (in thousands):

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Unrecognized prior service credit	\$ 3,489	\$ (3,244)	\$ -	\$ (649)
Unrecognized net actuarial loss	<u>140,845</u>	<u>164,000</u>	<u>(8,975)</u>	<u>(8,608)</u>
Total	<u>\$ 144,334</u>	<u>\$ 160,756</u>	<u>\$ (8,975)</u>	<u>\$ (9,257)</u>

An estimated \$121,000 in prior service cost and \$19,264,000 in net actuarial loss will be included as components of periodic pension plan expense in 2018. An estimated \$207,000 in net actuarial gain will be included as a component of period postretirement medical plan expense in 2018.

The accumulated benefit obligation was \$796,374,000 and \$780,121,000 as of December 31, 2017 and 2016, respectively.

Information regarding the net benefit cost of the pension and postretirement benefit plans for the System as of and for the years ended December 31, 2017 and 2016, is as follows (in thousands):

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Net pension benefit cost:				
Service cost	\$ 15,915	\$ 17,107	\$ 761	\$ 744
Interest cost	30,498	30,572	2,622	2,816
Expected return on assets	(43,651)	(41,468)	-	-
Amortization of prior service credit	(1,404)	(1,409)	(1,995)	(1,788)
Amortization of actuarial loss (gain)	9,950	4,933	(160)	(164)
Curtailment gains	(13,742)	-	-	-
Settlement cost	6,738	7,095	-	-
Special contractual termination benefits	<u>650</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net benefit cost	<u>\$ 4,954</u>	<u>\$ 16,830</u>	<u>\$ 1,228</u>	<u>\$ 1,608</u>

Assumptions are as follows:

Discount rate—benefit obligation	2.75%–3.70%	3.85%–4.15%	2.10%–3.65%	4.05%–4.15%
Discount rate—benefit cost	3.85%–4.15%	3.90%–4.35%	3.70%–4.15%	4.40%–4.50%
Expected return on plan assets	6.60%–6.98%	6.80%–7.28%	N/A	N/A

The qualified pension plan for union workers utilized 4% for the rate of compensation increase in estimating both the projected benefit obligation and the net benefit cost as of and for the years ended December 31, 2017 and 2016. The HAP plan used an age-related scale in estimating both the projected benefit obligation and the net benefit cost for that plan as of and for the years ended December 31, 2017 and 2016.

The expected future pension benefits, including settlements, to be paid for each of the next five years and in the aggregate for the succeeding five years thereafter are as follows: \$61,474,000 in 2018, \$62,789,000 in 2019, \$59,204,000 in 2020, \$58,867,000 in 2021, \$62,067,000 in 2022, and \$260,794,000 thereafter.

The expected future other postretirement benefits, net of Medicare Part D subsidy to be paid for each of the next five years and in the aggregate for the succeeding five years thereafter, are as follows: \$4,403,000 in 2018, \$4,363,000 in 2019, \$4,900,000 in 2020, \$4,925,000 in 2021, \$4,890,000 in 2022, and \$22,817,000 thereafter.

The expected future Medicare Part D subsidy for each of the next five years and in the aggregate for the succeeding five years thereafter are as follows: \$727,000 in 2018, \$780,000 in 2019, \$213,000 in 2020, \$205,000 in 2021, \$195,000 in 2022, and \$802,000 thereafter.

The medical inflation assumption is 6.8% in 2018 for Blue Cross Blue Shield of Michigan Medical, grading down to 5% in 2033 and after; 7.2% in 2018 for HAP full network, grading down to 5% in 2033 and after; and 10.9% in 2018 for HAP preferred network, grading down to 5% in 2033 and after. The prescription drug inflation assumption is 7.2% in 2018, grading down to 5% in 2033 and after.

The health care cost trend rate assumptions have a significant effect on the amounts reported for the postretirement plan. A one-percentage-point change in assumed health care cost trends would have effects on the amounts as follows:

	<u>One-Percentage- Point Increase</u>	<u>One-Percentage- Point Decrease</u>
Effect on postretirement benefit obligation	4.27%	(3.61)%
Effect on total of service cost and interest cost components	4.01%	(3.34)%

12. LONG-TERM OBLIGATIONS

Long-term obligations as of December 31, 2017 and 2016, consisted of the following (in thousands):

	<u>2017</u>	<u>2016</u>
Revenue and refunding bonds Series 2016, fixed rate, maturing serially through 2042, interest rates of 3.00% to 5.00%; term due 2041, interest rate of 5.00%; term due 2046, interest rate of 4.00%	\$ 849,225	\$ 853,030
Taxable term loan, maturing 2021, variable interest rate, 2.16% at December 31, 2017	37,235	38,035
Tax-exempt loan, fixed interest rate of 2.07%, maturing 2020	33,479	44,184
Other obligations (interest rates from 3.16% to 4.80%)	4,423	5,089
Deferred issuance costs on bonds, net	(6,242)	(6,591)
Unamortized premium on bonds	<u>106,068</u>	<u>111,257</u>
Total	1,024,188	1,045,004
Less current portion	<u>17,383</u>	<u>15,967</u>
Total long-term obligations	<u>\$ 1,006,805</u>	<u>\$ 1,029,037</u>

On September 28, 2016, the System issued \$853,030,000 in Series 2016 hospital revenue refunding bonds (“Series 2016”) and entered into a taxable term loan of \$38,035,000. The Series 2016 bonds were issued at a premium of \$112,649,000. The proceeds were used to cash defease or refund all its existing tax-exempt bonds, plus accrued interest, and to pay certain issuance costs. The System recognized a loss on refinancing of \$58,742,000. Escrow accounts were established for the refunded bonds in amounts sufficient to cover interest, principal, and call premiums. These refundings were recorded as a legal defeasance.

The 2016 Master Indenture contains financial covenants relating to permitted debt, permitted encumbrances, permitted dispositions of cash and other assets, permitted guarantees, and permitted mergers and reorganizations. The System has no knowledge of any default in the performance of the terms, covenants, provisions, or conditions of the 2016 Master Indenture.

The approximate principal requirements on long-term obligations for the next five years and thereafter are as follows: \$17,383,000 in 2018, \$17,085,000 in 2019, \$17,573,000 in 2020, \$51,543,000 in 2021, \$17,703,000 in 2022, and \$803,075,000 thereafter.

13. CAPITAL LEASE OBLIGATIONS

The System has capital lease agreements for buildings. The capital lease obligations require payments in future years as follows (in thousands):

Years Ending December 31:	
2018	\$ 2,824
2019	2,837
2020	2,837
2021	2,837
2022	2,851
Later years	<u>7,593</u>
Total minimum lease payments	21,779
Less interest (interest rates from 4.49% to 57.11%)	<u>12,087</u>
Obligations under capitalized lease, including \$175 due within one year	<u><u>\$ 9,692</u></u>

14. COMMITMENTS AND CONTINGENCIES

The System has entered into various operating lease agreements, which expire through 2035 and include varying renewal options. Rental expense under such leases was approximately \$53,285,000 and \$49,287,000 for the years ended December 31, 2017 and 2016, respectively.

The aggregate remaining lease payments required under operating leases with noncancelable terms in excess of one year as of December 31, 2017, approximate \$177,341,000. The approximate payment requirements under these leases for each of the five years ending after December 31, 2017, are \$34,702,000, \$29,595,000, \$21,965,000, \$18,701,000, and \$13,032,000, respectively.

In connection with the ASR Put Option, discussed in Note 1, HAP has obtained independent third-party evaluations of both the fair value of the ASR business and its calculation of the value of the Put Option to aid in supporting its position. The NCI holder disputes HAP’s position and is pursuing litigation to resolve this matter. The case is currently in the preliminary deposition stage from which the ultimate

resolution of this matter cannot be assessed at this time. HAP has recognized a liability in this matter based upon its calculated value of the Put Option.

The System is also party to other lawsuits incidental to its operations and management believes that the ultimate outcome of these other contingencies will not have a material effect on the accompanying consolidated financial statements.

The health care industry is subject to numerous and complex laws and regulations of federal, state, and local governments. Compliance with these laws and regulations, specifically those relating to the Medicare and Medicaid programs, can be subject to review and interpretation, as well as future regulatory enforcement actions, such as fines, penalties, and repayment of previously billed and collected revenues. Management believes that the System is in compliance with current laws and regulations.

15. UNRESTRICTED NET ASSETS

Changes in consolidated unrestricted net assets attributable to the System and the noncontrolling interests for the years ended December 31, 2017 and 2016, are as follows (in thousands):

	<u>Henry Ford Health System</u>	<u>Noncontrolling Interests</u>	<u>Total</u>
Unrestricted net assets—December 31, 2015	\$ 1,335,025	\$ 9,168	\$ 1,344,193
Excess of revenue over expenses from consolidated operations	275,605	2,715	278,320
Change in net unrealized gains and losses on investments	9,202	-	9,202
Net assets released from restrictions for capital	6,395	-	6,395
Acquisition of noncontrolling interest	(22,834)	(4,890)	(27,724)
Distributions to noncontrolling interests	-	(3,858)	(3,858)
Pension and other postretirement net adjustments	<u>(10,094)</u>	<u>-</u>	<u>(10,094)</u>
Increase (decrease) in unrestricted net assets	<u>258,274</u>	<u>(6,033)</u>	<u>252,241</u>
Unrestricted net assets—December 31, 2016	<u>1,593,299</u>	<u>3,135</u>	<u>1,596,434</u>
Excess of revenue over expenses from consolidated operations	203,679	2,057	205,736
Net cumulative unrealized gains transferred to trading securities	(59,216)	-	(59,216)
Change in net unrealized gains and losses on investments	22,558	-	22,558
Net assets released from restrictions for capital	8,862	-	8,862
Distributions to noncontrolling interests	-	(1,861)	(1,861)
Pension and other postretirement net adjustments	<u>16,140</u>	<u>-</u>	<u>16,140</u>
Increase in unrestricted net assets	<u>192,023</u>	<u>196</u>	<u>192,219</u>
Unrestricted net assets—December 31, 2017	<u>\$ 1,785,322</u>	<u>\$ 3,331</u>	<u>\$ 1,788,653</u>

16. ENDOWMENTS

The System's endowments consist of various funds established for specific purposes. The assets are managed in a custodial account. As a result of the ALM discussed in Note 1, the endowment is transitioning to a revised asset allocation target. The account is using targeted asset allocations of 45% stock and stock funds, 16% private markets (equity/debt), 15% hedge funds, 14% bond and bond funds, 6% real assets, and 4% global asset allocations. The annual spending appropriation from the endowments is determined by the average of the beginning balance for each of the three previous years

multiplied by a 5% spending factor. The endowment corpus is maintained in perpetuity for donor-restricted endowments.

Endowment net assets as of December 31, 2017 and 2016, are composed of the following (in thousands):

	<u>Unrestricted Net Assets</u>	<u>Permanently Restricted Net Assets</u>	<u>Total</u>
December 31, 2017			
Donor-restricted endowment funds	\$ -	\$ 114,123	\$ 114,123
Board-designated endowment funds	<u>336,193</u>	<u>-</u>	<u>336,193</u>
Total endowment funds	<u>\$ 336,193</u>	<u>\$ 114,123</u>	<u>\$ 450,316</u>
December 31, 2016			
Donor-restricted endowment funds	\$ -	\$ 106,064	\$ 106,064
Board-designated endowment funds	<u>303,730</u>	<u>-</u>	<u>303,730</u>
Total endowment funds	<u>\$ 303,730</u>	<u>\$ 106,064</u>	<u>\$ 409,794</u>

Changes in endowment net assets for the years ended December 31, 2017 and 2016, are summarized as follows (in thousands):

	<u>Unrestricted Net Assets</u>	<u>Permanently Restricted Net Assets</u>	<u>Total</u>
Endowment net assets—December 31, 2015	\$ 297,992	\$ 98,597	\$ 396,589
Investment return	21,938	3,503	25,441
Contributions and other	-	7,908	7,908
Acquisition of Allegiance Health Group and Affiliates	-	721	721
Annual spending appropriation	<u>(16,200)</u>	<u>(4,665)</u>	<u>(20,865)</u>
Endowment net assets—December 31, 2016	303,730	106,064	409,794
Investment return	48,463	9,479	57,942
Contributions and other	-	3,377	3,377
Annual spending appropriation	<u>(16,000)</u>	<u>(4,797)</u>	<u>(20,797)</u>
Endowment net assets—December 31, 2017	<u>\$ 336,193</u>	<u>\$ 114,123</u>	<u>\$ 450,316</u>

17. FUNCTIONAL EXPENSES

Total expenses categorized by functional classifications for the years ended December 31, 2017 and 2016, were as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Health care services	\$ 5,124,182	\$ 4,895,810
Management and general	<u>706,304</u>	<u>712,382</u>
Total expenses	<u>\$ 5,830,486</u>	<u>\$ 5,608,192</u>

18. SUBSEQUENT EVENTS

Pursuant to FASB Accounting Standards Codification Topic 855-10, *Subsequent Events—Overall*, the System has evaluated subsequent events through April 9, 2018, the date the consolidated financial statements were issued. As a result of this evaluation, the System has no subsequent events to disclose.

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