

March 23, 2018

Dear Investor:

Enclosed are Inova Health System's 2017 Audited Consolidated Financial Statements and Other Supplementary Information Relating to the IHS Obligated Group. Management Discussion and analysis is also enclosed for the year ended December 31, 2017 and 2016.

We appreciate your interest in Inova Health System. If we can provide any information, please let me know.

Sincerely,

Chris Smith
Director, Financial Reporting
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Attachments

Inova Health System
Management’s Discussion and Analysis of Results of Operations and Financial Position
as of and for the Year Ended December 31, 2017

Introduction

Inova Health System (“IHS”) is an integrated, not-for-profit health care delivery system that owns, operates and manages clinical, educational, research, and hospital facilities located in northern Virginia, serving northern Virginia, the Washington, D.C. metropolitan area, and contiguous counties in Virginia and Maryland. The principal line of business for IHS is the delivery of acute care hospital services at locations in northern Virginia. IHS also operates an integrated network of health services including ambulatory care, home health care, senior services, assisted living, and other health related services. IHS also maintains a group of primary care and specialty physicians operating as the Inova Medical Group. IHS formed a Population Health division in 2013 that operated INTotal Health (“INTotal”), a Medicaid health maintenance organization. This division also operates a Program of All-Inclusive Care for the Elderly, a clinically integrated physician network known as Signature Partners, and Innovation Health, a joint venture with Aetna offering commercial health insurance plans. In 2015 IHS established the Inova Center for Personalized Health (“ICPH”) which intends to integrate genomics into personalized medicine and individualized wellness.

The following discussion and analysis provides information that IHS management believes is relevant to an assessment and understanding of IHS’ results of operations and financial position. This analysis should be read in conjunction with IHS’ financial statements for the periods ended December 31, 2017 and 2016. The discussion and analysis focuses on IHS as a whole, which management believes provides a fair description and analysis, in all material respects, of the Obligated Group’s results of operations and financial condition, insofar as the Obligated Group represents approximately 88.4% of total operating revenues and nearly 100% of unrestricted net assets of IHS as of and for the year ended December 31, 2017.

Results of Operations as of and for the year ended December 31, 2017 and 2016

Overall, IHS reported strong operating performance achieving cash flow and operating margins of 13.2% and 5.1%, respectively, exceeding prior year performance. Investment returns benefited from the sharp rise in global equity markets resulting in investment income in excess of \$674.7 million when compared to \$265.0 million in 2016. Strong portfolio returns coupled with improved operating performance contributed to a net margin of 20.7% for the year.

Operating Revenues. Total operating revenues for IHS for the year ended December 31, 2017 were \$3.4 billion, up 5.3% over 2016. Net patient service revenue increased 6.0% primarily due to strong acute and ambulatory volumes in selective areas:

- Hospital inpatient surgical cases: +2.0%
- Outpatient visits: +2.2%
- Rehabilitation treatments: +29.7%

- Urgent care center visits: +25.4%
- Ambulatory surgery center cases: +11.1%

Ambulatory and non-acute care patient volumes were strong due to the addition of new sites and increased patient visits for existing sites. Revenue cycle optimization initiatives have contributed to stronger top line yield in both hospital and ambulatory settings. Premium revenue of \$190.4 million was 9.1% lower than the prior year resulting from the sale of INTotal on October 31, 2017. See the discussion below.

IHS and Aetna each have a 50% ownership interest in Innovation Health (Innovation), a commercial health insurance plan with approximately 200,000 covered lives in the northern Virginia market. IHS accounts for its interest in Innovation under the equity method whereby 50% of Innovation's net income/(loss) is recorded as Other Operating Revenue in IHS' Statement of Operations. In 2017, Innovation recorded losses associated with the Health Insurance Exchange and, beginning January 1, 2018, will not participate in any public health insurance exchange products. Innovation's other insurance products were profitable. Innovation recognized a \$33.4 million net operating loss for 2017. IHS' share of Innovation's 2017 net operating loss was \$16.7 million.

In October, IHS completed the sale of all of the non-monetary assets of its wholly owned subsidiary, INTotal Health, to United Healthcare Insurance Company. The sales price included \$12.0 million in cash and an estimated \$20.4 million of additional consideration payable in the fourth quarter of 2018. A \$13.5 million gain was recorded in connection with the sale, which is included in the non-operating section of the income statement.

Operating Expenses for the year ended December 31, 2017 were \$3.3 billion, an increase of 4.1% over 2016. Salaries and benefits increased \$122.2 million, or 8.1%, primarily due to increased staffing associated with higher patient acuity, additional nursing supervisors and clinical training and fellowship programs. IHS continued to incur high costs associated with temporary labor and premium pay in specialty areas. Medical supply costs increased \$28.3 million, or 9.1%, due to increased surgical volume and patient acuity. Depreciation and amortization expense increased \$8.2 million, or 3.8% in 2017, primarily as a result of the new hospital construction projects coming on line.

Operating Income before Impairment, Pension Settlement and Other Gain was \$174.8 million, or 5.1% of total operating revenues, for 2017, as compared to \$130.9 million, or 4.0% of total operating revenues, in 2016. Excluding losses in the two business lines (Health Insurance Exchange and Medicaid Health Plan) that IHS will no longer participate effective January 2018, operating income through December 31, 2017 would have been \$195.1 million.

Non-Operating Revenue. Investment returns benefited from the sharp rise in global equity markets were strong throughout 2017 across most asset classes and exceeded benchmarks. Investment returns on Inova's Strategic Fund were 16.6% for the year. Total non-operating revenue, which includes most investment returns, was \$674.7 million resulting in a net margin of 20.7% for the year.

Financial Position as of December 31, 2017

Current Assets and Liquidity. IHS' balance sheet remains strong, with significant unrestricted cash and investments at December 31, 2017 of \$5.1 billion, of which \$2.8 billion represents investments that can be liquidated within 3 days. Operating cash flow of \$421 million exceeded prior year by \$19.4 million, or 4.8%.

Investments. The following table summarizes the asset allocation for the Strategic Fund and the Capital Fund, which together comprised the Board designated funds as of December 31, 2017 (dollars in thousands):

	<u>Amount</u>	<u>%</u>
<u>Strategic Fund</u>		
Cash and cash equivalents	\$ 439,915	9.0%
Fixed income	653,789	13.3%
Public equity	2,607,564	53.1%
Growth hedge fund	266,268	5.4%
Private equity	107,693	2.2%
Diversifying hedge fund	508,709	10.4%
Real assets	154,828	3.2%
	<u>4,738,766</u>	<u>96.6%</u>
<u>Capital fund</u>	167,419	3.4%
Total	<u>\$ 4,906,185</u>	100.0%

Fixed income securities are primarily investment-grade U.S. bonds with maturities ranging from 1 year to 30 years. Public equity securities are typically exchange traded U.S. and non-U.S. stocks. Hedge funds include strategies with moderate to low correlation with more traditional equity and fixed income sectors. Private equity includes early stage venture capital and buyout funds. Real assets include private real estate, commodities, and inflation-protected securities.

IHS maintains a separate portfolio comprised of limited maturity, high quality bonds (Capital Fund). This fund was established to ensure that IHS would have sufficient liquidity to complete critical construction projects in the event of a major financial market disruption.

Property, Plant, and Equipment. Capital expenditures were \$380.1 million for the year ended December 31, 2017 including \$122.7 million related to major hospital expansion and renovation projects at the Inova Fairfax Medical Campus, Inova Loudoun Hospital and the ICPH campus, \$99.0 million for the new Inova Schar Cancer Institute, located on the ICPH campus, \$82.3 million related to information technology strategic and infrastructure projects, and \$76.1 million related to major and minor equipment purchases.

All planned capital expenditures are regularly evaluated based upon business need, economic conditions and IHS' financial position. IHS management currently anticipates that capital expenditures will be financed with a combination of operating cash flow, existing cash

reserves, donations, and tax-exempt borrowing. The actual undertaking of any construction project or equipment purchase program contemplated by IHS is dependent upon a number of factors, including receipt of appropriate Certificates of Public Need from the Virginia Department of Health and subject to changes in the methods and requirements pertaining to the delivery of necessary health care services.

Debt Structure and Liability Management. At December 31, 2017, total long-term debt outstanding, including financing obligations, was \$1.8 billion, or 23.6% of capitalization. IHS's capital structure is diversified to mitigate interest rate risk by utilizing different modes and durations of long-term debt as well as interest rate swaps. At December 31, 2017, IHS underlying and effective fixed rate debt as a percent of total long term debt was 74.1% and 82.6% respectively, resulting in an all-in interest cost of 2.9%

IHS maintains a self-liquidity taxable commercial paper ("CP") program with \$100.0 million outstanding of short term debt having maturity dates from 1 to 270 days. The outstanding CP is included in notes payable and other liabilities in the current liabilities section of the balance sheet.

In December, IHS issued \$179.3 million of Series 2017 bonds at a rate of 1.55% and served to advance refund the remaining 2009A and 2009C Series bonds. A \$10.8 million accounting loss was recognized on early extinguishment of debt related to this transaction, which is included in the non-operating section of the income statement.

Executive Leadership Changes

In September 2017, Knox Singleton announced his intention to retire as the Chief Executive Officer of IHS ("CEO") effective on June 30, 2018. On March 14, 2018, following a national search for a new CEO, the Board of Trustees of Inova announced that J. Stephen Jones, MD, FACS, a nationally recognized leader in urological oncology as well as clinical transformation at the Cleveland Clinic, will become Inova's new CEO effective April 9, 2018.

On December 31, 2017, Richard Magenheimer retired as the Chief Financial Officer ("CFO") of IHS. The Board of Trustees has appointed Stephanie Schnittger as the interim CFO. Mr. Magenheimer continues to remain with IHS in an advisory capacity to assist in the transition of new executive leadership.

Other Financial Information

The following are selected financial indicators for IHS as of and for the years ended December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Operating Margin ¹	5.1%	4.0%
Operating Cash Flow Margin ²	13.2%	12.3%
Net Margin ³	20.7%	8.0%
Net Days in Accounts Receivable ⁴	38.8	38.1
Days in Unrestricted Cash ⁵	619.1	567.7
Unrestricted Cash to Debt ⁶	2.9x	2.5x
Debt Service Coverage Ratio ⁷	12.8x	8.4x

1 Operating income excluding impairment, pension settlement, and other gain divided by operating revenue

2 Operating income excluding impairment, pension settlement, and other gains, plus interest expense, plus depreciation and amortization expense divided by total operating revenue

3 Excess revenues over expenses divided by total operating revenue plus investment income and other, net

4 Net Patient Receivables divided by three-month average daily net patient service revenue

5 Cash and short-term investments plus unrestricted cash reserves plus unrestricted long-term investments divided by average daily operating expenses excluding depreciation and amortization expense

6 Cash and short-term investments plus unrestricted cash reserves plus unrestricted long-term investments divided by debt-current portion plus debt-long-term portion

7 Income Available for Debt Service divided by long-term debt service requirement

INOVA HEALTH SYSTEM



**Audited Consolidated
Financial Statements and
Other Supplementary Information
Relating to the IHS Obligated Group**

**Fiscal Year Ended
December 31, 2017**

Inova Health System
Audited Consolidated Financial Statements
And Other Supplementary Information
Relating to the IHS Obligated Group
December 31, 2017 and 2016

Audited Consolidated Financial Statements

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Report of Independent Auditors

The Board of Trustees
Inova Health System

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

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Inova Health System at December 31, 2017 and 2016, and the consolidated results of its operations and changes in net assets, and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

March 23, 2018

Inova Health System
Consolidated Balance Sheets
December 31, 2017 and 2016
(in thousands)

	2017	2016
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 232,528	\$ 284,076
Assets whose use is limited, current	129,630	129,985
Patient accounts receivable (less allowance for doubtful accounts: 2017 - \$99,065; 2016 - \$94,624)	332,055	306,721
Other current assets	144,035	127,022
Total Current Assets	838,248	847,804
Property, Equipment and Leasehold Interests, net (Note 5)	2,182,062	1,989,253
Assets Whose Use Is Limited (Notes 2, 6, 7, 12)		
Held by bond trustee	8,921	22,039
By board for plant replacement and expansion	4,738,766	4,036,417
By board for construction projects	167,419	189,985
By donor	128,979	112,283
For professional liability	127,588	106,647
For health plan liability	12,230	12,178
	5,183,903	4,479,549
Less amounts required to meet current obligations	(129,630)	(129,985)
Total Assets Whose Use Is Limited, noncurrent	5,054,273	4,349,564
Other Assets		
Investments in and receivables from affiliates (Note 8)	42,903	41,808
Goodwill and other intangible assets (Note 9)	42,965	62,472
Interest rate swap	1,986	-
Other long-term assets	83,313	43,485
Total Other Assets	171,167	147,765
TOTAL ASSETS	\$ 8,245,750	\$ 7,334,386
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable and other accrued expenses	\$ 389,708	\$ 338,196
Third-party settlements	52,963	47,000
Notes payable and other liabilities	126,775	144,945
Current portion of long-term debt (Note 10)	159,233	156,789
Total Current Liabilities	728,679	686,930
Non-current Liabilities		
Long-term debt, less current portion (Note 10)	1,319,778	1,342,349
Interest rate swap liability (Note 11)	314	2,846
Financing obligation (Note 14)	184,423	183,410
Other non-current obligations	87,831	95,655
Total Non-current Liabilities	1,592,346	1,624,260
Net Assets		
Unrestricted	5,744,855	4,891,147
Temporarily restricted	116,236	94,819
Permanently restricted	44,212	37,230
Total Net Assets Attributable to IHS	5,905,303	5,023,196
Noncontrolling interest	19,422	-
Total Net Assets	5,924,725	5,023,196
TOTAL LIABILITIES AND NET ASSETS	\$ 8,245,750	\$ 7,334,386

See notes to the consolidated financial statements.

Inova Health System
Consolidated Statements of Operations and Changes in Net Assets
For the Years Ended December 31, 2017 and 2016
(in thousands)

	2017	2016
Operating Revenues		
Net patient service revenue	\$ 3,264,046	\$ 3,069,800
Provision for bad debts	(158,041)	(140,165)
Net Patient Service Revenue Less Provision for Bad Debts	3,106,005	2,929,635
Premium revenue	190,392	209,488
Other operating revenue	132,694	116,401
Total Operating Revenues	3,429,091	3,255,524
Operating Expenses		
Salaries and benefits	1,640,192	1,517,961
Other operating expenses	1,218,018	1,190,934
Medical claims	118,853	147,105
Depreciation and amortization	224,808	216,595
Interest	52,394	52,053
Total Operating Expenses	3,254,265	3,124,648
Operating Income before impairment, pension settlement and other gain	174,826	130,876
Impairment, pension settlement and other gain	13,474	(112,900)
Operating Income	188,300	17,976
Investment income and other, net	674,755	265,020
Excess of Revenues Over Expenses	863,055	282,996
Less: Noncontrolling Interest	(13,971)	-
Excess of Revenues Over Expenses, Attributable to IHS	849,084	282,996

Continued on page 4.

See notes to the consolidated financial statements.

Inova Health System
Consolidated Statements of Operations and Changes in Net Assets (continued)
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Noncontrolling Interest</u>	<u>Total</u>
Balance at December 31, 2015	\$ 4,584,661	\$ 78,708	\$ 36,953	\$ -	\$ 4,700,322
Excess of revenues over expenses (from page 3)	282,996	-	-	-	282,996
Unrealized (loss)/gain on investments, net	(150)	44	405	-	299
Capital reimbursements for grants	2,048	-	-	-	2,048
Change in plan assets and benefit obligations of pension	16,463	-	-	-	16,463
Gifts and bequests	-	30,123	102	-	30,225
Restricted investment income	-	970	(864)	-	106
Net assets released from restriction	-	(14,519)	-	-	(14,519)
Other	5,129	(507)	634	-	5,256
Change in net assets	<u>306,486</u>	<u>16,111</u>	<u>277</u>	<u>-</u>	<u>322,874</u>
Balance at December 31, 2016	4,891,147	94,819	37,230	-	5,023,196
Reclassification of beginning balance of noncontrolling interest	-	-	-	17,855	17,855
Excess of revenues over expenses (from page 3)	849,084	-	-	13,971	863,055
Unrealized gain/(loss) on investments, net	8	(25)	3,323	-	3,306
Capital reimbursements for grants	207	-	-	-	207
Gifts and bequests	-	40,955	1,236	-	42,191
Restricted investment income	-	1,225	2,529	-	3,754
Net assets released from restriction	-	(21,370)	-	-	(21,370)
Change in noncontrolling equity interest	-	-	-	(12,404)	(12,404)
Other	4,409	632	(106)	-	4,935
Change in net assets	<u>853,708</u>	<u>21,417</u>	<u>6,982</u>	<u>19,422</u>	<u>901,529</u>
Balance at December 31, 2017	<u>\$ 5,744,855</u>	<u>\$ 116,236</u>	<u>\$ 44,212</u>	<u>\$ 19,422</u>	<u>\$ 5,924,725</u>

See notes to the consolidated financial statements.

Inova Health System
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
Operating Activities		
Change in net assets	\$ 901,529	\$ 322,874
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation and amortization	224,808	216,595
Change in plan assets and benefit obligations of pension	-	(16,463)
Loss on impairment of goodwill and intangible assets	-	48,406
Loss on extinguishment of debt	10,787	18,000
Net realized and unrealized gains on investments	(652,131)	(229,232)
Change in fair value of interest rate swaps	305	(2,164)
Equity investment losses, net	23,367	22,393
Increase in accounts receivable and third-party settlements, net	(24,187)	(22,630)
Increase in other current assets	(18,161)	(8,673)
Increase in accounts payable and other current liabilities	4,979	17,628
Decrease in pension asset	-	69,402
Increase in estimated professional liability and other deferred liability items	10,335	4,987
Restricted contributions and investment income	(31,440)	(30,331)
Change in the noncontrolling interest	(17,855)	-
Other	(10,574)	(8,396)
Net Cash Provided by Operating Activities	<u>421,762</u>	<u>402,396</u>
Investing Activities		
Capital expenditures	(380,074)	(237,678)
Investments in and advances to joint ventures and affiliates	(24,462)	(35,835)
Purchases of marketable securities	(1,895,603)	(3,094,952)
Proceeds from sale of marketable securities	1,824,991	3,025,388
Other	1,376	-
Net Cash Used in Investing Activities	<u>(473,772)</u>	<u>(343,077)</u>
Financing Activities		
Principal payments on long-term debt	(28,453)	(29,979)
Proceeds from issuance of long-term debt	183,416	278,027
Refunding of long-term debt	(181,117)	(279,400)
Swap termination and modification payments	(4,824)	(17,757)
Restricted contributions and investment income	31,440	30,331
Other	-	(3,397)
Net Cash Provided by (Used in) Financing Activities	<u>462</u>	<u>(22,175)</u>
Net (Decrease)/Increase in Cash and Cash Equivalents	(51,548)	37,144
Cash and cash equivalents at beginning of year	<u>284,076</u>	<u>246,932</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u><u>\$ 232,528</u></u>	<u><u>\$ 284,076</u></u>

See notes to the consolidated financial statements.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

1. Nature of Operations

Organization: Inova Health System (“IHS”) is an integrated, not-for-profit health care delivery system that owns, operates and manages clinical, educational, research and hospital facilities located in Northern Virginia, serving Northern Virginia, the Washington, D.C. metropolitan area and contiguous counties in Virginia and Maryland. The principal line of business for IHS is the delivery of acute care hospital services at five hospitals located in Northern Virginia. IHS also operates an integrated network of health services including a medical group, ambulatory care, home health care, senior services, assisted living and other health related services.

IHS formed a Population Health division in 2013 that operated INTotal Health, LLC (“INTotal”), a Medicaid health maintenance organization (“HMO”). This division also operates a Program of All-Inclusive Care for the Elderly (“PACE”) program, and a clinically integrated physician network known as Signature Partners, and Innovation Health a joint venture with Aetna offering commercial health insurance plans. On October 31, 2017, IHS completed the sale of all of the non-monetary assets of its wholly owned subsidiary, INTotal, to United Healthcare Insurance Company (UnitedHealth). See Note 17. In 2015, IHS formed the Inova Center for Personalized Health (“ICPH”) which is committed to lead the way in the integration of genomics into personalized medicine and individualized wellness.

2. Summary of Significant Accounting Policies

Basis of Presentation: The financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). The preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Principles of Consolidation: The IHS consolidated financial statements include the accounts of the Inova Health System Foundation (the “Foundation”); Inova Health Care Services (“IHCS”); Loudoun Hospital Center (“LHC”); Inova Holdings, Inc. (“IHI”); INTotal; and their majority-owned subsidiaries and controlled affiliates. All material intercompany accounts and transactions have been eliminated in consolidation.

The Foundation is a tax-exempt, non-stock corporation, which controls its affiliated corporations through its authority to appoint the governing boards of the tax-exempt, non-stock affiliates or its stock ownership. The Foundation also supports and maintains the programs, services, and facilities of IHS’ health care delivery system in part through the solicitation, receipt, administration, and distribution of philanthropic gifts on behalf of its tax-exempt affiliates. INTotal, a former wholly-owned subsidiary of the Foundation, was a Medicaid HMO licensed and authorized to do business in Virginia. During 2017, the non-monetary assets of INTotal were sold to UnitedHealthcare Insurance Company. See Note 17.

IHCS is a tax-exempt, non-stock corporation that serves the health care needs of the community by establishing, maintaining and operating hospital and health care facilities, programs, and other shared and integrated health care delivery arrangements. IHCS operates the following facilities, among others: Inova Fairfax Hospital (“Fairfax”); Inova Mount Vernon Hospital (“Mount Vernon”), Inova Fair Oaks Hospital (“Fair Oaks”) and Inova Alexandria Hospital (“Alexandria”). IHCS also provides and manages the clinical, non-hospital facilities and programs whose services include senior services, assisted living facilities, addiction treatment services for adults and adolescents, outpatient rehabilitation services, urgent care and other outpatient health care services. IHCS also maintains a group of primary care and specialty physicians operating as the Inova Medical Group.

LHC is a tax-exempt, non-stock corporation that serves the health care needs of Loudoun County, Virginia, and surrounding areas. In addition to Inova Loudoun Hospital (“Loudoun”), LHC operates Loudoun Nursing and Rehabilitation Center, Loudoun Healthcare Foundation and other health care and related facilities.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

2. Summary of Significant Accounting Policies (continued)

IHI is a wholly owned subsidiary of the Foundation and is the parent holding company for various taxable entities within IHS including Technical Dynamics Inc., a biomedical equipment maintenance and engineering company. IHI and its subsidiaries operate facilities providing a variety of health care and support services to patients and affiliated health care providers.

Cash and Cash Equivalents: Cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. Cash equivalents are valued at cost, which approximates fair value.

Patient Accounts Receivable: Patient accounts receivable include charges for amounts due from all patients less allowances for the excess of established charges over the payments to be received on behalf of patients covered by Medicare, Medicaid and other insurers. The provision for bad debts is recognized when providing an allowance for uncollectible accounts.

The provision for bad debts is based upon management's assessment of historical and expected net collections considering historical business and economic conditions, trends in health care cover, and other collection indicators. Periodically throughout the year, management assess the adequacy of the allowance for uncollectible accounts based upon historical write-off experience of self-pay accounts receivable, including those balances after insurance payments and not covered by insurance. The results of this review are then used to make any modifications to the provision for bad debts to establish an appropriate allowance for uncollectible accounts. There have been no significant changes in the current year to the underlying assumptions used by IHS to estimate the allowance for uncollectible accounts. Patient accounts receivable are written off after collection efforts have been followed in accordance with IHS policies.

All operating entities of IHS treat emergency patients and provide medically necessary treatment to patients regardless of their ability to pay. A patient is classified as a charity patient based upon established IHS policies that consider patient income levels. Since IHS does not pursue collection of amounts that qualify as charity care, they are deducted from gross revenue.

Assets Whose Use Is Limited: Assets whose use is limited include board-designated funds for the acquisition of property and equipment, funds restricted by donors for charitable purposes, funds to cover self-insurance and medical claim liabilities, and trustee-held assets for the retirement of long-term liabilities.

Investments in equity securities with readily determinable fair values and all investments in debt securities held by IHS' custodian are designated as trading securities. Investment income (including realized gains and losses, unrealized gains and losses, interest, and dividends) is included in excess of revenues over expenses unless such earnings are subject to donor-imposed restrictions. Investment income restricted by donor stipulations is reported as an increase in temporarily restricted net assets. Unrealized gains and losses on investments classified as other-than-trading are reported as a change in unrestricted net assets and, in accordance with relevant accounting literature, are excluded from excess of revenues over expenses. IHS also holds investments in limited partnerships as a conduit for investments that are not actively traded. These investments are summarized as alternative investments. Alternative investments are accounted for under the equity method of accounting. Investments designated as other-than-trading are periodically reviewed for impairment conditions, including the magnitude and duration of the decline that indicate the occurrence of an other-than-temporary decline. If such conditions exist, the investment's cost is then written down to its current market value. IHS did not identify the occurrence of other-than-temporary declines in fair value for the years ended December 31, 2017 or 2016.

Investment securities and limited partnerships, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility risks. Due to the level of risks associated with certain investment securities and limited partnerships, it is reasonably possible that changes in the value of the investments could occur in the short-term and that changes could materially affect the amounts reported in the IHS consolidated financial statements.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

2. Summary of Significant Accounting Policies (continued)

Fair Value Measurements: IHS evaluates assets and liabilities subject to fair value measurements on a recurring basis to determine the appropriate level in which to classify them for each reporting period. See Note 7.

Property, Equipment and Leasehold Interests: Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable assets, and is computed using the straight-line method. The general range of useful lives is five to twenty years for land improvements, ten to thirty years for buildings, fixed equipment, and leasehold improvements, and five to ten years for major movable equipment. Software and other IT equipment are included in major movable equipment with useful lives of three to five years. Equipment under capital lease obligations is amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated statements of operations and changes in net assets. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Repairs and maintenance are expensed as incurred.

Donated assets are recorded at their fair value at the date of donation. Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support.

Temporarily and Permanently Restricted Net Assets: Temporarily restricted net assets are those whose use by IHS has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by IHS in perpetuity. Annual changes in fair value are reported as increases or decreases in permanently restricted net assets.

Donor-restricted Gifts: Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Contributions received are reported as either temporarily or permanently restricted assets if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the accompanying consolidated statements of operations and changes in net assets as net assets released from restriction. Donor-restricted contributions whose restrictions are met within the same year as received and contributions received where no restrictions were stipulated are reflected as unrestricted contributions reported in the accompanying consolidated financial statements as other operating revenue.

Excess of Revenues Over Expenses The consolidated statements of operations include the excess of revenues over expenses as the performance indicator. Changes in unrestricted net assets that are excluded from the excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on other-than-trading assets limited as to use and investments to the extent losses are deemed temporary, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets)

Impairment, Pension Settlement and Other Gain The impairment, pension settlement and other gain caption includes the following items. For the year ended December 31, 2016, IHS recorded an impairment of intangible assets and goodwill totaling \$48,406 which is further discussed in Note 9. During 2016, IHS also recorded a loss on the settlement of the defined benefit pension plan totaling \$64,494 which is further discussed in Note 18. During 2017, IHS completed the sale of all of the non-monetary assets of its wholly owned subsidiary, INTotal, to United Healthcare Insurance Company (UnitedHealth) as discussed in Note 17.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

2. Summary of Significant Accounting Policies (continued)

Investments in and Receivables from Affiliates: IHS makes investments in corporations and other forms of businesses. Investments where less than 20% of the ownership interest is held by IHS, and IHS does not exert significant influence over the investee, are accounted for using the cost method. Investments where 20% to 50% of the voting common stock is owned by IHS as well as certain partnership and limited liability company investments are accounted for using the equity method. The equity method is also applied to investments in which IHS owns less than 20% of the ownership interest but can exert significant influence over the investee. See Note 8.

Goodwill and Other Intangible Assets: Financial Accounting Standard Board (“FASB”) guidance requires business combinations to be accounted for using the acquisition method of accounting and it also specifies the types of acquired intangible assets that are required to be recognized and reported separately from goodwill. Goodwill represents the excess of cost of acquisition over the fair value of net assets acquired. Other intangible assets primarily represent the values assigned to subscriber bases, provider and hospital networks, and trademarks. Goodwill and other intangible assets with indefinite lives are not amortized but are tested for impairment at least annually. See Note 9.

Interest Rate Swap Agreements: IHS has entered into interest rate swap agreements to manage the net exposure to interest rate changes related to its borrowings and to manage its overall borrowing costs. For designated cash flow hedges, the change in its fair value is recorded as a change in other unrestricted net assets. For interest rate swaps not designated or qualifying as hedges, changes in fair value are recorded in investment income and other, net. See Note 11.

Premium Revenue: IHS records premium revenues based on premium information from each government agency with whom they contract to provide services. Premiums are due monthly and are recognized as revenue during the period in which IHS is obligated to provide service to members. Premium payments from contracts with government agencies are based on eligibility lists produced by the government agencies.

Medical Claims Liability: INTotal incurs medical claims expenses on behalf of its members and establishes an accrual for amounts billed and not paid and an estimate of costs incurred for unbilled services provided. The estimated liability for unbilled services is based principally on historical payment patterns using actuarial techniques. Changes in assumptions for medical costs caused by changes in actual experience could cause the estimates to change in the near term. Such changes are reflected in current operations. Medical claims liability is recorded in notes payable and other liabilities in the accompanying consolidated balance sheets.

Income Taxes: The Foundation, IHCS, LHC, and INTotal are not-for-profit corporations and have been determined to be exempt from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code. IHI and its subsidiaries are taxable organizations. Deferred income taxes are provided for all significant timing differences between revenues and expenses reported for financial statement and for tax purposes. Management annually reviews its tax positions and has determined that there are no material uncertain tax positions that require recognition in the consolidated financial statements.

Noncontrolling Interest: The noncontrolling interest in a subsidiary is presented within net assets in the IHS’s Consolidated Balance Sheet and Consolidated Statements of Operations and Changes in Net Assets and represents the proportionate share owned by third parties. IHS presents the unrestricted noncontrolling interest and the amount of consolidated changes in net assets in its Consolidated Statements of Operations and Changes in Net Assets. The carrying amount of the noncontrolling interest is adjusted based on an allocation of subsidiary earnings based on ownership interest. Amounts attributable to noncontrolling interests of \$17.8 million were reclassified from other noncurrent obligations to unrestricted net assets during 2017. These amounts are shown as “reclassification of beginning balance of noncontrolling interest” in the Consolidated Statements of Operations and Changes in Net Assets for the year ended December 31, 2017.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

2. Summary of Significant Accounting Policies (continued)

Risk Factors: IHS' ability to maintain and/or increase future revenues or income could be adversely affected by: (i) the pressure to contain costs and assume risks that may result from payors promoting alternative methods for health care delivery or payment of services, such as discounted fee for service networks, value-based payments, and capitated fee arrangements; (ii) increased competition from other hospital facilities and integrated health care delivery systems in IHS' service areas; (iii) new statutory, legal or regulatory requirements, or structural, operational or payment changes to the health care industry, resulting from the enactment and implementation of the Patient Protection and Affordable Care Act and other similar health care reform measures; (iv) Changes in revenue mix, or delays in receiving payments from third party payors, including any payments from the State of Virginia that may result if there were delays in appropriations and state budget deficits; (v) proposed and/or future changes in the laws, rules, regulations and policies relating to the definition, activities, and/or taxation of non-profit tax-exempt entities; (vi) future legislation, regulation or other actions by federal, state and local governments and their agencies which may impose requirements or continue the trend toward more restrictive limitations on reimbursement for health care services; (vii) future legislation or adverse trends affecting the costs related to professional liability coverage; (viii) the future of Virginia's Certificate of Need program, where future deregulation could result in the entrance of new competitors, or future additional regulation may eliminate IHS' ability to expand new services; (ix) changes in general and local economic conditions that could influence patients' ability to pay for services or the adequacy of patients' health insurance coverage; (x) a potential shortage of physicians, qualified nurses and other skilled health care professionals in the local employment market; and (xi) changes in general and local economic conditions that could cause volatility in capital and debt markets and may impose limitations to timely access to debt markets.

Subsequent Events: IHS has evaluated subsequent events that have occurred for recognition and disclosure through March 23, 2018, the date the accompanying consolidated financial statements were available for issuance.

Recent Accounting Pronouncements: In March 2017, the FASB issued ASU 2017-08, *Receivables—Nonrefundable Fees and Other Costs: Premium Amortization on Purchased Callable Debt Securities* (Subtopic 310-20). The amendments to this update shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest called date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Management is currently evaluating the impact that the adoption of ASU 2017-08 will have on its consolidated financial statements.

In February 2017, the FASB issued ASU 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets: Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets* (Subtopic 610-20). The amendments in this update clarify that a financial asset is within the scope of Subtopic 610-20 if it meets the definition of an in substance nonfinancial asset. The amendment also defines the term *in substance nonfinancial asset* and clarifies that nonfinancial assets within the scope of Subtopic 610-20 may include nonfinancial assets transferred within a legal entity to a counterparty. The amendments in this update are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Management is currently evaluating the impact that the adoption of ASU 2017-05 will have on its consolidated financial statements.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

2. Summary of Significant Accounting Policies (continued)

In January 2017, the FASB issued ASU 2017-04, *Intangibles—Goodwill and Other: Simplifying the Test for Goodwill Impairment* (Topic 350). To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. The FASB also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendments in this update are effective for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. Management is currently evaluating the impact that the adoption of ASU 2017-04 will have on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-02, *Not-for-Profit Entities—Consolidation: Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity* (Subtopic 958-810). Under this update, not-for-profit organizations that are general partners continue to be presumed to control a for-profit limited partnership, regardless of the extent of this ownership interest, unless that presumption is overcome. This update also adds new guidance to the general consolidation guidance in Subtopic 810-10 on when limited partners should consolidate limited partnerships that are not variable interest entities or that are not within the scope of the consolidation guidance for variable interest entities. The amendments in this update are effective for fiscal years beginning after December 15, 2016 and interim periods within fiscal years beginning after December 15, 2017. Management adopted ASU 2017-02 in 2017. Its adoption did not have a material impact to the financial statements.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. Key elements of the ASU include: 1.) Reducing net asset classifications from three categories to two reporting net assets with donor restrictions and net assets without donor restrictions, 2.) Expanding disclosures about the nature and amount of any donor restrictions, 3.) Expanding disclosures on any board designations of net assets without donor restrictions, and 4.) Classifying underwater donor-restricted endowments as net assets with donor restrictions. Additional disclosures, both qualitative and quantitative, will also be required. The new guidance is effective for fiscal years beginning after December 15, 2017. Management does not expect the impact to the consolidated financial statements to be material.

In February 2016, the FASB issued ASU 2016-02, *Leases* (Topic 842). The underlying principle of ASU 2016-02 is that lessees should be required to recognize the assets and liabilities arising from leases on the statements of financial position. The guidance requires a lessee to recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from previous generally accepted accounting principles. There continues to be a differentiation between finance leases and operating leases. However, the principal difference from previous guidance is that the lease assets and lease liabilities arising from operating leases should be recognized in the consolidated balance sheets. The guidance is currently effective for fiscal years beginning after December 31, 2018. Management is currently evaluating the impact that the adoption of ASU 2016-02 will have on its consolidated financial statements.

In May 2014 the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 provides for a single comprehensive principles-based standard for the recognition of revenue across all industries through the application of a five-step model. The new standard changes the healthcare industry specific guidance under ASU 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2014-09 is effective for annual periods beginning after December 15, 2016, early adoption is permitted. On July 9, 2015, the FASB approved a one-year deferral of the effective date of the standard to 2018. In December 2016, the FASB issued ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, which amends various aspects of ASU 2014-09. The amendments in these ASUs are effective for IHS as of January 1, 2018. Management intends to adopt the new standard on a full retrospective basis and is in process of finalizing its assessment of the impact of adoption under ASU 606 for each of its revenue streams under the scope of the ASUs. Management does not expect the impact to the consolidated financial statements to be material.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

3. Net Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors and others for services rendered. IHS recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, IHS recognizes revenue on the basis of discounted (or negotiated) rates for services rendered as provided by policy. On the basis of historical experience, a portion of IHS' uninsured patients will be unable or unwilling to pay for the services provided. Thus, IHS records a provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts and after the provision for bad debts, is recognized from these major payor sources for the years ended December 31, 2017 and 2016 as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Gross Patient Revenue	\$ 6,715,063	\$ 6,418,641
Deductions:		
Medicare and Medicaid allowances	(1,635,339)	(1,636,588)
Commercial, self-pay, and other payor discounts and allowances	(1,512,051)	(1,426,974)
Charity care	(303,627)	(285,279)
Net Patient Service Revenue	<u>3,264,046</u>	<u>3,069,800</u>
Less: Provision for Bad Debts	(158,041)	(140,165)
Total	<u>\$ 3,106,005</u>	<u>\$ 2,929,635</u>

Significant portions of IHS' services are provided under agreements with the respective patients' health insurance carriers. The following summarizes the sources of gross revenue for acute care hospital services for the years ended December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Managed care and commercial	52.4%	52.0%
Medicare	30.2%	30.7%
Medicaid (Includes Medicaid Managed Care)	10.3%	10.1%
Uninsured	7.1%	7.2%
Total	<u>100.0%</u>	<u>100.0%</u>

IHS agreements with third-party payors provide for payments to IHS at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- *Managed Care and Commercial Payors:* Under managed care and commercial insurance plans, IHS is typically reimbursed for services provided under various contractual arrangements on a discounted fee, per diem or case rate basis. Patients covered by these types of contractual arrangements are obligated to pay IHS any co-payments or deductible amounts required pursuant to the provisions of their managed care plans.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

3. Net Patient Service Revenue (continued)

- *Medicare:* Inpatient acute, non-acute (psych, skilled nursing, rehab, and home health) and outpatient services provided to Medicare beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Ultimately, Medicare reimbursement also takes other factors into consideration such as medical education costs, disproportionate share payments, transplant costs and bad debts which are reimbursed at tentative rates with final settlement determined after submission and audit of the annual cost reports. IHS' classification of patients under the Medicare program and the appropriateness of their admission may be subject to independent review by a peer review organization.
- *Medicaid:* The Medicaid program is administered by the Department of Medical Assistance Services ("DMAS") of the Commonwealth of Virginia, pursuant to federal and state laws and regulations. DMAS receives funding for program expenditures from both the federal government and the Commonwealth of Virginia. Federal and state laws or regulations may affect limits on Medicaid payment. For inpatient Medicaid and other state programs, IHCS and LHC are reimbursed based upon a blend of the All-Patient Refined Diagnosis-Related Group (APR-DRG) and the All Payor-Diagnostic Related Group (AP-DRG) prospective payment systems. Outpatient reimbursement for Medicaid patients is paid under the Enhanced Ambulatory Patient Groups (EAPG) prospectively determined payment system.

Patient accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, IHS analyzes its past 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. Net patient service revenue also includes estimated retrospective adjustments resulting from future audits, reviews and investigations. Retrospective adjustments are considered in recognition of revenue on an estimated basis in the period the related services are rendered and such amounts are adjusted in future periods as adjustments are made known or as years are no longer subject to such audits, reviews and investigations. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is a reasonable possibility that recorded estimates will change by a material amount in the near term.

4. Charity Care and Other Community Benefits

IHS provides healthcare services to patients who meet certain criteria under its charity care policy without charge (or at amounts less than the established rates). Since IHS does not pursue collection of amounts that qualify as charity care, such amounts are not reported as net patient service revenue. The amounts reported as charity care represent the cost of rendering such services based on the cost to charge ratio for each hospital. Various government programs provide for the indigent, including Medicaid recipients. These programs provide a percentage of reimbursement for qualifying patients; however, payment is typically below the cost of those services.

In addition to charity and uncompensated care, IHS provides benefits to the broader community. These services include free health screenings, educational services, prevention services, and support programs. In addition, IHS incurs significant unreimbursed costs in providing medical education and performing medical research. The cost is estimated by utilizing a ratio of cost to gross charges applied to the gross uncompensated charges associated with providing charity care.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

4. Charity Care and Other Community Benefits (continued)

IHS' estimated costs of providing services to the poor and broader community for the years ended December 31, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Charity care	\$ 130,165	\$ 123,217
Unpaid cost of state programs to financially disadvantaged persons	124,521	82,916
Community health programs	25,100	18,822
Medical education and research	21,495	23,223
Total community benefits, at cost	<u>\$ 301,281</u>	<u>\$ 248,178</u>

5. Property, Equipment and Leasehold Interests

The components of property, equipment and leasehold interests, including capital lease assets, at cost, and the related accumulated depreciation were as follows at December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Land and land improvements	\$ 238,845	\$ 238,114
Buildings, fixed equipment and leasehold improvements	2,598,526	2,468,879
Major movable equipment	1,498,489	1,400,356
	<u>4,335,860</u>	<u>4,107,349</u>
Less: Accumulated depreciation and amortization	<u>(2,454,191)</u>	<u>(2,259,947)</u>
	1,881,669	1,847,402
Construction-in-progress	300,393	141,851
Total	<u>\$ 2,182,062</u>	<u>\$ 1,989,253</u>

6. Investments

IHS' investments as of December 31, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Trading securities	\$ 1,795,150	\$ 1,614,384
Alternative investments	2,918,861	2,460,877
Available for sale securities	469,892	404,288
Total	<u>\$ 5,183,903</u>	<u>\$ 4,479,549</u>

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

6. Investments (continued)

Income from alternative investments is recorded in Investment income and other, net on the Statement of Operations and Changes in Net Assets. IHS invests in an array of alternative investments, primarily public, hedge, fund of funds and real asset funds, distressed debt and private equity. A substantial portion of the underlying securities held by these funds are in actively traded marketable securities. Total unfunded commitments to alternative investment funds are \$302.3 million and \$183.4 million as of December 31, 2017 and 2016, respectively.

Investment returns for the years ended December 31, 2017 and 2016 are summarized as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Interest and dividend income	\$ 46,465	\$ 64,544
Net realized gains, including income from alternative investments	417,590	178,244
Net gains related to trading securities	231,235	49,097
Net unrealized gains	3,306	299
Total	<u>\$ 698,596</u>	<u>\$ 292,184</u>

	<u>2017</u>	<u>2016</u>
Included in investment income and other, net		
- Income from investments, net	\$ 57,413	\$ 17,637
- Income from alternative investments, net	402,888	225,045
Net gains related to trading securities	231,235	49,097
Increase/(decrease) in unrestricted net assets	8	(150)
Increase in temporarily restricted net assets	1,200	1,014
Increase/(decrease) in permanently restricted net assets	5,852	(459)
Total	<u>\$ 698,596</u>	<u>\$ 292,184</u>

IHS records investment values on a trade-date basis. Amounts for sales and purchases of securities unsettled as of the balance sheet date are included net in the fair value amounts disclosed above in the appropriate asset class. Net open trades related to trading securities were \$(0.5) million for 2017 and \$(3.6) million for 2016. Open sales totaled \$6.0 thousand and \$0.4 million as of December 31, 2017 and 2016, respectively.

Investments are carried at estimated fair value, unless recorded on the equity method of accounting. Realized gains and losses from sales of investments are reflected in income for the period in which they occur. The average cost of the investment sold is used to determine the realized gain or loss. Interest and dividend income is reported net of investment-related expenses of \$14.9 million in 2017 and \$14.4 million in 2016.

Management continually reviews its investment portfolio and evaluates whether declines in the fair value of securities should be considered other-than-temporary. During the years ended December 31, 2017 and 2016, IHS did not recognize any other-than-temporary declines in the fair market value of investments.

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Notes To Consolidated Financial Statements
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6. Investments (continued)

Details of investments held as available for sale securities in assets whose use is limited as of December 31, 2017 and 2016 are as follows (in thousands):

	2017		2016	
	Cost	Fair Value	Cost	Fair Value
Cash and cash equivalents	\$ 425,356	\$ 423,334	\$ 365,145	\$ 365,164
U.S. government and agency securities	20,661	20,502	16,526	16,364
Domestic equity securities and mutual funds	20,068	26,056	20,094	22,760
Total	\$ 466,085	\$ 469,892	\$ 401,765	\$ 404,288

7. Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability, or the exit price, in an orderly transaction between market participants at the measurement date. ASC Topic 820, "Fair Value Measurement," establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy distinguishes between market participant assumptions based on independent sources (observable inputs classified within Levels 1 and 2) and the reporting entity's own notions about market participant assumptions (unobservable inputs classified within Level 3). Transfers into and out of all levels of the fair value hierarchy are reflected at end-of-period fair value. The fair value levels are as follows:

- Level 1 inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that IHS has the ability to access at the measurement date.
- Level 2 inputs are other observable inputs for the assets or liabilities, either directly or indirectly. These may include quoted prices for similar assets and liabilities in active markets, interest rates, foreign exchange rates and yield curves that are observable at commonly quoted intervals.
- Level 3 inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

Fair value level assignment for assets and liabilities is based on the lowest level input that is significant to the fair value measurement in its entirety. IHS' assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets and liabilities.

Alternative investments measured at fair value represent funds included on the balance sheet that are reported using the net asset value (NAV) practical expedient as prescribed by ASU 2015-07, *Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share*. These amounts are not required to be categorized in the fair value hierarchy. The fair value of these investments is based on the net asset value information provided by the general partner. Fair value is based on the proportionate share of the NAV based on the most recent partner's capital statements received from the general partners.

The following tables present IHS' assets and liabilities measured at fair value on a recurring basis as of December 31, 2017 and 2016, respectively (in thousands). Certain assets such as open purchases and sales do not have fair values classified within a level in the valuation hierarchy. Alternative investments are accounted for under the equity method of accounting. As a result, these are excluded from fair value tables below.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

7. Fair Value Measurements (continued)

	December 31, 2017	Level 1	Level 2	Level 3
Assets:				
Estimated consideration receivable	\$ 20,407	\$ -	\$ -	\$ 20,407
Cash and cash equivalents	552,446	547,496	4,950	-
U.S. government and agency securities	360,166	-	360,166	-
Corporate and other bonds				
- Asset-backed securities	161,675	-	161,675	-
- Corporate and other bonds	260,426	-	260,426	-
- Other government securities	47,789	-	47,789	-
Equity securities				
- Domestic	283,308	283,308	-	-
- International	265,213	259,781	5,432	-
Mutual fund / ETF				
- Equity	278,350	278,350	-	-
- Fixed Income and other	56,141	56,141	-	-
Subtotal	2,285,921	1,425,076	840,438	20,407
Interest rate swap asset	1,986	-	1,986	-
Total assets	\$ 2,287,907	\$ 1,425,076	\$ 842,424	\$ 20,407
Liabilities:				
Interest rate swap liability	\$ (314)	\$ -	\$ (314)	\$ -
Total liabilities	\$ (314)	\$ -	\$ (314)	\$ -
	December 31, 2016	Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 458,345	\$ 458,345	\$ -	\$ -
U.S. government and agency securities	149,126	-	149,126	-
Corporate and other bonds				
- Asset-backed securities	188,595	-	188,595	-
- Corporate and other bonds	284,862	-	284,862	-
- Other government securities	70,360	-	70,360	-
Equity securities				
- Domestic	229,576	229,576	-	-
- International	334,662	334,662	-	-
Mutual fund / ETF				
- Equity	244,282	244,282	-	-
- Fixed Income and other	61,976	61,976	-	-
Total assets	\$ 2,021,784	\$ 1,328,841	\$ 692,943	\$ -
Liabilities:				
Interest rate swap liabilities	\$ (2,846)	\$ -	\$ (2,846)	\$ -
Total liabilities	\$ (2,846)	\$ -	\$ (2,846)	\$ -

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

7. Fair Value Measurements (continued)

The fair value of IHS' securities is determined by management using third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the LIBOR curve and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2.

Assets utilizing Level 1 inputs include: cash and cash equivalents, exchange-traded equity securities, equity and fixed income mutual funds and exchange-traded funds.

Assets and liabilities utilizing Level 2 inputs include: U.S. government and agency securities, corporate, and municipal bonds, certain mortgage-backed securities, asset-backed securities, and foreign government issued securities. IHS entered into interest rate swap agreements in conjunction with the issuance of variable rate bonds. The swap contracts are valued using models based on readily observable market parameters for all substantial terms of the contract. See Note 11 for additional information.

Estimated consideration receivable at December 31, 2017, includes the estimated contingent consideration received related to the sale of INTotal. The fair value of IHS's estimated consideration receivable is estimated based on the fair value approach using the probability weighted average method, which is a quantitative technique that estimates the distribution of an outcome variable that depends on probabilistic input variables and as such is a Level 3 measurement.

8. Investments in and Receivables from Affiliates

IHS makes strategic investments in corporations and other forms of businesses. IHS accounts for investments with 20% to 50% ownership under the equity method of accounting and includes IHS' net equity interest in investments in and receivables from affiliates in the consolidated balance sheets. Investments with less than 20% ownership are accounted for using the cost method.

IHS invested in a joint venture with Aetna that established Innovation Health ("IHealth"), a licensed health plan serving Northern Virginia. IHealth commenced operations in July 2013. IHealth provides employers and consumers access to more affordable, coordinated and integrated health care in the region. IHS holds a 50% interest in IHealth.

IHS' ownership in significant nonconsolidated entities and the amounts included in IHS' consolidated financial statements as of December 31, 2017 and 2016 are as follows (in thousands):

	Carrying Value		Equity Method (Losses) Income	
	2017	2016	2017	2016
IHealth	\$ 37,042	\$ 30,718	\$ (16,676)	\$ (10,417)
Other investments accounted for under equity method	5,368	10,597	(6,691)	(11,976)
Investments accounted for under cost method	493	493	-	-
Total investments in affiliates	\$ 42,903	\$ 41,808	\$ (23,367)	\$ (22,393)

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

8. Investments in and Receivables from Affiliates (continued)

The summarized financial positions and results of operations for investments accounted for under the equity method as of and for the years ended December 31, 2017 and 2016 are as follows (in thousands) (unaudited):

	<u>2017</u>	<u>2016</u>
Total Assets	\$ 283,461	\$ 241,248
Total Liabilities	156,763	132,131
Net Assets	126,699	109,117
Total revenues, net	565,132	470,910
Excess of expenses over revenue	(37,088)	(30,248)

9. Goodwill and Other Intangible Assets

The majority of goodwill and other intangible assets prior to 2017 pertain to the acquisition of INTotal in 2012. During 2017, certain non-monetary assets of INTotal were sold to UnitedHealthcare Insurance Company. As a result, the balance of goodwill and intangible assets associated with INTotal are \$0 as of December 31, 2017. A summary of goodwill and other intangible assets at December 31, 2017 and 2016 is as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Provider network	\$ -	\$ 7,111
Customer relations	-	6,705
Medicaid license	-	4,070
Other	8,293	7,843
Subtotal	<u>8,293</u>	<u>25,729</u>
Accumulated amortization	<u>(2,631)</u>	<u>(7,310)</u>
Total intangibles, net	5,662	18,419
Goodwill	37,303	44,053
Total Goodwill and Intangibles	<u>\$ 42,965</u>	<u>\$ 62,472</u>

Amortization expense of intangible assets was \$3.2 million and \$2.3 million, for the years ended December 31, 2017 and 2016, respectively.

A summary of the changes in goodwill for the years ended December 31, 2017 and 2016 is as follows:

	<u>2017</u>	<u>2016</u>
Beginning balance	\$ 44,053	\$ 53,959
Acquisitions	-	14,686
Disposal of business unit	(3,300)	-
Impairment loss	-	(24,592)
Other	(3,450)	-
Ending balance	<u>\$ 37,303</u>	<u>\$ 44,053</u>

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

9. Goodwill and Other Intangible Assets (continued)

On an annual and interim basis, management evaluates whether any triggering events exist that would indicate the potential that a reporting unit with goodwill might have a carrying value in excess of the reporting unit's fair value. If there is no indication that the carrying value of the reporting unit exceeds the fair value, no further testing is performed.

Upon the occurrence of a triggering event, management assesses qualitative factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount, including goodwill. If management determines that it is more likely than not that the fair value of the reporting unit is less than its carrying amount, management will determine the fair value of the reporting unit and compare the fair value of the reporting unit with its carrying amount. Goodwill impairment is recognized if the carrying amount of the reporting unit exceeds its fair value and the loss recorded shall not exceed the reporting unit's carrying amount of goodwill.

Management completed its required annual impairment tests as of October 1, 2017 and 2016.

In 2016, due to certain Medicaid regulatory changes in the Commonwealth of Virginia, future operating profits and cash flows for INTotal were forecasted to be lower than originally anticipated by management. The revised forecasted amounts caused the estimated fair value of INTotal to drop below its carrying value as of October 1, 2016. As a result, an impairment loss was recognized by INTotal for goodwill and each of its intangible assets. The amount of impairment losses was determined based on the difference between the carrying value of goodwill and intangible assets when compared to the implied fair value of goodwill and estimated fair value intangible assets. A summary of impairment losses recognized during 2017 and 2016 and the method of estimating fair value for goodwill and each intangible asset are as follows:

	2016	Method of Estimating Fair Value
Provider network	\$ 3,389	Discounted Cash Flows, Relief-from-Royalty Method
Customer relations	3,195	Discounted Cash Flows, With and Without Method
Medicaid license	17,230	Excess Earnings Method
	<u>23,814</u>	
Goodwill	24,592	Discounted Cash Flows, Income Method
Total impairment losses	<u>\$ 48,406</u>	

The fair value measurements that were utilized in the calculation of the impairment loss associated with goodwill and intangible assets were based on unobservable inputs that are Level 3 within the fair value hierarchy. These inputs were principally forecasted profits and cash flows that relate solely to INTotal.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

10. Long-Term Debt

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

	December 31,	
	2017	2016
Long-term Debt of the IHS Obligated Group:		
1988A,B,C,D Variable Rate Demand Obligation Revenue Bonds; maturing 10/1/25; monthly interest at a variable rate and maximum of 15%	\$ 11,700	\$ 11,700
1993A Hospital Revenue Refunding Bonds; maturing 8/15/23; semi-annual interest at a fixed rate of 2.75% to 5.25%	45,115	51,395
2000 Variable Rate Demand Health Care Revenue Bonds; maturing 1/1/30; monthly interest at a variable rate and maximum of 12.0%	30,300	30,300
2005A Health Care Revenue Bonds; maturing 5/15/35; monthly interest at a variable rate and maximum of 12.0%	109,730	109,730
2005C Health Care Revenue Bonds; maturing 5/15/26; monthly interest at a variable rate and maximum of 12.0%	18,610	18,610
2009A Health Care Revenue Bonds; maturing 5/15/35; semi-annual interest at a fixed rate of 3.0% to 5.5%	-	132,400
2009C Health Care Revenue Bonds; maturing 5/15/25; semi-annual interest at a fixed rate of 2.0% to 5.0%	-	46,750
2010A-2 Health Care Revenue Bonds; maturing 5/15/39; monthly interest at a variable rate and maximum of 12.0%	95,000	95,000
2011 Health Care Revenue Bonds; maturing 8/1/2017; monthly interest at a fixed rate of 1.8%	-	6,054
2012A Health Care Revenue Bonds; maturing 5/15/42; semi-annual interest at a fixed rate of 2.25% to 5.0%	268,765	273,230
2012B Health Care Revenue Bonds; maturing 5/15/22; semi-annual interest at a fixed rate of 3.0% to 5.0%	60,000	60,000
2012D Health Care Revenue Bonds; maturing 5/15/29; semi-annual interest at a fixed rate of 3.0% to 5.0%	70,395	70,395
2013 Health Care Revenue Bonds; maturing 12/1/23; monthly interest at a fixed rate of 2.15%	78,030	79,530
2014A Health Care Revenue Bonds; maturing 5/15/44; semi-annual interest at a fixed rate of 2.5% to 5.0%	200,000	200,000
2016A Health Care Revenue Bonds; maturing 5/15/31; semi-annual interest at a fixed rate of 5.0%	111,880	111,880
2016B Health Care Revenue Bonds; maturing 5/15/26; semi-annual interest at a fixed rate of 5.0%	31,295	31,295
2016C Health Care Revenue Bonds; maturing 5/15/42; monthly interest at a variable rate and maximum of 12%	99,330	99,685
2017 Health Care Revenue Bonds; maturing 5/15/2035; monthly interest at a fixed rate of 1.55%	179,285	-
Total Long-term Debt of the IHS Obligated Group	1,409,435	1,427,954
Less: Current Portion of Long-term Debt	(157,845)	(155,605)
Net Original Issue Premium	66,751	72,771
Net Deferred Financing Costs	(6,065)	(7,657)
Net Long-term Debt of the IHS Obligated Group	\$ 1,312,276	\$ 1,337,463
Total Long-term Debt of Non-Obligated IHS Affiliates	\$ 8,890	\$ 6,070
Less: Current Portion of Long-term Debt	(1,388)	(1,184)
Net Long-term Debt of Non-Obligated IHS Affiliates	\$ 7,502	\$ 4,886
Total Net IHS Long-term Debt	\$ 1,319,778	\$ 1,342,349

The maturities of non-obligated IHS affiliates' long-term debt ranged from July 15, 2024 to December 24, 2024 at the rate of 2.75%.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

10. Long-Term Debt (continued)

The preponderance of IHS' debt is tax-exempt revenue bonds issued under a Master Trust Indenture, which defines the obligated subsidiaries and affiliates under the bonds. The Members of the IHS Obligated Group consist of the Foundation, IHCS and LHC. The financial statements presented for the Obligated Group include only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.

On December 27, 2017, the Virginia Small Business Financing Authority issued \$179.3 million of Series 2017 bonds for the benefit of the Obligated Group. The Series 2017 bonds are comprised of fixed rate term bonds with principal payment starting in the year 2018. The Series 2017 bonds bear an initial fixed rate of 1.55% per annum. From time to time, at the direction of the Obligated Group, the bonds may convert to a weekly interest rate, a daily interest rate, a long-term interest rate, bond interest term rates, a windows interest rate, or an index interest rate. Interest is payable on the 15th of each month beginning in January 2018. Interest payment dates for other interest modes vary depending on the specific mode. The bonds were issued at face value. The bonds are also subject to mandatory redemption on May 15, 2019.

The Series 2017 bonds were issued to advance refund the remaining 2009A Series bonds and the 2009C Series bonds. IHS recognized a \$10.8 million loss on extinguishment of debt related to this transaction, which is included in the balance of non-operating revenues (expenses) in the accompanying consolidated statements of operations and changes in net assets.

On May 11, 2016 the Industrial Development Authority issued \$111.9 million of Series 2016A bonds for the benefit of the Obligated Group for the advanced refunding of Series 2009A bonds. The Series 2016A bonds are comprised of fixed rate term and coupon bonds with principal payment starting in the year 2020. Interest is payable semi-annually on May 15 and November 15 of each year, commencing November 15, 2016. The premium received was \$26.5 million. The total proceeds from the offering were \$138.3 million.

On May 11, 2016 the Industrial Development Authority issued \$31.3 million of Series 2016B bonds for the benefit of the Obligated Group for the refunding of Series 2012C bonds. The Series 2016B bonds are comprised of fixed rate term and coupon bonds with principal payment starting in the year 2026. Interest is payable semi-annually on May 15 and November 15 of each year, commencing November 15, 2016. The premium received was \$8.7 million. The total proceeds from the offering were \$40.0 million.

On May 11, 2016 the Industrial Development Authority issued \$99.7 million of Series 2016C bonds for the benefit of the Obligated Group for the refunding of Series 2012C bonds. The Series 2016C bonds are comprised of variable rate term and coupon bonds with principal payment starting in the year 2017 with interest payable monthly. The initial rate was set at 0.10% and is supported by Inova's self-liquidity.

The 2016A, 2016B, and 2016C Series bonds were issued to advance refund the 2009A Series fixed rate bonds and currently refund all of the 2012C Series variable rate bonds. IHS recognized an \$18 million loss on extinguishment of debt related to this transaction, which is included in the balance of non-operating revenues (expenses) in the accompanying consolidated statements of operations and changes in net assets.

IHS Obligated Group debts are secured by an interest in all funds held by the Bond Trustee for purposes of debt service, construction and equipment acquisition. Each Member of the IHS Obligated Group covenants that it will not pledge or grant a security interest in (except as may be otherwise provided in the Master Trust Indenture) any of its property. The Master Trust Indenture for the IHS Obligated Group requires that certain minimum financial ratios be met. IHS is in compliance with the financial ratio requirements.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

10. Long-Term Debt (continued)

IHS estimates the December 31, 2017 and 2016 fair value of its long-term debt, based on mid-market estimate, a market bid and/or ask, or any other price or estimate within a market spread, to be approximately \$1,511 million and \$1,518 million, respectively, compared with the face value of approximately \$1,485 million and \$1,506 million, respectively. The fair value of all financial instruments other than investments and debt is estimated by management to approximate or equal their reported carrying value.

The interest rate on the variable rate bonds ranged between 0.61% and 1.75% in 2017 and 0.02% and 0.96% in 2016. The variable rate bonds include an optional tender feature that allows the bond holder to tender the bonds on a weekly interest payment date.

IHS maintains SBPAs and LOCs to support the optional tender features on the VRDO bonds excluding the 2005A-1 and 2005A-2 bonds. The liquidity providers are summarized as follows as of December 31, 2017 (in thousands):

Liquidity Provider - Bond Series:	<u>Amount</u>	<u>Expiration Date</u>
Branch Bank & Trust - 2000	\$ 30,300	12/31/2018
Northern Trust - 1988ABCD, 2005C-1, and 2005C-2	30,310	6/18/2019
	<u>\$ 60,610</u>	

In the event of a failed remarketing, the banks are obligated to extend credit to purchase the tendered bonds. The banks may subsequently remarket the bonds and if the bonds are not remarketed, they are subject to mandatory redemption in quarterly installments by IHS. The SBPAs and LOC agreements include a provision which specifies re-payment of advances made by the bank will begin in the 13th calendar month after the bonds are acquired by the bank. This provision ensures that tendered bonds do not become an obligation for IHS for at least one year. Accordingly, the underlying debt is not classified as current liabilities except for principal amounts due within twelve months.

The tender feature of the 2016C Bonds and certain variable rate bonds requires IHS to maintain current assets of \$129.6 million and \$129.9 million as of December 31, 2017 and 2016, respectively, to provide for redemption of the tendered bonds. These assets are included in the current portion of assets whose use is limited.

Costs incurred in the issuance or conversion of long-term debt are deferred and amortized over the life of the related debt using the principal balance outstanding method.

Certain bonds are subject to mandatory sinking fund redemption and to earlier redemption under certain circumstances as defined in the respective bond indenture agreements. Maturities of long-term debt for the five years succeeding December 31, 2017 are as follows (in thousands):

	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>There-after</u>	<u>Total</u>
Scheduled Maturities	\$ 29,978	\$ 31,979	\$ 33,033	\$ 34,194	\$ 95,376	\$ 1,064,510	\$ 1,289,070
Bonds under remarketing agreement and subject to mandatory tender	129,255	-	-	-	-	-	129,255
Total	<u>\$ 159,233</u>	<u>\$ 31,979</u>	<u>\$ 33,033</u>	<u>\$ 34,194</u>	<u>\$ 95,376</u>	<u>\$ 1,064,510</u>	<u>\$ 1,418,325</u>

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

10. Long-Term Debt (continued)

IHS issued \$100.0 million of taxable commercial paper (“CP”) under a program authorized for borrowings up to \$100.0 million with maturity dates from one to 270 days. Proceeds from this issuance were used for a variety of working capital requirements. IHS maintains a self-liquidity program that would be used to repurchase any CP that is not remarketed. All outstanding CP is included in notes payable and other liabilities in the current liabilities section of the accompanying consolidated balance sheets. As of December 31, 2017 and 2016, the amount of CP outstanding was \$100.0 million.

As of December 31, 2017 and 2016, IHS maintains unsecured lines of credit with three large commercial banks with a combined available principal amount of \$237.5 million. There were no amounts outstanding on these credit lines as of December 31, 2017 or 2016, respectively. The \$100 million line of credit is scheduled to expire on July 31, 2018. Management intends to renew the line of credit.

11. Derivative Financial Instruments

IHS entered into interest rate swap agreements in order to hedge the variability of cash flows related to changes in market interest rates on underlying variable rate debt. Below is a summary of the interest rate swap agreements as of December 31, 2017 and 2016, respectively (in thousands):

Counter Party	Notional Amount	Hedged Bonds	Maturity Date	Type	Payer Rate	Receiver Rate	Fair Value	Collateral Threshold	Collateral Posted
As of December 31, 2017:									
Merrill Lynch Capital Services, Inc.	\$ 50,000	N/A	5/15/2034	Fixed Payer	1.65%	67% of one-month USD LIBOR	\$ (314)	\$ 30,000	\$ -
JPMorgan Chase Bank, N.A.	69,495	N/A	5/15/2034	Fixed Payer	1.45%	67% of one-month USD LIBOR	1,986	25,000	-
Total	<u>\$ 119,495</u>						<u>\$ 1,672</u>	<u>\$ 55,000</u>	<u>\$ -</u>
As of December 31, 2016:									
Merrill Lynch Capital Services, Inc.	\$ 50,000	N/A	5/15/2034	Fixed Payer	1.65%	67% of one-month USD LIBOR	\$ (393)	\$ 30,000	\$ -
JPMorgan Chase Bank, N.A.	69,495	N/A	5/15/2034	Fixed Payer	1.45%	67% of one-month USD LIBOR	2,822	25,000	-
Citigroup Financial Products Inc.	25,000	N/A	4/9/2035	Fixed Payer	3.25%	67% of one-month USD LIBOR	(5,275)	35,000	-
Total	<u>\$ 144,495</u>						<u>\$ (2,846)</u>	<u>\$ 90,000</u>	<u>\$ -</u>

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

12. Professional and Other Insurance Liabilities

IHS maintains coverage for professional and general liability through claims-made policies issued by InovaCap, LLC (“InovaCap”). InovaCap is a wholly owned captive insurance company domiciled in Vermont. Because InovaCap is a wholly owned subsidiary of IHS, its assets, liabilities, revenues and expenses are fully consolidated in the accompanying financial statements.

InovaCap retains risk of \$2.3 million per claim and \$19.0 million in annual aggregate for professional liability. Additional risk is reinsured in umbrella forms through Lloyds of London, other European companies, Zurich North American, and CNA, together providing limits of \$50.0 million per claim, and \$50.0 million in the aggregate, in excess of the InovaCap retention. The consolidated balance sheets at December 31, 2017 and 2016 include in other non-current obligations \$30.2 million and \$25.6 million, respectively, based on actuarial estimates of payments to be made under its professional liability insurance programs for known claims, as well as for estimated losses on unfiled claims, which relate to events occurring in 2017 and prior years. The liabilities are discounted at 1.88% and 1.48% at December 31, 2017 and 2016, respectively. InovaCap also recorded a liability of \$2.4 million and \$2.5 million as of December 31, 2017 and 2016, respectively, for reinsurance of certain health plan obligations.

Investments and other assets held by InovaCap of \$127.6 million and \$106.6 million at December 31, 2017 and 2016, respectively, are restricted by statute from being transferred to another subsidiary or obligated for any other purpose and accordingly are included as assets whose use is limited in the consolidated balance sheets.

13. Fairfax County Leases

The land upon which the majority of Inova Fairfax Hospital and the entirety of Inova Mount Vernon Hospital are located and the related buildings are leased to IHS by the Board of Supervisors of Fairfax County, Virginia (“County”), under an agreement that was partially amended in 2010 (the “County Lease”). The 2010 agreement included sale of property whereby a portion of the Inova Fairfax Hospital campus land was taken out of the County Lease and ownership of that land was conveyed to IHS. There is also land owned by IHS, off-site of the hospital campus that was conveyed to Fairfax County. Effective as of December 3, 2010, the 2010 agreement extends the County Lease for the residual land for a term of 99 years and, thus, the County Lease now expires in December 2109. Under the County Lease, the property and equipment leased from the County are recorded as leasehold interests at the cost to construct or acquire. Upon termination of the County Lease, such property, including leasehold improvements and equipment will revert to the County, subject to all related long-term liabilities of IHS incurred to finance the construction and acquisition of such property, buildings and equipment.

The County Lease also requires IHS to set aside funds in an amount at least equal to the depreciation expense on the related leasehold interests. Such funds may be expended by IHS for major repairs or alterations, construction of or additions to buildings, or the purchase or replacement of equipment. IHS’ Board of Trustees has also designated additional funds for the purpose of plant expansion.

The terms of the County Lease outline an indigent care policy to assure all individuals in the County have access to medically necessary care. Patients’ payment obligations under the policy are determined using a sliding income scale which is based on the federal poverty guidelines. During the term of the County Lease, IHS has agreed to notify the County of any intent to incur additional debt in excess of \$1.0 million. IHS has also agreed to notify the County of any intent to enter into contractual agreements for the management or operation of Inova Fairfax Hospital or Inova Mount Vernon Hospital by persons other than IHS, or any intent to change hospital rates.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

14. Other Leases and Financing Obligation

IHS leases equipment, office space and certain facilities. Included in the operating expenses of IHS are lease expenses of approximately \$38.9 million and \$36.6 million in 2017 and 2016, respectively. Future minimum payments under non-cancellable operating leases with initial or remaining terms of one year or more consisted of the following at December 31, 2017 (in thousands):

	Operating Leases
2018	\$ 36,038
2019	30,374
2020	22,406
2021	16,646
2022	13,606
Thereafter	31,036
Total lease payments	150,106
Less: minimum lease income from non-cancellable subleases	(1,771)
Total	\$ 148,335

On February 5, 2015, IHS entered into a 99-year lease agreement for rights to 117 acres of land and 1.2 million square feet of office space. This large corporate campus is adjacent to its flagship hospital in Fairfax, Virginia. Inova took possession of the site on October 1, 2015. The lease agreement provides the lessor with a put option to sell the property to IHS upon 90 days written notice for \$180.0 million at any time during the first 5 years of the lease. Starting in year 6, the lease payments decline by 50% assuming IHS makes certain capital investments on the site and the lessor becomes responsible for the property taxes. Because of these provisions in the lease, IHS believes that the lessor will exercise the put option on or before October 1, 2020. This transaction is accounted for as a long term debt financing due in part to IHS' assumption of certain obligations typically associated with ownership.

Future minimum payments under this agreement with the remaining terms of one year or more consisted of the following at December 31, 2017 (in thousands):

	Financing Obligation
2018	\$ 7,750
2019	8,875
2020	8,750
2021	5,000
2022	5,000
Thereafter	1,244,533
Total	\$ 1,279,908

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

15. Other Commitments and Contingencies

IHS has entered into several contracts for the acquisition of equipment and for the construction of facilities. Future commitments under these contracts at December 31, 2017 were approximately \$317.1 million. IHS currently anticipates that these projects will be financed with a combination of bond proceeds, funds generated from earnings and donations. These projects include expansion and renovation of Fairfax, Mt. Vernon, Loudoun, Alexandria and Fair Oaks hospitals and the buildout of the new cancer center on the Inova Center for Personalized Health campus.

IHS is subject to various legal claims and contingencies arising in the ordinary course of its business. While the outcomes of such matters are uncertain, management believes that their ultimate resolution will not have a material adverse effect on IHS' financial position or on the changes in its net assets or cash flows.

16. Functional Expenses

IHS provides various health care services to patients within its geographic region. Operating expenses related to providing these services for the years ended December 31, 2017 and 2016 are as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Health care services	\$ 2,830,723	\$ 2,737,308
General and administrative	423,542	387,340
Total	<u>\$ 3,254,265</u>	<u>\$ 3,124,648</u>

17. Disposal of Business Line

On October 31, 2017, IHS completed the sale of all of the non-monetary assets of its wholly owned subsidiary, INTotal, to United Healthcare Insurance Company (UnitedHealth). The sales price included \$12 million in cash and approximately \$20.4 million of additional estimated consideration payable in the fourth quarter of 2018. This estimated consideration is measured based on the number of members assigned to the UnitedHealthcare contract after Virginia Medicaid completes its procurement process. The consolidated balance sheet as of December 31, 2017, includes a receivable of \$20.4 million representing the estimated consideration from UnitedHealth. The receivable was estimated based on a probability weighted approach to determine the expected value as of December 31, 2017. In connection with the sale, IHS incurred a \$13.5 million gain, which is included in the gain on disposal of business line in the accompanying Statements of Operations and Changes in Net Assets. The accompanying consolidated Statements of Operations and Changes in Net Assets include revenues related to INTotal of \$176.7 million and \$197.6 million for 2017 and 2016, respectively. The statements also include Net Operating Income of \$1.3 million for 2017 and a Net Operating Loss of \$3.8 million for 2016. Management believes that any future gains or losses resulting from this transaction will be immaterial to the financial statements.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2017 and 2016

18. Retirement Obligations

The IHS Retirement Income Plan (the “IHS Plan”) was a defined benefit pension plan that covered substantially all full-time employees of IHS. During 2016, management settled all obligations and the IHS Plan was terminated. The settlement resulted in a non-cash loss of \$64.5 million in 2016.

The reconciliation of the beginning and ending balances of the projected benefit obligation and the fair value of plan assets for the year ended December 31, 2016 and the accumulated benefit obligation at December 31, 2016 is as follows (in thousands):

	2016
Projected Benefit Obligation:	
Beginning of year	\$ 490,041
Service Cost	5,000
Interest Cost	19,274
Actuarial (gain) loss	49,320
Benefits payments	(563,635)
End of year	\$ -
Fair Value of Plan Assets:	
Beginning of year	\$ 542,980
Actual return on plan assets	16,766
Employer contributions	3,889
Benefits payments	(563,635)
End of year	\$ -
Funded status at end of year	\$ -
	2016
Net periodic benefit cost:	
Service cost	\$ 5,000
Interest cost	19,274
Expected return on plan assets	(15,714)
Recognized actuarial loss	1,619
Recognized settlement loss	64,494
Net periodic benefit cost	\$ 74,673

IHS also sponsors the Inova Health System Retirement Savings Plan (“401K Plan”) that covers substantially all employees. Employees may contribute to the 401K Plan and receive a matching contribution of up to 5% of qualifying pay. The total matching contribution was \$50.8 million and \$47.3 million for 2017 and 2016, respectively.



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Report of Independent Auditors on Other Supplementary Information

The Board of Trustees
Inova Health System

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

Ernst + Young LLP

March 23, 2018

Inova Health System Obligated Group
Consolidating Balance Sheets
December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 189,263	\$ 236,802
Assets whose use is limited, current	129,630	129,985
Patient accounts receivable (less allowance for doubtful accounts: 2017 - \$99,065; 2016 - \$94,624)	313,394	290,039
Other current assets	<u>125,249</u>	<u>94,249</u>
Total Current Assets	757,536	751,075
Property, Equipment and Leasehold Interests, net	2,131,841	1,928,089
Assets Whose Use Is Limited		
Held by bond trustee	8,921	22,039
By board for plant replacement and expansion	4,739,684	4,035,863
By board for construction projects	167,419	189,985
By donor	<u>108,208</u>	<u>91,967</u>
	5,024,232	4,339,854
Less amounts required to meet current obligations	<u>(129,630)</u>	<u>(129,985)</u>
Total Assets Whose Use Is Limited, noncurrent	4,894,602	4,209,869
Other Assets		
Investments in and receivables from affiliates	94,450	188,474
Interest rate swap	1,986	-
Other long-term assets	<u>197,248</u>	<u>138,406</u>
Total Other Assets	293,684	326,880
TOTAL ASSETS	<u>\$ 8,077,663</u>	<u>\$ 7,215,913</u>
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable and other accrued expenses	\$ 365,395	\$ 315,513
Third-party settlements	52,736	46,822
Notes payable and other liabilities	111,794	120,170
Current portion of long-term debt	<u>157,845</u>	<u>156,067</u>
Total Current Liabilities	687,770	638,572
Non-current Liabilities		
Long-term debt, less current portion	1,312,274	1,337,464
Interest rate swap liability	314	2,846
Financing obligation	184,423	183,409
Other non-current obligations	<u>58,393</u>	<u>54,109</u>
Total Non-current Liabilities	1,555,404	1,577,828
Net Assets		
Unrestricted	5,694,791	4,890,634
Temporarily restricted	101,908	77,379
Permanently restricted	<u>37,790</u>	<u>31,500</u>
Total Net Assets	5,834,489	4,999,513
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 8,077,663</u>	<u>\$ 7,215,913</u>

Note: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group include only their accounts, which include their investment interest in controlled affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenue, expenses, assets or liabilities of any of those controlled, affiliated entities.

Inova Health System Obligated Group
Consolidating Statements of Operations and Changes in Unrestricted Net Assets
For the Years Ended December 31, 2017 and 2016
(in thousands)

	2017	2016
Operating Revenues		
Net patient service revenue	\$ 3,088,804	\$ 2,880,683
Provision for bad debts	(155,642)	(137,543)
Net Patient Service Revenue Less Provision for Bad Debts	2,933,162	2,743,140
Other operating revenue	99,391	85,691
Total Operating Revenues	3,032,553	2,828,831
Operating Expenses		
Salaries and benefits	1,504,142	1,383,546
Other operating expenses	1,122,700	1,082,741
Depreciation and amortization	212,994	205,502
Interest	51,366	51,559
Total Operating Expenses	2,891,202	2,723,348
Operating Income before impairment, pension settlement and other gain	141,351	105,483
Impairment, pension settlement and other gain	13,474	(64,494)
Operating Income	154,825	40,989
Investment income and other, net	642,199	288,707
Excess of Revenues Over Expenses	797,024	329,696
Unrealized gain/(loss) on investments, net	(35)	(137)
Loss on extinguishment of swap termination	1,813	1,853
Capital reimbursements for grants	2,551	2,048
Change in plan assets and benefit obligations of pension	-	16,463
Other	2,804	584
Increase in Unrestricted Net Assets	\$ 804,157	\$ 350,507

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Inova Health System Obligated Group
Consolidating Statements of Cash Flows
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
Operating Activities		
Change in net assets	\$ 834,976	\$ 365,112
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation and amortization	212,994	205,502
Change in plan assets and benefit obligations of pension	-	(16,463)
Loss on extinguishment of debt	10,787	18,000
Net realized and unrealized gains on investments	(637,471)	(225,560)
Change in fair value of interest rate swaps	305	(2,164)
Equity investment losses, net	6,837	10,289
Increase in accounts receivable and third-party settlements, net	(12,996)	(20,968)
Increase in accounts payable and other current liabilities	4,188	14,551
Decrease in pension asset	-	69,402
Increase (decrease) in estimated professional liability and other deferred liability items	5,222	(264)
Increase in intangibles and other assets	(14,483)	(26,053)
Restricted contributions and investment income	(28,006)	(24,950)
Other	5,785	-
Net Cash Provided by Operating Activities	<u>388,138</u>	<u>366,434</u>
Investing Activities		
Capital expenditures	(372,873)	(226,166)
Investments in and advances to joint ventures and affiliates	(3,265)	(21,936)
Purchases of marketable securities	(1,807,170)	(3,072,706)
Proceeds from sale of marketable securities	1,741,592	3,012,644
Proceeds from sale of property, plant, and equipment	1,376	-
Net Cash Used in Investing Activities	<u>(440,340)</u>	<u>(308,164)</u>
Financing Activities		
Principal payments on long-term debt	(27,474)	(28,830)
Proceeds from issuance of long-term debt	179,285	276,049
Refunding of long-term debt	(170,330)	(279,400)
Swap termination and modification payments	(4,824)	(17,757)
Restricted contributions and investment income	28,006	24,840
Other	-	(3,397)
Net Cash Provided by (Used in) Financing Activities	<u>4,663</u>	<u>(28,495)</u>
Net (Decrease)/Increase in Cash and Cash Equivalents	(47,539)	29,775
Cash and cash equivalents at beginning of year	<u>236,802</u>	<u>207,027</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 189,263</u>	<u>\$ 236,802</u>

Note: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group include only their accounts, which include their investment interest in controlled affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenue, expenses, assets or liabilities of any of those controlled, affiliated entities.