

INOVA HEALTH SYSTEM

**Audited Consolidated Financial Statements and
Other Supplementary Information Relating to the
IHS Obligated Group, and Management's
Discussion and Analysis of Results of Operations
and Financial Position**

**Period Ended
December 31, 2018**

Inova Health System
Management's Discussion and Analysis of Results of Operations and Financial Position
As of and for the Year Ended December 31, 2018

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 maintains a group of primary care and specialty physicians operating as the Inova Medical Group as well as a clinically integrated physician network known as Signature Partners and Innovation Health (“Innovation”), a joint venture with Aetna offering commercial health insurance plans.

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 years ended December 31, 2018 and 2017. 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 93.7% of total operating revenues and nearly 100% of unrestricted net assets of IHS as of and for the year ended December 31, 2018.

Results of Operations as of and for the year ended December 31, 2018 and 2017

Overall, IHS reported strong operating results achieving Operating and Cash Flow margins of 5.8% and 13.8% respectively. Both profitability indicators exceeded prior year performance.

Operating Revenues. Total operating revenues for IHS for the year ended December 31, 2018 were \$3.4 billion, a 0.8% reduction from prior year. This reduction was attributable to a \$180.1 million decrease in premium revenue resulting of the sale of INTotal, IHS’ former Medicaid health plan, in October 2017. However, Net Patient Service Revenue increased 4.6% primarily due to commercial rate inflators, improved revenue cycle yield and Medicaid rate improvement that went into effect October 1, 2018. Acute hospital admissions and patient days declined by 2.8% and 2.7%, respectively, but were offset by a 2.5% increase in other outpatient visits and migration of outpatient surgeries and selective other services to ambulatory sites.

Other operating revenue increased 7.7% during 2018 due primarily to Innovation’s operating performance. IHS and Aetna each have a 50% ownership interest in Innovation, a commercial health insurance plan. 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's Statement of Operations. During 2018, Innovation recorded a \$15.4 million favorable adjustment for favorable reserve development and risk adjustments related to the run-out of Health Insurance Exchange products for 2017 and prior. IHS's share of the gain was \$7.7 million.

Operating Expenses Total operating expenses for the year ended December 31, 2018 were \$3.2 billion, a decrease of 1.5% over the comparable period in 2017. After adjusting for 2017 health care claims expenses of INTotal, operating expenses increased by 2.0%. Salaries and benefits increased \$53.7 million, or 3.3%, primarily due to merit and market based pay adjustments.

Operating Income was \$196.2 million, or 5.8% of total operating revenues, for the year ended December 31, 2018, as compared to \$174.8 million, or 5.1% of total operating revenues, in 2017. The increase in operating earnings was principally driven by the improvement in the profitability of Innovation and growth of ambulatory services.

Investment Income and Other, net. Due to the market down turn late in the year investments returns were negative for 2018. Inova's Strategic Fund lost -7.5% in 2018. Total *Investment Income and Other, net*, was (\$344.2) million resulting in a net margin of -5.1% for the year.

Financial Position as of December 31, 2018

Current Assets and Liquidity. IHS' balance sheet remains strong, with significant unrestricted cash and investments at December 31, 2018 of \$4.9 billion, of which \$2.3 billion represents investments that can be liquidated within 3 days. Operating cash flow remained strong at \$449.7 million.

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, 2018 (dollars in thousands):

| | <u>Amount</u> | <u>%</u> |
|------------------------------|----------------------------|---------------|
| <u>Strategic Fund</u> | | |
| Cash and cash equivalents | \$ 310,275 | 6.8% |
| Fixed income | 665,652 | 14.6% |
| Public equity | 2,443,775 | 53.5% |
| Growth hedge funds | 259,771 | 5.7% |
| Private equity | 183,762 | 4.0% |
| Diversifying hedge funds | 462,741 | 10.1% |
| Real assets | 74,139 | 1.6% |
| | <u>4,400,115</u> | <u>96.3%</u> |
| <u>Capital fund</u> | 169,313 | 3.7% |
| Total | <u>\$ 4,569,428</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.

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 \$437.2 million for the year ended December 31, 2018, which included \$310.1 million of major hospital expansion and renovation projects at the Inova Fairfax and Loudoun Hospital's and the ICPH campus including \$57.7 million for the new Inova Schar Cancer Institute. The remainder of capital expenditures related to information technology projects, and routine capital replacement.

All planned capital expenditures are regularly evaluated based upon business need, economic conditions and IHS' financial position and will be financed through a combination of operating cash flow, donations, tax-exempt borrowing and cash reserves if necessary.

Debt Structure and Liability Management. At December 31, 2018, total long-term debt outstanding, including financing obligations, was approximately \$2.0 billion, or 26.2% of capitalization. IHS' 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. The following debt related transactions occurred in 2018:

- In July, IHS issued \$457 million in aggregate par value of tax-exempt revenue bonds (2018 Bonds). Approximately \$265 million will be used to finance various capital projects, and the remaining proceeds refunded all or a portion of Series 2017, Series 2005C and Series 2000A bonds.
- In September, IHS cash defeased the outstanding 1988 bonds for \$11.7 million.

At the end of 2018, 70% of IHS underlying long-term debt is in some form of fixed rate. Inova also holds two fixed-payer swap contracts with a combined notional amount of \$119 million which raises IHS' effective fixed rate debt percentage to 77%. Both swaps are currently cash flow positive with a combined fair market value of +\$6.5 million.

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 Consolidated Balance Sheet.

Executive Leadership Changes

In March 2019, Richard Magenheimer announced his intention to retire as Chief Financial Officer ("CFO") effective June 2019. IHS has initiated a national search for a new CFO.

Other Financial Information

The following are selected financial indicators for IHS as of and for the years ended December 31, 2018 and 2017:

| | <u>2018</u> | <u>2017</u> |
|--|-------------|-------------|
| Operating Margin ¹ | 5.8% | 5.1% |
| Operating Cash Flow Margin ² | 13.8% | 13.2% |
| Net Margin ³ | -5.1% | 20.6% |
| Net Days in Accounts Receivable ⁴ | 35.2 | 38.8 |
| Days in Unrestricted Cash ⁵ | 600.1 | 619.1 |
| Unrestricted Cash to Debt ⁶ | 2.5 | 2.9 |
| Debt Service Coverage Ratio ⁷ | 2.6x | 12.8x |

1 Operating income divided by operating revenue

2 Operating income 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 long term debt plus financing obligation plus commercial paper borrowings

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, 2018**

Inova Health System
Audited Consolidated Financial Statements
And Other Supplementary Information
Relating to the IHS Obligated Group
December 31, 2018 and 2017

Audited Consolidated Financial Statements

| | |
|---|------|
| Report of Independent Auditors..... | 1 |
| Consolidated Balance Sheets | 2 |
| Consolidated Statements of Operations and Changes in Net Assets | 3-4 |
| Consolidated Statements of Cash Flows..... | 5 |
| Notes to Consolidated Financial Statements..... | 6-27 |

Other Supplementary Information

| | |
|--|----|
| Report of Independent Auditors on Other Supplementary Information..... | 28 |
| Consolidating Balance Sheets..... | 29 |
| Consolidating Statements of Operations..... | 30 |
| Consolidating Statements of Cash Flows | 31 |



Ernst & Young LLP
621 East Pratt Street
Baltimore, MD 21202

Tel: +1 410 539 7940
Fax: +1 410 783 3832
ey.com

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, 2018 and 2017, 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 IHS at December 31, 2018 and 2017, 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.

Adoption of New Accounting Pronouncement

As discussed in Note 2 to the consolidated financial statements, IHS changed its method for revenue recognition as a result of the adoption of the amendments to the FASB Accounting Standards Codification resulting from Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, effective January 1, 2018. IHS also changed the presentation and related disclosures of net assets as a result of the adoption of the amendments to the FASB Accounting Standards Codification resulting from Accounting Standards Update No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, effective December 31, 2018. Our opinion is not modified with respect to these matters.

March 22, 2019

Inova Health System
Consolidated Balance Sheets
December 31, 2018 and 2017
(in thousands)

| | 2018 | 2017 |
|--|--------------|--------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 333,100 | \$ 232,528 |
| Assets whose use is limited, current | 198,955 | 129,630 |
| Patient accounts receivable, net | 321,920 | 332,055 |
| Other current assets | 136,930 | 144,035 |
| Total Current Assets | 990,905 | 838,248 |
| Property, Equipment and Leasehold Interests, net (Note 5) | 2,379,138 | 2,182,062 |
| Assets Whose Use Is Limited (Notes 2, 6, 7, 12) | | |
| Held by bond trustee | 135,679 | 8,921 |
| By board for plant replacement and expansion | 4,400,115 | 4,738,766 |
| By board for construction projects | 169,313 | 167,419 |
| By donor | 135,341 | 128,979 |
| For professional liability | 80,422 | 127,588 |
| For health plan liability | 534 | 12,230 |
| | 4,921,404 | 5,183,903 |
| Less amounts required to meet current obligations | (198,955) | (129,630) |
| Total Assets Whose Use Is Limited, noncurrent | 4,722,449 | 5,054,273 |
| Other Assets | | |
| Investments in and receivables from affiliates (Note 8) | 63,053 | 42,903 |
| Goodwill and other intangible assets (Note 9) | 42,233 | 42,965 |
| Interest rate swap (Note 11) | 6,522 | 1,986 |
| Long-term investments | 49,766 | 31,344 |
| Other long-term assets | 80,501 | 51,969 |
| Total Other Assets | 242,075 | 171,167 |
| TOTAL ASSETS | \$ 8,334,567 | \$ 8,245,750 |
| LIABILITIES AND NET ASSETS | | |
| Current Liabilities | | |
| Accounts payable and other accrued expenses | \$ 406,078 | \$ 389,708 |
| Third-party settlements | 46,657 | 52,963 |
| Notes payable and other liabilities | 114,239 | 126,775 |
| Current portion of long-term debt (Note 10) | 228,429 | 159,233 |
| Total Current Liabilities | 795,403 | 728,679 |
| Non-current Liabilities | | |
| Long-term debt, less current portion (Note 10) | 1,463,060 | 1,319,778 |
| Financing obligation (Note 14) | 184,461 | 184,423 |
| Other non-current obligations | 82,247 | 88,145 |
| Total Non-current Liabilities | 1,729,768 | 1,592,346 |
| Net Assets | | |
| Without donor restrictions | 5,597,535 | 5,744,855 |
| With donor restrictions | 191,237 | 160,448 |
| Total Net Assets Attributable to IHS | 5,788,772 | 5,905,303 |
| Non-controlling Interest | 20,624 | 19,422 |
| Total Net Assets | 5,809,396 | 5,924,725 |
| TOTAL LIABILITIES AND NET ASSETS | \$ 8,334,567 | \$ 8,245,750 |

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, 2018 and 2017
(in thousands)

| | 2018 | 2017 |
|---|------------------|------------------|
| Operating Revenues | | |
| Net patient service revenue | \$ 3,249,667 | \$ 3,106,005 |
| Premium revenue | 10,247 | 190,392 |
| Other operating revenue | 142,921 | 132,694 |
| Total Operating Revenues | 3,402,835 | 3,429,091 |
| Operating Expenses | | |
| Salaries and benefits | 1,693,913 | 1,640,192 |
| Other operating expenses | 1,230,767 | 1,218,018 |
| Medical claims | 7,234 | 118,853 |
| Depreciation and amortization | 224,632 | 224,808 |
| Interest | 50,135 | 52,394 |
| Total Operating Expenses | 3,206,681 | 3,254,265 |
| Operating Income before Gain on Disposal of Business Line | 196,154 | 174,826 |
| Gain on disposal of business line | 4,714 | 13,474 |
| Operating Income | 200,868 | 188,300 |
| Investment (loss) income and other, net | (344,242) | 674,755 |
| Excess of (Expenses over Revenues) Revenues over Expenses | (143,374) | 863,055 |
| Less: Non-controlling Interest | (13,841) | (13,971) |
| Excess of (Expenses over Revenues) Revenues over Expenses, Attributable to IHS | (157,215) | 849,084 |

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, 2018 and 2017
(in thousands)

| | <u>Without donor restrictions</u> | <u>With donor restrictions</u> | <u>Non-controlling Interest</u> | <u>Total</u> |
|---|---------------------------------------|------------------------------------|-------------------------------------|---------------------|
| Balance at December 31, 2016 | \$ 4,891,147 | \$ 132,049 | \$ – | \$ 5,023,196 |
| Reclassification of beginning balance of non-controlling interest | – | – | 17,855 | 17,855 |
| Excess of revenues over expenses (from page 3) | 849,084 | – | 13,971 | 863,055 |
| Unrealized gain on investments, net | 8 | 3,298 | – | 3,306 |
| Capital reimbursements for grants | 207 | – | – | 207 |
| Gifts and bequests | – | 42,191 | – | 42,191 |
| Restricted investment income | – | 3,754 | – | 3,754 |
| Net assets released from restrictions | – | (21,370) | – | (21,370) |
| Changes in non-controlling equity interest | – | – | (12,404) | (12,404) |
| Other | 4,409 | 526 | – | 4,935 |
| Change in Net Assets | <u>853,708</u> | <u>28,399</u> | <u>19,422</u> | <u>901,529</u> |
| Balance at December 31, 2017 | 5,744,855 | 160,448 | 19,422 | 5,924,725 |
| Excess of expenses over revenues (from page 3) | (157,215) | – | 13,841 | (143,374) |
| Unrealized gain/(loss) on investments, net | 804 | (1,583) | – | (779) |
| Sale of non-controlling position | 8,624 | – | – | 8,624 |
| Capital reimbursements for grants | 89 | – | – | 89 |
| Gifts and bequests | – | 51,008 | – | 51,008 |
| Restricted investment income | – | (225) | – | (225) |
| Net assets released from restriction | – | (18,617) | – | (18,617) |
| Other changes in non-controlling equity interest | (784) | – | (12,639) | (13,423) |
| Other | 1,162 | 206 | – | 1,368 |
| Change in Net Assets | <u>(147,320)</u> | <u>30,789</u> | <u>1,202</u> | <u>(115,329)</u> |
| Balance at December 31, 2018 | <u>\$ 5,597,535</u> | <u>\$ 191,237</u> | <u>\$ 20,624</u> | <u>\$ 5,809,396</u> |

See notes to the consolidated financial statements.

Inova Health System
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2018 and 2017
(in thousands)

| | <u>2018</u> | <u>2017</u> |
|--|-------------------|-------------------|
| Operating Activities | | |
| Change in net assets | \$ (115,329) | \$ 901,529 |
| Adjustments to reconcile change in net assets to net cash provided by operating activities | | |
| Depreciation and amortization | 224,632 | 224,808 |
| Loss on extinguishment of debt | 120 | 10,787 |
| Net realized and unrealized losses/(gains) on investments | 411,132 | (652,131) |
| Change in fair value of interest rate swaps | (4,849) | 305 |
| Equity investment (gains)/losses, net | (1,321) | 23,367 |
| Gain on sale of long-lived assets | (2,253) | - |
| Decrease/(Increase) in accounts receivable and third-party settlements, net | 10,135 | (24,187) |
| Decrease/(Increase) in other current assets | 25,784 | (18,161) |
| (Decrease)/Increase in accounts payable and other current liabilities | (18,504) | 4,979 |
| (Decrease)/Increase in estimated professional liability and other deferred liability items | (4,388) | 10,335 |
| Restricted contributions and investment income | (51,035) | (31,440) |
| Change in the non-controlling interest | - | (17,855) |
| Other | (24,441) | (10,574) |
| Net Cash Provided by Operating Activities | <u>449,683</u> | <u>421,762</u> |
| Investing Activities | | |
| Capital expenditures | (437,210) | (380,074) |
| Proceeds from sale of long-lived assets | 20,242 | - |
| Investments in and advances to joint ventures and affiliates | (10,205) | (24,462) |
| Purchases of marketable securities | (1,258,364) | (1,895,603) |
| Proceeds from sale of marketable securities | 1,087,557 | 1,824,991 |
| Other | - | 1,376 |
| Net Cash Used in Investing Activities | <u>(597,980)</u> | <u>(473,772)</u> |
| Financing Activities | | |
| Principal payments on long-term debt | (43,178) | (28,453) |
| Proceeds from issuance of long-term debt | 484,977 | 183,416 |
| Refunding of long-term debt | (220,050) | (181,117) |
| Restricted contributions and investment income | 30,353 | 31,440 |
| Other | (3,233) | (4,824) |
| Net Cash Provided by Financing Activities | <u>248,869</u> | <u>462</u> |
| Net Increase/(Decrease) in Cash and Cash Equivalents | 100,572 | (51,548) |
| Cash and cash equivalents at beginning of year | 232,528 | 284,076 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | <u>\$ 333,100</u> | <u>\$ 232,528</u> |

See notes to the consolidated financial statements.

Inova Health System
Notes To Consolidated Financial Statements
December 31, 2018 and 2017

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.

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.

Certain reclassifications have been made to the 2017 consolidated financial statements to conform with classifications used in 2018. The reclassifications had no significant effect on total assets, total liabilities, total revenue or total revenue in excess of expenses previously reported.

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”); Inova Health Plan, LLC (“IHP”); 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. IHP, a former wholly-owned subsidiary of the Foundation previously known as INTotal, 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 and the company was renamed to Inova Health Plan, LLC. 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.

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 to affiliated health care providers.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

2. Summary of Significant Accounting Policies (continued)

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 price concessions relating to 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 price concessions is based upon management's assessment of historical and expected net collections considering historical business and economic conditions, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the price concessions based upon historical 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 price concessions. 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, these amounts are deducted from gross revenue as a price concession.

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 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 (expenses over revenues) revenues over expenses unless such earnings are subject to donor-imposed restrictions. Investment income restricted by donor stipulations is reported as an increase in net assets with donor restrictions. Unrealized gains and losses on investments classified as other-than-trading are reported as a change in net assets without donor restrictions and, in accordance with relevant accounting literature, are excluded from excess of (expenses over revenues) 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, 2018 or 2017.

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.

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.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

2. Summary of Significant Accounting Policies (continued)

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.

Net Assets: Net assets, revenues, gains, and losses are classified based on the existence or absence of donor or grantor imposed restrictions. Accordingly, net assets and changes therein are classified and reported as follows:

Net Assets without Donor Restrictions: Net assets available for use in general operations and not subject to donor restrictions. The governing board has designated, from net assets without donor restrictions, net assets for an operating reserve and board-designated endowment.

Net Assets with Donor Restrictions: Net assets with donor restrictions are those whose use by IHS has been limited by donors to a specific time period or purpose, or in perpetuity. Annual changes in fair value are reported as increases or decreases in net assets with donor restrictions.

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 net assets with donor restrictions if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, net assets with donor restrictions are reclassified as assets without donor restrictions 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 contributions without donor restrictions and reported in the accompanying consolidated financial statements as other operating revenue.

Excess of (Expenses over Revenues) Revenues Over Expenses: The Consolidated Statements of Operations and Changes in Net Assets include the excess of (expenses over revenues) revenues over expenses as the performance indicator. Changes in unrestricted net assets that are excluded from the excess of (expenses over revenues) 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).

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

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.

Long-term Investments: IHS maintains a strategic portfolio of investments in various funds and other unaffiliated companies. IHS’ ownership stake ranges from 0.8% to 14.5% and IHS does not have the ability to exert significant influence over the investees. These investments are accounted for on the cost basis.

Income Taxes: The Foundation, IHCS, and LHC 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.

The Tax Cuts and Jobs Act (“TCJA”) was enacted on December 22, 2017. For tax-exempt entities, TCJA requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income subject to tax, pay an excise tax on compensation above certain thresholds, and record income or losses for tax determination purposes from unrelated business activities on an activity-by-activity basis, among other provisions. Regulations necessary to implement certain aspects of TCJA are expected to be promulgated by the Internal Revenue Service (“IRS”) in 2019. As of and for the year ended December 31, 2018, IHS has made reasonable estimates of the provision for income taxes, the compensation excise tax, and the effects, if any, on existing deferred tax balances based on accounting guidance included in Accounting Standards Codification 740, *Income Taxes*.

Non-controlling Interest: The non-controlling 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 non-controlling 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 non-controlling interest is adjusted based on an allocation of subsidiary earnings based on ownership interest. Amounts attributable to non-controlling interests of \$17.8 million as of January 1, 2018 were reclassified from other noncurrent obligations to unrestricted net assets during 2017. These amounts are shown as “reclassification of beginning balance of non-controlling 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 (continued)
December 31, 2018 and 2017

2. Summary of Significant Accounting Policies (continued)

Subsequent Events: IHS has evaluated subsequent events that have occurred for recognition and disclosure through March 22, 2019, the date the accompanying consolidated financial statements were available for issuance.

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, valued-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.

Recent Accounting Pronouncements: Effective January 1, 2018, IHS adopted Financial Accounting Standards Board ("FASB") Accounting Standard Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)*, using the full retrospective method of transition. This ASU converged and replaced existing revenue recognition guidance, including industry-specific guidance and requires revenue to be recognized in an amount that reflects the consideration the entity expects to be entitled in an exchange of goods or services. The adoption of this ASU did not materially impact the consolidated financial statements.

Effective December 31, 2018, IHS adopted FASB ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)*. This ASU changes certain financial statement requirements for not-for-profit entities in an effort to make the information more meaningful to users and reduce reporting complexity. IHS adopted the ASU and has adjusted the presentation in these consolidated financial statements accordingly. The ASU has been applied retrospectively to all periods presented. IHS has elected to apply the practical expedient and not disclose prior year liquidity and availability of resources.

New Accounting Standards Not Yet Adopted: In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This ASU requires the rights and obligations arising from the lease contracts, including existing and new arrangements, to be recognized as assets and liabilities on the consolidated statements of financial position. The ASU will require disclosures to help financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. The ASU was adopted on January 1, 2019 using a modified retrospective approach. While management is in the process of finalizing its evaluation of the impact of adopting ASU 2016-02, currently management anticipates recording lease assets and lease liabilities of approximately \$140 million in the consolidated balance sheets. However, the ultimate impact of adopting ASU 2016-02 will depend on the lease portfolio as of the adoption date.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

2. Summary of Significant Accounting Policies (continued)

In January 2016, the FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10)*. This Update requires: 1.) certain equity investments to be measured at fair value, 2.) simplifies the impairment assessment of equity investments, 3.) eliminates certain disclosures, 4.) requires management to evaluate the need for a valuation allowance on certain deferred tax assets and, 5.) requires separate presentation of certain amounts in the financial statements. The amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Management is currently evaluating the impact that the adoption of ASU 2016-01 will have on its consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, *Restricted Cash – a consensus of the FASB Emerging Issues Task Force (Topic 230)*. This Update requires amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The Update is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Management is currently evaluating the impact that the adoption of ASU 2016-18 will have on its consolidated financial statements.

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 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 updated 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 call 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 June 2018, the FASB issued ASU No. 2018-08, *Not-for-Profit Entities – Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made (Topic 958)*. This ASU provides a more robust framework to determine when a transaction should be accounted for as a contribution or as an exchange transaction and provides additional guidance about how to determine whether a contribution is conditional. This ASU was adopted by IHS January 1, 2019 using a modified prospective basis. The adoption of ASU 2018-08 is not expected to have a material impact on the consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurements (Topic 820)*. This ASU improves the effectiveness of the notes to the financial statements through changes in disclosure requirements for fair value measurement. The ASU is effective January 1, 2020 and will be applied using a retrospective approach. IHS is currently assessing the impact of the ASU on the consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-15, *Intangibles – Goodwill and Other, Internal-Use Software (Subtopic 350-40), Customer’s Accounting for Implementation Cost Incurred in a Cloud Computing Arrangement That Is a Service Contract*. This ASU aligns the requirements for capitalizing cost incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

2. Summary of Significant Accounting Policies (continued)

internal use software. The ASU is effective January 1, 2020 and will be applied using a prospective approach. IHS is currently assessing the impact of the ASU on the consolidated financial statements.

3. Net Patient Service Revenue

In May 2014, the Financial Accounting Standards Board (“FASB”) issued a new standard related to revenue recognition. IHS adopted the new standard effective January 1, 2018, using the full retrospective method. The most significant change from the adoption of the new standard relates to IHS’ estimation for the allowance for doubtful accounts. Under the previous standards, IHS’ estimate for amounts not expected to be collected based upon historical experience, were reflected as provision for bad debts and deducted from net patient service revenue to arrive at net patient service revenue less provision for bad debts. Under the new standard, those amounts will continue to be recognized as a reduction to net patient service revenue, however, not reflected separately as provision for bad debts, and accordingly the caption net patient service revenue less provision for bad debts will no longer be presented on the Consolidated Statements of Operations and Changes in Net Assets. Subsequent changes in the estimate of collectability due to a change in the financial status of a payor, for example a bankruptcy, will be recognized as bad debt expense in operating expenses. The application of the full retrospective approach resulted in the reclassification to net patient service revenue of \$158.0 million that was presented as a provision for bad debts for the year ended December 31, 2017, and the removal of the net patient service revenue less provision for bad debts caption. This reclassification did not have a material impact on the consolidated financial statements.

IHS’s revenues generally relate to contracts with patients in which our performance obligations are to provide health care services to the patients. Revenues are recorded during the period the obligations to provide health care services are satisfied. Performance obligations for inpatient services are generally satisfied over periods that average approximately five days, and revenues are recognized based on charges incurred in relation to total expected charges. Performance obligations for outpatient services are generally satisfied over a period of less than one day. The contractual relationship with patients, in most cases, also involve a third-party payor (Medicare, Medicaid, managed care health plans and commercial insurance companies, including plans offered through the health insurance exchanges) and the transaction prices for services provided are dependent upon the terms provided by (Medicare and Medicaid) or negotiated with (managed care health plans and commercial insurance companies) the third-party payors. The payment arrangements with third-party payors for services provided patients typically specify payments at amounts less than IHS’s standard charges. Medicare generally pays for inpatient and outpatient services at prospectively determined rates based on clinical, diagnostic and other factors. Services provided to patients having Medicaid coverage are generally paid at prospectively determined rates per discharge, per identified service or per covered member. Agreements with commercial insurance carriers, managed care and preferred provider organizations generally provide for payments based on predetermined rates per diagnosis, per diem rates or discounted fee-for-service rates. Management continually reviews the contractual estimation process to incorporate updates to laws and regulations and the frequent changes in managed care contractual terms resulting from contract renegotiations and renewals.

IHS’ revenues are based upon the estimated amounts that management expects to be entitled to receive from patients and third-party payors. Estimates of contractual allowances under managed care and commercial insurance plans are based upon the payment terms specified in the related contractual agreements. Revenues related to uninsured patients and uninsured copayment and deductible amounts for patients who have health care coverage may have discounts applied (uninsured discounts and contractual discounts). Management also records estimated implicit price concessions (based primarily on historical collection experience) related to uninsured accounts to record self-pay revenues at the estimated amounts that it expects to collect.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

3. Net Patient Service Revenue (continued)

IHS has elected the practical expedient allowed under FASB ASC 606-10-32-18 and does not adjust the promised amount of consideration from patients and third-party payors for the effects of a significant financing component due to IHS' expectation that the period between the time the service is provided to a patient and the time that the patient or third-party payor pays for that service will be one year or less. However, IHS does, in certain circumstances, enter into payment agreements with patients that allow payments in excess of one year. For those cases, the financing component is not deemed to be significant to the contract.

| | 2018 | | 2017 | | | |
|------------------------------------|-------------|------------------|---------------|-----------|------------------|---------------|
| Medicare | \$ | 625,279 | 18.4% | \$ | 611,142 | 17.7% |
| Medicaid | | 135,108 | 4.0% | | 130,286 | 3.8% |
| Commercial and other | | 2,489,280 | 73.1% | | 2,364,577 | 69.0% |
| Net Patient Service Revenue | | 3,249,667 | 95.5% | | 3,106,005 | 90.5% |
| Premium revenue | | 10,247 | 0.3% | | 190,392 | 5.6% |
| Other operating revenue | | 142,921 | 4.2% | | 132,694 | 3.9% |
| Total Operating Revenues | \$ | 3,402,835 | 100.0% | \$ | 3,429,091 | 100.0% |

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Settlements with third-party payors for retroactive adjustments due to audits, reviews, or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreements with the payor, correspondence from the payor and IHS' historical settlement activity, including an assessment to ensure it is probable a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known, or as years are settled or are no longer subject to such audits, reviews and investigations. Adjustments arising from a change in the transactions price were not significant in 2018 and 2017.

The collection of outstanding receivables for Medicare, Medicaid, managed care payors, other third-party payors and patients is IHS' primary source of cash and is critical to its operating performance. IHS' practice is to assign a patient to the primary payor and not reflect other uninsured balances as self-pay. Therefore the payors listed above contain patient responsibility components such as deductibles and copayments. The primary collection risks relate to uninsured patient accounts, including patient accounts for which the primary insurance carrier has paid the amounts covered by the applicable agreement, but patient responsibility amounts remain outstanding. Implicit price concessions relate primarily to amounts due directly from patients. Estimated price concessions are recorded for all uninsured account, regardless of the aging of those accounts. Accounts are written off when all reasonable internal and external collection efforts have been performed.

The estimates for implicit price concessions are based upon management's assessment of historical write-offs and expected net collections, business and economic conditions, trends in federal, state and private employer health care coverage and other collection indicators. Management relies on the results of detailed reviews of historical write-offs and collections at facilities that represent a majority of IHS' revenues and patient accounts receivable (the "hindsight analysis") as a primary source of information in estimating the collectability of patient accounts receivable. Management performs a hindsight analysis monthly, utilizing rolling twelve-month patient accounts receivable collection and write-off data. Management believes monthly updates to the estimated implicit price concession amounts at each of IHS' healthcare facilities provide reasonable estimates of its revenues and valuations of its patient accounts receivable. These routine, monthly changes in estimates have not resulted in material adjustments to the valuations of patient accounts receivable or period-to-period comparisons of the results of operations. For the years ended December 31, 2018 and 2017, estimated implicit price concessions of \$182.3 million and \$158.0 million, respectively, had been recorded as reductions to IHS' revenues and patient accounts receivable balances to enable management to

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

3. Net Patient Service Revenue (continued)

record IHS' revenues and patient accounts receivable at the estimated amounts that they expect to collect.

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 typically based on the cost to charge ratio for each facility. 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.

IHS' estimated costs of providing services to the poor and broader community for the years ended December 31, 2018 and 2017 are as follows (in thousands):

| | <u>2018</u> | <u>2017</u> |
|--|--------------------------|--------------------------|
| Charity care | \$ 129,984 | \$ 130,165 |
| Unpaid cost of state programs to financially disadvantaged persons | 144,908 | 124,521 |
| Community health programs | 24,776 | 25,100 |
| Medical education and research | <u>23,777</u> | <u>21,495</u> |
| Total community benefits, at cost | <u>\$ 323,445</u> | <u>\$ 301,281</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, 2018 and 2017 (in thousands):

| | <u>2018</u> | <u>2017</u> |
|---|----------------------------|----------------------------|
| Land and land improvements | \$ 222,032 | \$ 238,845 |
| Buildings, fixed equipment and leasehold improvements | 2,703,086 | 2,598,526 |
| Major movable equipment | <u>1,634,559</u> | <u>1,498,489</u> |
| | 4,559,677 | 4,335,860 |
| Less: Accumulated depreciation and amortization | <u>(2,671,098)</u> | <u>(2,454,191)</u> |
| | 1,888,579 | 1,881,669 |
| Construction-in-progress | <u>490,559</u> | <u>300,393</u> |
| Total | <u>\$ 2,379,138</u> | <u>\$ 2,182,062</u> |

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

6. Investments

IHS' investments as of December 31, 2018 and 2017 are as follows (in thousands):

| | <u>2018</u> | <u>2017</u> |
|-------------------------------|----------------------------|----------------------------|
| Trading securities | \$ 1,720,534 | \$ 1,795,150 |
| Alternative investments | 2,736,529 | 2,918,861 |
| Available for sale securities | 464,341 | 469,892 |
| Total | <u>\$ 4,921,404</u> | <u>\$ 5,183,903</u> |

Income from alternative investments is recorded in Investment income and other, net on the Statements 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 \$399.0 million and \$275.7 million as of December 31, 2018 and 2017, respectively.

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 \$(3.2) million for 2018 and \$(0.5) million for 2017. Open sales totaled \$5.8 million and \$6.0 million as of December 31, 2018 and 2017, 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.

Details of investments held as available for sale securities in assets whose use is limited as of December 31, 2018 and 2017 are as follows (in thousands):

| | <u>2018</u> | | <u>2017</u> | |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| | <u>Cost</u> | <u>Fair Value</u> | <u>Cost</u> | <u>Fair Value</u> |
| Cash and cash equivalents | \$ 420,067 | \$ 420,642 | \$ 425,356 | \$ 423,334 |
| U.S. government and agency securities | 18,813 | 18,703 | 20,661 | 20,502 |
| Domestic equity securities and mutual funds | 20,800 | 24,996 | 20,068 | 26,056 |
| Total | <u>\$ 459,680</u> | <u>\$ 464,341</u> | <u>\$ 466,085</u> | <u>\$ 469,892</u> |

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

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 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. This valuation methodology is consistent with the equity method.

The following tables present IHS’ assets and liabilities measured at fair value on a recurring basis as of December 31, 2018 and 2017, 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 excluded from fair value tables below.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

7. Fair Value Measurements (continued)

| | December 31, 2018 | Level 1 | Level 2 | Level 3 |
|---------------------------------------|----------------------|---------------------|-------------------|------------------|
| Assets: | | | | |
| Cash and cash equivalents | \$ 526,322 | \$ 501,703 | \$ 24,619 | \$ - |
| U.S. government and agency securities | 322,714 | - | 322,714 | - |
| Corporate and other bonds | | | | |
| - Asset-backed securities | 208,601 | - | 208,601 | - |
| - Corporate and other bonds | 256,869 | - | 256,869 | - |
| - Other government securities | 39,855 | - | 39,855 | - |
| Equity securities | | | | |
| - Domestic | 259,700 | 259,700 | - | - |
| - International | 223,066 | 216,418 | 6,648 | - |
| Mutual funds / exchange traded funds | | | | |
| - Equity | 310,815 | 310,815 | - | - |
| - Fixed Income and other | 40,159 | 40,159 | - | - |
| Subtotal | 2,188,101 | 1,328,795 | 859,306 | - |
| Interest rate swap asset | 6,522 | - | 6,522 | - |
| Total assets | \$ 2,194,623 | \$ 1,328,795 | \$ 865,828 | \$ - |
| | | | | |
| | 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 funds / exchange traded funds | | | | |
| - 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) | \$ - |

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.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

7. Fair Value Measurements (continued)

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, included the estimated contingent consideration received related to the sale of IHP. 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. See Note 17.

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, 2018 and 2017 are as follows (in thousands):

| | Carrying Value | | Equity Method Income (Losses) | |
|---|------------------|------------------|-------------------------------|--------------------|
| | 2018 | 2017 | 2018 | 2017 |
| IHealth | \$ 46,318 | \$ 37,042 | \$ 9,277 | \$ (16,676) |
| Other investments accounted for under equity method | 16,242 | 5,368 | (7,956) | (6,691) |
| Investments accounted for under cost method | 493 | 493 | - | - |
| Total investments in affiliates | \$ 63,053 | \$ 42,903 | \$ 1,321 | \$ (23,367) |

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, 2018 and 2017 are as follows (in thousands) (unaudited):

| | 2018 | 2017 |
|---|------------|------------|
| Total Assets | \$ 210,173 | \$ 283,461 |
| Total Liabilities | 73,301 | 156,763 |
| Net Assets | 136,872 | 126,699 |
| Total revenues, net | 393,037 | 565,132 |
| Excess of revenue over expenses (expenses over revenue) | 6,615 | (37,088) |

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

9. Goodwill and Other Intangible Assets

A summary of goodwill and other intangible assets at December 31, 2018 and 2017 is as follows (in thousands):

| | <u>2018</u> | <u>2017</u> |
|---------------------------------------|-------------------------|-------------------------|
| Intangible assets | \$ 8,827 | \$ 8,293 |
| Accumulated amortization | <u>(3,897)</u> | <u>(2,631)</u> |
| Total intangibles, net | 4,930 | 5,662 |
| Goodwill | <u>37,303</u> | <u>37,303</u> |
| Total Goodwill and Intangibles | <u>\$ 42,233</u> | <u>\$ 42,965</u> |

Amortization expense of intangible assets was \$1.3 million and \$3.2 million, for the years ended December 31, 2018 and 2017, respectively.

On an annual and interim basis, management evaluates whether any qualitative factors 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, 2018 and 2017. There were no impairment losses for 2018 or 2017.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

10. Long-Term Debt

Long-term debt issues consisted of the following as of December 31, 2018 and 2017 (in thousands):

| | December 31, | |
|---|---------------------|---------------------|
| | 2018 | 2017 |
| 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 |
| 1993A Hospital Revenue Refunding Bonds; maturing 8/15/23; semi-annual interest at a fixed rate of 2.75% to 5.25% | 38,505 | 45,115 |
| 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 |
| 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 |
| 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 |
| 2012A Health Care Revenue Bonds; maturing 5/15/42; semi-annual interest at a fixed rate of 2.25% to 5.0% | 265,325 | 268,765 |
| 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% | 66,510 | 78,030 |
| 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 12.0% | 98,955 | 99,330 |
| 2017 Health Care Revenue Bonds; maturing 5/15/2035; monthly interest at a fixed rate of 1.55% | — | 179,285 |
| 2018A Health Care Revenue Bonds; maturing 5/15/2048; semi-annual interest at a fixed rate of 3.0% to 5.0% | 206,860 | — |
| 2018B Health Care Revenue Bonds; maturing 5/15/2057; semi-annual interest at a fixed rate of 5.0% | 150,000 | — |
| 2018C Health Care Revenue Bonds; maturing 5/15/2033; monthly interest at a variable rate and maximum of 12.0% | 100,000 | — |
| Total Long-term Debt of the IHS Obligated Group | 1,604,455 | 1,409,435 |
| Less: Current Portion of Long-term Debt | (227,210) | (157,845) |
| Net Original Issue Premium | 88,230 | 66,751 |
| Net Deferred Financing Costs | (8,698) | (6,065) |
| Net Long-term Debt of the IHS Obligated Group | \$ 1,456,777 | \$ 1,312,276 |
| Total Long-term Debt of Non-Obligated IHS Affiliates | \$ 7,502 | \$ 8,890 |
| Less: Current Portion of Long-term Debt | (1,219) | (1,388) |
| Net Long-term Debt of Non-Obligated IHS Affiliates | \$ 6,283 | \$ 7,502 |
| Total Net IHS Long-term Debt | \$ 1,463,060 | \$ 1,319,778 |

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 (continued)
December 31, 2018 and 2017

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 July 31, 2018, the Industrial Development Authority issued \$206.9 million of Series 2018A bonds for the benefit of the Obligated Group. The 2018A bonds are comprised of fixed rate term and coupon bonds with principal payments starting in the year 2019. Interest is payable semiannually on May 15 and November 15 of each year, commencing on November 15, 2018. The premium received was \$12.1 million. The total proceeds from the offering were \$219.0 million.

On July 31, 2018, the Industrial Development Authority issued \$150.0 million of Series 2018B bonds for the benefit of the Obligated Group. The 2018B bonds are comprised of coupon bonds with principal payments starting in May 2033. Interest is payable semiannually on May 15 and Nov 15 of each year, commencing November 15, 2018. The premium received was \$16.0 million. The total proceeds from the offering were \$166.0 million.

On July 31, 2018, the Industrial Development Authority issued \$100.0 million of Series 2018C bonds for the benefit of the Obligated Group. The 2018C bonds are comprised of self-liquidity variable rate demand bonds. Interest is payable on the first day of each month, commencing on September 1, 2018.

On September 5, 2018, IHS redeemed the outstanding balance of the 1988A, B, C, and D bonds with funds from its unrestricted cash reserves. IHS recognized a \$27 thousand loss on extinguishment as a result of the transaction.

Approximately \$264.9 million of the proceeds of the 2018A, B, and C bonds will be used to finance various capital projects, and the remaining proceeds refunded all or a portion of Series 2017, Series 2005C and Series 2000A bonds. IHS recognized a \$93 thousand 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 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 were refunded by the 2018 A, B, and C bonds.

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 for the year ended December 31, 2017.

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 (continued)
December 31, 2018 and 2017

10. Long-Term Debt (continued)

IHS estimates the December 31, 2018 and 2017 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 \$1,694 million and \$1,511 million, respectively, compared with the face value of approximately \$1,700 million and \$1,485 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 2.36% and 0.80% in 2018 and 0.61% and 1.75% in 2017. The variable rate bonds include an optional tender feature that allows the bond holder to tender the bonds on a weekly interest payment date.

The tender feature of the 2016C Bonds and certain variable rate bonds requires IHS to maintain current assets of \$199.0 million and \$129.6 million as of December 31, 2018 and 2017, 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, 2018 are as follows (in thousands):

| | <u>2019</u> | <u>2020</u> | <u>2021</u> | <u>2022</u> | <u>2023</u> | <u>There-after</u> | <u>Total</u> |
|---|-------------------|------------------|------------------|------------------|------------------|---------------------|---------------------|
| Scheduled Maturities | \$ 29,474 | \$ 32,093 | \$ 33,284 | \$ 94,511 | \$ 35,668 | \$ 1,187,972 | \$ 1,413,002 |
| Bonds under remarketing agreement and subject to mandatory tender | 198,955 | - | - | - | - | - | 198,955 |
| Total | <u>\$ 228,429</u> | <u>\$ 32,093</u> | <u>\$ 33,284</u> | <u>\$ 94,511</u> | <u>\$ 35,668</u> | <u>\$ 1,187,972</u> | <u>\$ 1,611,957</u> |

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, 2018 and 2017, the amount of CP outstanding was \$100.0 million.

Total interest paid was \$62.3 million and \$61.6 million for the years ended December 31, 2018 and 2017, respectively.

As of December 31, 2018 and 2017, 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, 2018 or 2017, respectively. Included in this amount, is a \$100 million line of credit that is scheduled to expire on June 30, 2019, which Management intends to renew.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

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, 2018 and 2017, 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, 2018: | | | | | | | | | |
| Merrill Lynch Capital Services, Inc. | \$ 50,000 | N/A | 5/15/2034 | Fixed Payer | 1.65% | 67% of one-month USD LIBOR | \$ 3,186 | \$ 30,000 | \$ - |
| JPMorgan Chase Bank, N.A. | 69,495 | N/A | 5/15/2034 | Fixed Payer | 1.45% | 67% of one-month USD LIBOR | 3,336 | 25,000 | - |
| Total | <u>\$ 119,495</u> | | | | | | <u>\$ 6,522</u> | <u>\$ 55,000</u> | <u>\$ -</u> |
| 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> |

In January 2019, IHS entered into an interest rate swap agreement with the Citibank, N.A. (“Citibank”). The swap has a notional amount of \$100 million with final maturity on January 15, 2034. Under the swap agreement, IHS is obligated to pay interest at a variable rate of 67% of USD-LIBOR-BBA, while Citibank is obligated to pay interest at a variable rate of 67% of the USD-ISDA-Swap Rate minus 0.387%.

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 \$2.4 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, 2018 and 2017 include in other non-current obligations \$26.7 million and \$30.2 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 2018 and prior years. The liabilities are discounted at 2.50% and 1.88% at December 31, 2018 and 2017, respectively. InovaCap also recorded a liability of \$2.3 million and \$2.4 million as of December 31, 2018 and 2017, respectively, for reinsurance of certain health plan obligations.

Investments and other assets held by InovaCap of \$80.4 million and \$127.6 million at December 31, 2018 and 2017, 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.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

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.

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 \$40.4 million and \$38.9 million in 2018 and 2017, 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, 2018 (in thousands):

| | Operating Leases |
|---|-----------------------------|
| 2019 | \$ 37,147 |
| 2020 | 28,461 |
| 2021 | 22,332 |
| 2022 | 19,176 |
| 2023 | 16,589 |
| Thereafter | 32,570 |
| Total lease payments | \$ 156,275 |
| Minimum income from non-cancellable subleases | (9,826) |
| Total minimum lease payments | \$ 146,449 |

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

14. Other Leases and Financing Obligation (continued)

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. The financing obligation was \$184.5 million and \$184.4 million as of December 31, 2018 and 2017, respectively.

Future minimum payments under this agreement with the remaining terms of one year or more consisted of the following at December 31, 2018 (in thousands):

| | Financing Obligation |
|--------------|---------------------------------|
| 2019 | \$ 8,875 |
| 2020 | 8,750 |
| 2021 | 5,000 |
| 2022 | 5,000 |
| 2023 | 5,000 |
| Thereafter | 1,239,533 |
| Total | \$ 1,272,158 |

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, 2018 were approximately \$291.9 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' primary program service is serving the health care needs of the community by establishing, maintaining, and operating hospital facilities, programs, and other services. Natural expenses attributable to more than one functional expense category are allocated across IHS on a variety of bases, where appropriate, including employee salaries, square footage, and operating expenses.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

16. Functional Expenses (continued)

Expenses by functional classification for the year ended December 31, 2018 consist of the following (in thousands):

| | 2018 | | |
|---------------------------------|---------------------------------|---------------------------------------|---------------------|
| | Health care services | General and administrative | Total |
| Salaries and benefits | \$ 1,460,278 | \$ 233,635 | \$ 1,693,913 |
| Other operating expenses | 1,076,911 | 153,856 | 1,230,767 |
| Medical claims | 7,234 | – | 7,234 |
| Depreciation and amortization | 161,470 | 63,162 | 224,632 |
| Interest | 45,608 | 4,527 | 50,135 |
| Total Operating Expenses | \$ 2,751,501 | \$ 455,180 | \$ 3,206,681 |

Expenses by functional classification for the year ended December 31, 2017 consist of the following (in thousands):

| | 2017 | | |
|---------------------------------|---------------------------------|---------------------------------------|---------------------|
| | Health care services | General and administrative | Total |
| Salaries and benefits | \$ 1,417,078 | \$ 223,114 | \$ 1,640,192 |
| Other operating expenses | 1,046,010 | 172,008 | 1,218,018 |
| Medical claims | 118,853 | – | 118,853 |
| Depreciation and amortization | 158,049 | 66,759 | 224,808 |
| Interest | 45,903 | 6,491 | 52,394 |
| Total Operating Expenses | \$ 2,785,893 | \$ 468,372 | \$ 3,254,265 |

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 UnitedHealth 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, 2018. 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 for the year ended December 31, 2017. Commensurate with the transaction, INTotal was renamed to Inova Health Plan, LLC (“IHP”).

During the fourth quarter of 2018, IHS received the final consideration from UnitedHealth in the amount of \$24.8 million resulting in an additional \$4.7 million gain, which is included in the gain on disposal of business line in the accompanying Statements of Operations and Changes in Net Assets for the year ended December 31, 2018.

The accompanying consolidated Statements of Operations and Changes in Net Assets include revenues related to IHP of \$176.7 million and a Net Operating Loss of \$1.3 million for the year ended December 31, 2017.

Inova Health System
Notes To Consolidated Financial Statements (continued)
December 31, 2018 and 2017

18. Net Assets with Donor Imposed Restrictions

Net assets with donor restrictions are restricted for the following purposes:

| | <u>2018</u> | <u>2017</u> |
|--|--------------------------|--------------------------|
| Subject to expenditure for specified purpose: | | |
| Healthcare services and programs | \$ 167,270 | \$ 137,747 |
| Employee education, recognition and support | 8,179 | 8,410 |
| Research | 10,894 | 8,171 |
| Buildings and equipment | 4,894 | 6,120 |
| Total net assets with donor restrictions | <u>\$ 191,237</u> | <u>\$ 160,448</u> |

19. Pledges Receivable

Pledges receivable are included in the other current assets and other long-term assets in the accompanying consolidated balance sheets. Amounts due in less than one year, one to five years, and more than five years were as follows as of December 31, 2018:

| | |
|-------------------------------------|-------------------------|
| Less than one year | \$ 13,577 |
| One to five years | 53,100 |
| More than five years | <u>10,400</u> |
| Total pledges receivable | 77,077 |
| Present value discount | (6,573) |
| Allowance for uncollectible pledges | <u>(12,691)</u> |
| Net pledges receivable | <u>\$ 57,813</u> |

20. Liquidity and Availability

Financial assets available for general expenditure within one year of the balance sheet date comprise the following at December 31, 2018:

| | <u>2018</u> |
|---|----------------------------|
| Cash and cash equivalents | \$ 333,100 |
| Patient accounts receivable, net | 321,920 |
| Pledges receivable, net | 10,863 |
| Other receivables | 21,092 |
| Investments with daily and weekly liquidity | <u>2,277,641</u> |
| Total | <u>\$ 2,964,616</u> |



Ernst & Young LLP
621 East Pratt Street
Baltimore, MD 21202

Tel: +1 410 539 7940
Fax: +1 410 783 3832
ey.com

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 22, 2019

Inova Health System Obligated Group
Consolidating Balance Sheets
December 31, 2018 and 2017
(in thousands)

| | December 31, 2018 | December 31, 2017 |
|---|----------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 302,609 | \$ 189,263 |
| Assets whose use is limited, current | 198,955 | 129,630 |
| Patient accounts receivable, net | 307,466 | 313,394 |
| Other current assets | 123,084 | 125,249 |
| Total Current Assets | 932,114 | 757,536 |
| Property, Equipment and Leasehold Interests, net | 2,331,837 | 2,131,841 |
| Assets Whose Use Is Limited | | |
| Held by bond trustee | 135,679 | 8,921 |
| By board for plant replacement and expansion | 4,397,693 | 4,739,684 |
| By board for construction projects | 169,313 | 167,419 |
| By donor | 117,732 | 108,208 |
| | 4,820,417 | 5,024,232 |
| Less amounts required to meet current obligations | (198,955) | (129,630) |
| Assets Whose Use Is Limited, noncurrent | 4,621,462 | 4,894,602 |
| Other Assets | | |
| Investments in and receivables from affiliates | 138,474 | 94,450 |
| Goodwill and other intangible assets | 30,474 | - |
| Interest rate swap | 6,522 | 1,986 |
| Long-term investments | 49,765 | 31,344 |
| Other long-term assets | 124,612 | 165,904 |
| Total Other Assets | 349,847 | 293,684 |
| TOTAL ASSETS | \$ 8,235,260 | \$ 8,077,663 |
| LIABILITIES AND NET ASSETS | | |
| Current Liabilities | | |
| Accounts payable and other accrued expenses | \$ 380,628 | \$ 365,395 |
| Third-party settlements | 46,354 | 52,736 |
| Notes payable and other liabilities | 108,258 | 111,794 |
| Current portion of long-term debt | 227,210 | 157,845 |
| Total Current Liabilities | 762,450 | 687,770 |
| Non-current Liabilities | | |
| Long-term debt, less current portion | 1,456,776 | 1,312,274 |
| Financing obligation | 184,461 | 184,423 |
| Other non-current obligations | 55,842 | 58,707 |
| Total Non-current Liabilities | 1,697,079 | 1,555,404 |
| Net Assets | | |
| Without donor restrictions | 5,608,819 | 5,694,791 |
| With donor restrictions | 166,912 | 139,698 |
| Total Net Assets | 5,775,731 | 5,834,489 |
| TOTAL LIABILITIES AND NET ASSETS | \$ 8,235,260 | \$ 8,077,663 |

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 Net Asset without Donor Restrictions
For the Years Ended December 31, 2018 and 2017
(in thousands)

| | 2018 | 2017 |
|--|--------------------|-------------------|
| Operating Revenues | | |
| Net patient service revenue | \$ 3,055,929 | \$ 2,933,162 |
| Other operating revenue | 132,462 | 99,391 |
| Total Operating Revenues | 3,188,391 | 3,032,553 |
| Operating Expenses | | |
| Salaries and benefits | 1,579,412 | 1,504,142 |
| Other operating expenses | 1,175,689 | 1,122,700 |
| Depreciation and amortization | 215,232 | 212,994 |
| Interest | 49,581 | 51,366 |
| Total Operating Expenses | 3,019,914 | 2,891,202 |
| Operating Income before Gain on Disposal of Business Line | 168,477 | 141,351 |
| Gain on disposal of business line | 4,714 | 13,474 |
| Operating Income | 173,191 | 154,825 |
| Investment (loss) income and other, net | (305,028) | 642,199 |
| Excess of (Expenses over Revenues) Revenues Over Expenses | (131,837) | 797,024 |
| Unrealized gain/(losses) on investments, net | 710 | (35) |
| Loss on extinguishment of swap termination | - | 1,813 |
| Capital infusion to controlled affiliate | (4,141) | - |
| Sale of noncontrolling position | 8,624 | - |
| Distributions received from non-obligated group members | 40,000 | - |
| Net assets released from restriction for purchase of equipment and land rights | - | 2,551 |
| Other | 672 | 2,804 |
| (Decrease)/Increase in net assets without donor restrictions | \$ (85,972) | \$ 804,157 |

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 Cash Flows
For the Years Ended December 31, 2018 and 2017
(in thousands)

| | 2018 | 2017 |
|---|-------------|-------------|
| Operating Activities | | |
| Change in net assets | \$ (58,758) | \$ 834,976 |
| Adjustments to reconcile change in net assets to net cash provided by operating activities: | | |
| Depreciation and amortization | 215,232 | 212,994 |
| Loss on extinguishment of debt | 120 | 10,787 |
| Net realized and unrealized gains/(losses) on investments | 403,720 | (637,471) |
| Change in fair value of interest rate swaps | (4,850) | 305 |
| Equity investment (gains)/losses, net | (31,293) | 6,837 |
| Gain on sale of long lived assets | (2,253) | - |
| Increase in accounts receivable and third-party settlements, net | (15,804) | (12,996) |
| Increase in accounts payable and other current liabilities | 11,017 | 4,188 |
| Decrease in estimated professional liability and deferred liability items | (1,359) | 5,222 |
| (Decrease)/Increase in intangibles and other assets | 52,921 | (14,483) |
| Restricted contributions and other restricted income | (42,410) | (28,006) |
| Increase in other long term assets | (22,393) | 5,785 |
| Net Cash Provided by Operating Activities | 503,890 | 388,138 |
| Investing Activities | | |
| Capital expenditures | (432,344) | (372,873) |
| Proceeds from sale of fixed assets | 20,242 | 1,376 |
| Investments in and advances to joint ventures and affiliates | (4,107) | (3,265) |
| Purchases of marketable securities | (1,237,255) | (1,807,170) |
| Proceeds from sale of marketable securities | 1,015,177 | 1,741,592 |
| Net Cash Used in Investing Activities | (638,287) | (440,340) |
| Financing Activities | | |
| Principal payments on long-term debt | (41,790) | (27,474) |
| Proceeds from issuance of long-term debt | 484,977 | 179,285 |
| Refunding of long-term debt | (220,050) | (170,330) |
| Swap termination and modification payments | - | (4,824) |
| Restricted contributions and other restricted income | 27,839 | 28,006 |
| Other | (3,233) | - |
| Net Cash Provided by Financing Activities | 247,743 | 4,663 |
| Net Increase (Decrease) Cash and Cash Equivalents | 113,346 | (47,539) |
| Cash and Cash Equivalents at Beginning of Year | 189,263 | 236,802 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | \$ 302,609 | \$ 189,263 |

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.