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# McLaren Health Care Corporation and Subsidiaries

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**Consolidated Financial Report  
with Additional Information  
September 30, 2018**

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## Independent Auditor's Report

To the Board of Directors  
McLaren Health Care Corporation  
and Subsidiaries

We have audited the accompanying consolidated financial statements of McLaren Health Care Corporation and Subsidiaries (the "Corporation"), which comprise the consolidated balance sheet as of September 30, 2018 and 2017 and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### ***Management's Responsibility for the Consolidated Financial Statements***

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

### ***Auditor's Responsibility***

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

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

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

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of McLaren Health Care Corporation and Subsidiaries as of September 30, 2018 and 2017 and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Plante & Moran, PLLC*

January 8, 2019

# McLaren Health Care Corporation and Subsidiaries

## Consolidated Balance Sheet

September 30, 2018 and 2017  
(in thousands)

	2018	2017
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 824,687	\$ 615,234
Collateral from securities lending (Note 7)	2,208	6,784
Accounts receivable - Net (Note 3)	277,990	219,635
Healthcare insurance receivables	250,261	8,261
Assets limited as to use (Note 7)	1,807	1,569
Other current assets	134,750	101,972
Total current assets	1,491,703	953,455
<b>Investments, Including Internally Designated (Note 7)</b>	1,141,112	1,022,052
<b>Other Assets (Note 7)</b>	550,700	454,734
<b>Property and Equipment - Net (Note 6)</b>	1,224,009	1,094,900
Total assets	<b>\$ 4,407,524</b>	<b>\$ 3,525,141</b>
<b>Liabilities and Net Assets</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 327,421	\$ 221,164
Medical claims payable (Note 9)	177,130	82,416
Current portion of long-term debt (Note 10)	23,500	32,455
Third-party payor settlements payable (Note 4)	19,889	28,667
Accrued and other liabilities (Note 12)	400,140	199,930
Total current liabilities	948,080	564,632
<b>Long-term Debt - Net of current portion (Note 10)</b>	1,036,337	744,528
<b>Fair Value of Interest Rate Swap Agreements (Note 10)</b>	5,973	22,005
<b>Other Liabilities</b>		
Accrued defined benefit pension cost (Note 14)	90,234	219,845
Accrued postretirement benefit cost (Note 14)	10,561	14,622
Accrued professional liability claims (Note 15)	97,467	83,855
Other long-term liabilities	75,746	69,176
Total liabilities	2,264,398	1,718,663
<b>Net Assets</b>		
Unrestricted	1,995,094	1,674,591
Temporarily restricted	71,455	58,208
Permanently restricted	76,577	73,679
Total net assets	2,143,126	1,806,478
Total liabilities and net assets	<b>\$ 4,407,524</b>	<b>\$ 3,525,141</b>

## McLaren Health Care Corporation and Subsidiaries

# Consolidated Statement of Operations

Years Ended September 30, 2018 and 2017

(in thousands)

	2018	2017
<b>Unrestricted Revenue, Gains, and Other Support</b>		
Net patient service revenue	\$ 2,885,990	\$ 2,777,265
Provision for bad debts	(95,490)	(105,334)
Net patient service revenue less provision for bad debts	2,790,500	2,671,931
Premium revenue	1,829,935	778,705
Other	148,834	134,595
Net assets released from restrictions used for operations	10,734	13,300
Total unrestricted revenue, gains, and other support	4,780,003	3,598,531
<b>Expenses</b>		
Salaries and wages	1,188,290	1,136,273
Employee benefits and payroll taxes	220,983	223,916
Supplies	599,410	570,663
Purchased services and other	1,197,963	921,411
Professional and other liability costs	25,260	22,496
Medical claims expense	1,291,489	425,453
Depreciation and amortization	116,602	110,973
Interest expense	21,716	17,253
Total expenses (Note 16)	4,661,713	3,428,438
<b>Operating Income - Before nonrecurring impairment loss</b>	118,290	170,093
<b>Nonrecurring Impairment Loss</b>	-	12,192
<b>Operating Income</b>	118,290	157,901
<b>Nonoperating Income (Loss)</b>		
Investment income (Note 7)	40,276	49,015
Change in interest rate swap agreements (Note 10)	(315)	15,512
Change in unrealized gains and losses on investments (Note 7)	34,841	77,001
Inherent contribution	19,584	-
Other	11,170	1,322
Total nonoperating income	105,556	142,850
<b>Excess of Revenue Over Expenses</b>	223,846	300,751
<b>Contributions for Capital</b>	-	2,400
<b>Other Changes in Net Assets</b>	(386)	3,211
<b>Pension-related Changes Other than Net Periodic Benefit Cost</b>	90,143	101,096
<b>Net Assets Released from Restriction</b>	6,900	4,319
<b>Increase in Unrestricted Net Assets</b>	<b>\$ 320,503</b>	<b>\$ 411,777</b>

## McLaren Health Care Corporation and Subsidiaries

### Consolidated Statement of Changes in Net Assets

Years Ended September 30, 2018 and 2017

(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
<b>Net Assets</b> - October 1, 2016	\$ 1,262,814	\$ 49,173	\$ 69,995	\$ 1,381,982
Excess of revenue over expenses	300,751	-	-	300,751
Capital contributions	2,400	-	-	2,400
Restricted contributions	-	27,099	991	28,090
Change in unrealized gains and losses on investments	-	1,617	-	1,617
Increase in fair value of perpetual trust	-	-	3,164	3,164
Pension-related changes other than net periodic benefit cost	101,096	-	-	101,096
Other changes in net assets	3,211	(4,636)	(495)	(1,920)
Net assets released from restriction	4,319	(17,619)	-	(13,300)
Restricted investment income	-	2,574	24	2,598
Increase in net assets	411,777	9,035	3,684	424,496
<b>Net Assets</b> - September 30, 2017	1,674,591	58,208	73,679	1,806,478
Excess of revenue over expenses	223,846	-	-	223,846
Restricted contributions	-	28,209	2,298	30,507
Inherent contribution from acquisitions	-	376	-	376
Change in unrealized gains and losses on investments	-	699	-	699
Increase in fair value of perpetual trust	-	-	605	605
Pension-related changes other than net periodic benefit cost	90,143	-	-	90,143
Other changes in net assets	(386)	-	(21)	(407)
Net assets released from restriction	6,900	(17,634)	-	(10,734)
Restricted investment income	-	1,597	16	1,613
Increase in net assets	320,503	13,247	2,898	336,648
<b>Net Assets</b> - September 30, 2018	<b>\$ 1,995,094</b>	<b>\$ 71,455</b>	<b>\$ 76,577</b>	<b>\$ 2,143,126</b>

# McLaren Health Care Corporation and Subsidiaries

## Consolidated Statement of Cash Flows

Years Ended September 30, 2018 and 2017

(in thousands)

	2018	2017
<b>Cash Flows from Operating Activities</b>		
Increase in net assets	\$ 336,648	\$ 424,496
Adjustments to reconcile increase in net assets to net cash and cash equivalents from operating activities:		
Depreciation	116,602	110,973
Loss on disposal of equipment	486	3,318
Net change in unrealized gains and losses on investments	(49,054)	(78,618)
Realized gains on investments	(41,868)	(57,403)
Income from unconsolidated subsidiaries	1,023	(4,288)
Pension-related changes other than periodic benefit costs	(90,143)	(101,096)
Increase in fair value of perpetual trusts	(605)	(3,164)
Change in fair value of interest rate swap agreement	315	(15,512)
Temporarily and permanently restricted contributions	(30,507)	(28,090)
Contributions for capital	-	(2,400)
Amortization of bond premium	(2,318)	(2,442)
Inherent contribution	(19,958)	-
Nonrecurring impairment loss	-	12,192
Changes in operating assets and liabilities which (used) provided cash and cash equivalents, net of assets acquired and liabilities assumed in connection with acquisitions:		
Accounts receivable - Net of provision for bad debt	(53,965)	(7,443)
Other current assets	(26,759)	9,888
Third-party payor settlements	(9,223)	(16,216)
Other assets	8,602	(8,719)
Accounts payable	27,578	(3,911)
Medical claims payable	(7,910)	12,583
Accrued and other liabilities	(4,637)	12,847
Healthcare receivables	(7,542)	(583)
Other liabilities	(23,347)	(40,538)
Net cash and cash equivalents provided by operating activities	123,418	215,874
<b>Cash Flows from Investing Activities</b>		
Purchase of property and equipment	(223,834)	(183,794)
Proceeds from disposition of property and equipment	317	312
Purchases of investments	(132,517)	(656,185)
Proceeds from sales and maturities of investments	145,840	638,853
Cash paid for intangible assets	-	(968)
Cash received as part of the acquisition of MDwise, Caro, and Thumb	103,311	-
Cash paid for the acquisition of MDwise	(169,000)	-
Cash paid to joint ventures	(150)	(526)
Cash received from joint ventures	966	8,637
Net cash and cash equivalents used in investing activities	(275,067)	(193,671)
<b>Cash Flows from Financing Activities</b>		
Change in funds held by trustee under bond indenture	57,161	36,715
Proceeds from issuance of debt obligations	300,000	-
Principal payments on long-term debt	(23,782)	(25,197)
Debt issuance costs	(2,784)	-
Temporarily and permanently restricted contributions	30,507	28,090
Net cash and cash equivalents provided by financing activities	361,102	39,608
<b>Net Increase in Cash and Cash Equivalents</b>	209,453	61,811
<b>Cash and Cash Equivalents - Beginning of year</b>	615,234	553,423
<b>Cash and Cash Equivalents - End of year</b>	<b>\$ 824,687</b>	<b>\$ 615,234</b>
<b>Supplemental Cash Flow Information - Cash paid for interest</b>	\$ 18,780	\$ 20,658
<b>Significant Noncash Transactions - Noncash purchases of property and equipment</b>	7,487	14,234

See notes to consolidated financial statements.

September 30, 2018 and 2017

### Note 1 - Nature of Business

McLaren Health Care Corporation and Subsidiaries (the "Corporation"), a not-for-profit corporation, is a major provider of healthcare and insurance services to residents of southeast Michigan and the cities of Flint, Lansing, Bay City, Lapeer, Mt. Pleasant, Petoskey, Port Huron, Caro, and Bad Axe, Michigan and surrounding communities. A significant portion of the Corporation's revenue is derived through its insurance organizations in the states of Michigan and Indiana.

The consolidated financial statements include the corporations listed below, as well as their subsidiaries and related foundations, of which McLaren Health Care (MHC) is the sole member:

McLaren Flint (Flint)  
McLaren Bay Region (Bay)  
McLaren Lapeer Region (Lapeer)  
McLaren Greater Lansing (Lansing)  
McLaren Macomb (Macomb)  
McLaren Oakland (Oakland)  
McLaren Central Michigan (Central)  
McLaren Northern Michigan (Northern)  
McLaren Port Huron (Port Huron)  
McLaren Caro (Caro)  
McLaren Thumb Region (Thumb)  
Barbara Ann Karmanos Cancer Institute (Karmanos)  
McLaren Medical Group (MMG)  
McLaren High Performance Network (ACO)  
McLaren Homecare Group (MHG)  
McLaren Insurance Group (MIG)  
McLaren Health Plan (MHP)  
MDwise  
McLaren Bay Special Care (BSC)  
McLaren Insurance Company, LTD (MICOL)

### Note 2 - Significant Accounting Policies

#### *Principles of Consolidation*

The consolidated financial statements include the accounts of McLaren Health Care Corporation and all of its subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation.

**Note 2 - Significant Accounting Policies (Continued)**

***Cash and Cash Equivalents***

Cash and cash equivalents include investments in highly liquid debt investments purchased with an original maturity of three months or less, excluding those amounts included in assets limited as to use by board designation or other arrangements under trust agreements (see Note 7).

The Corporation routinely invests its surplus operating funds in money market mutual funds and in insured bank deposits. The money market mutual funds invest only in high-quality, short-term securities that are issued or guaranteed by the U.S. government or by U.S. government agencies and instrumentalities. The bank deposits, backed by the full faith and credit of the U.S. government, utilize a series of insured deposit accounts that are electronically linked and aggregated. Both investments aim to preserve capital, maintain liquidity, and provide a competitive yield.

***Accounts Receivable***

Accounts receivable for patients, insurance companies, and governmental agencies are based on gross charges. An allowance for contractual adjustments and interim payment advances is based on expected payment rates from payors based on current reimbursement methodologies. In addition, accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectibility of accounts receivable, the Corporation analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party coverage, the Corporation analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely).

For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Corporation records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the discounted rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts in the period they are determined to be uncollectible.

***Healthcare Insurance Receivables***

Healthcare insurance receivables include uncollected capitation and premiums due from the Michigan and Indiana Departments of Medicaid and other amounts due from networks and delivery systems. Certain receivable balances are secured under an escrow account established as a result of the acquisition described in Note 18. Amounts due from Michigan and Indiana Departments of Medicaid are unsecured and are estimated based on provisions of the contracts with Michigan and Indiana Departments of Medicaid and capitation rates in effect throughout the year.

**Note 2 - Significant Accounting Policies (Continued)**

***Investments***

Investments include general investments held by the Corporation and assets set aside by the governing boards of various subsidiaries for future capital improvements, over which the boards retain control and may at their discretion subsequently use for other purposes, subject to the reserve powers of the Corporation's governing board. Investments in equity securities with readily determinable fair values and all investments in debt securities are stated at fair market value. Investment income or loss (including interest and dividend income, realized gains or losses, and changes in unrealized gains or losses on investments) is included in excess of revenue over expenses, unless the income or loss is restricted by the donor.

The Corporation's investments are exposed to various risks, such as interest rate, market, and credit risk. Due to the level of risk associated with certain investments and the level of uncertainty related to changes in the value of investments, it is at least reasonably possible that changes in the value of investments in the near term could materially affect the amounts reported in the consolidated balance sheet and the consolidated statements of operations and changes in net assets.

***Securities Lending Arrangements***

The Corporation engages in transactions whereby certain securities in its portfolio are loaned to other institutions, generally for a short period of time. The Corporation records the fair value of the collateral received as a current asset and a current liability since the Corporation is obligated to return the collateral upon the return of the borrowed securities.

***Pooled Funds***

The Corporation has authorized investment pools for flexibility in investing its assets and maximizing its rate of return. Realized and unrealized gains or losses and income on unallocated investments are allocated to the unrestricted and temporarily restricted net assets participating in the pool based upon the average balance of the respective net assets.

***Assets Limited as to Use***

Assets limited as to use include assets held by trustees under indenture agreements, funds held in trust by foundations, funds restricted by donors for specific purposes, funds held in trust for payment of employee benefits, and self-insurance trust arrangements (see Note 7).

***Property and Equipment***

Property and equipment acquisitions are recorded at cost. Donated property and equipment are recorded at the estimated fair market value at the time of donation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Costs of maintenance and repairs are charged to expense when incurred.

***Impairment of Long-lived Assets***

The Corporation evaluates the recoverability of long-lived assets and the related estimated remaining lives when indicators of impairment are present. For the purpose of impairment analysis, assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. The Corporation records an impairment charge or changes the useful life if events or changes in circumstances indicate that the carrying amount may not be recoverable or the useful life has changed. No impairment loss was recognized in 2018, and an impairment loss of approximately \$12,192,000 was recognized in 2017.

**Note 2 - Significant Accounting Policies (Continued)**

***Goodwill***

The recorded amounts of goodwill from prior business combinations are based on management's best estimates of the fair values of assets acquired and liabilities assumed at the date of acquisition. Goodwill is not amortized, but rather is assessed on an annual basis for impairment.

No impairment charge was recognized during the years ended September 30, 2018 and 2017.

***Intangible Assets***

The recorded amount of intangible assets results primarily from the acquisition of plan members and provider networks by MHP and MDwise, and the acquisition of various physician practices. Intangible assets are based on management's best estimates of the fair value of assets acquired at the date of acquisition. As described in Note 7, certain components of the intangible assets are being amortized. The remainder is assessed for impairment on an annual basis. No impairment charge related to intangible assets was recognized in 2018 and 2017.

***Medical Claims Payable***

The reported liability for unpaid claims is comprised of two components: a liability for known claims that are unpaid as of the consolidated balance sheet date and a liability for claims incurred but not reported (IBNR).

The liability for unpaid claims is determined in aggregate, employing actuarial methods that are commonly used by health insurance actuaries and meet actuarial standards of practice. Claims incurred but not reported are based primarily on past experience, including claim payment patterns, enrollment data, historical utilization of services, emerging healthcare cost trends, seasonality and other relevant information and determined by actuarial calculations. Healthcare cost trends are primarily impacted by service utilization and unit costs that are affected by changes in the level and mix of healthcare benefits offered, in addition to the impact of copayments and deductibles, changes in provider practices, and changes in consumer demographics. Under this process, historical paid claims data is formatted into claim triangles, which compare claim incurred dates to the dates of claim payments. This information is analyzed to create completion factors that represent the average percentage of total incurred claims that have been paid through a given date. Completion factors are applied to claims paid through the period end date to estimate the ultimate claim expense incurred for the period. Actuarial estimates of incurred but not paid claim liabilities are then determined by subtracting the actual paid claims from the estimate of the ultimate incurred claims.

Although considerable variability is inherent in such estimates, management believes the recorded liability for unpaid claims and claims adjustment expenses is adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known. Such adjustments are reflected in current operations. There were no significant changes in estimates or assumptions during 2018 or 2017.

***Interest Rate Swaps***

The Corporation has entered into interest rate swap agreements to manage its investments and capitalization, including risks associated with changes in interest rates. The Corporation records its interest rate swaps at fair value in the accompanying consolidated balance sheet as either assets or liabilities. None of the Corporation's current swaps are designated as a hedge. Accordingly, both the unrealized and realized gains or losses related to the interest rate swaps are included in nonoperating income (loss) on the consolidated statement of operations (see Note 10).

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 2 - Significant Accounting Policies (Continued)**

***Classification of Net Assets***

Net assets of the Corporation are classified based on the presence and characteristics of donor-imposed restrictions limiting the Corporation's ability to use or dispose of contributed assets or the economic benefits embodied in those assets. Donor-imposed restrictions that expire with the passage of time or that can be removed by meeting certain requirements result in temporarily restricted net assets. Permanently restricted net assets result from donor-imposed restrictions that limit the use of net assets in perpetuity. Earnings, gains, and losses on restricted net assets are classified as unrestricted unless specifically restricted by the donor or by applicable state law.

Temporarily restricted net assets consist of assets contributed or pledged to the Corporation and its subsidiaries, the use of which is restricted by the donor. Temporarily restricted net assets are restricted for medical education, research, clinical and outreach programs, indigent care, and property and equipment purchases. Investment earnings on temporarily restricted investments are restricted by donors for specific purposes.

Permanently restricted net assets are composed of the estimated present value of the future cash receipts from certain trust assets and restricted investments held in perpetuity for research, clinical, and outreach programs. The present value of the future receipts from the trusts is recorded at the fair value of the assets of the trusts, net of liabilities.

***Excess of Revenue Over Expenses***

The consolidated statement of operations includes excess of revenue over expenses. Changes in unrestricted net assets, which are excluded from excess of revenue over expenses, consistent with industry practice, include net assets released from restrictions for the acquisition of long-lived assets, pension-related changes other than net periodic benefit cost, net assets transferred (to) from affiliates, contributions for capital, and other.

***Net Patient Service Revenue***

The Corporation recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, the Corporation recognizes revenue on the basis of its discounted rates, provided by policy. On the basis of historical experience, a significant portion of the Corporation's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Corporation records a significant provision for bad debts related to uninsured patients in the period the services are provided.

Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources as percentages, is as follows:

	2018	2017
Medicare	46 %	46 %
Medicaid	16	15
Blue Cross	20	20
Commercial and other	15	16
Total third party	97	97
Self-pay	3	3
Total	100 %	100 %

**Note 2 - Significant Accounting Policies (Continued)**

Retroactively calculated adjustments arising under reimbursement agreements with third-party payors are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Final determination of compliance of such laws and regulations is subject to future government review and interpretation. Violations may result in significant regulatory action, including fines, penalties, and exclusions from the Medicare and Medicaid programs. Management is not aware of any potential noncompliance with laws and regulations that they believe will be material to the consolidated financial statements.

***Contributions***

The Corporation reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statement of operations and the consolidated statement of changes in net assets as net assets released from restrictions.

The Corporation reports gifts of property and equipment as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Corporation reports the expiration of donor restrictions when the assets are placed in service.

***Premium Revenue***

Premiums and capitated premiums are recognized in the period members are entitled to healthcare services. Additional premium revenue received from the Michigan and Indiana Department of Medicaid for maternity cases is recognized in the period maternity services are provided. Premiums billed and collected in advance are recorded as unearned premiums. The majority of premiums are received from the Michigan and Indiana Departments of Medicaid.

***Premium Deficiency Reserve***

A reserve for premium deficiency and related expense is recognized when it is probable that expected future healthcare costs, under a group of existing contracts, will exceed future premiums and stop-loss coverage recoveries anticipated over the remaining term of the contract. The Corporation determines whether a premium deficiency reserve is necessary, including investment income as a factor in the premium deficiency calculation. At September 30, 2018 and 2017, the Corporation did not have a premium deficiency reserve.

***Healthcare Claims Expense***

The Corporation contracts with various healthcare providers for the provision of certain medical care related to its members. The Corporation compensates those providers on a variety of bases, including capitation, fixed fee for service, and discounted charges. Medical expenses include all amounts incurred by the Corporation under membership contracts with individual members and employer groups or with members assigned to the plan by the Medicaid programs in the states of Michigan and Indiana. Contracts with providers for medical services are executed between the providers and the Corporation's insurance affiliates.

Medical expenses represent expenses incurred under contracts with healthcare providers. Such costs are charged to expense in the month in which the service is rendered. These expenses include liabilities for incurred and reported claims and an estimate of incurred but not reported claims using past experience adjusted for current trends.

**Note 2 - Significant Accounting Policies (Continued)**

***Professional Liability Insurance***

Subsidiaries of the Corporation and qualifying medical staff are insured for professional liability on a claims-made basis by MICOL, a multiprovider, offshore captive insurance company that is wholly owned by the Corporation. The Corporation and its subsidiaries accrue an estimate of the ultimate expense, including litigation and settlement expense, for professional service liability claims occurring during the year, as well as for those claims that have not been reported at year end, which is based on estimates provided by an independent actuary (see Note 15). The expected amount of insurance recoveries is recorded as a receivable, net of allowance for uncollectible receivables, if applicable.

***Charity Care***

Subsidiaries of the Corporation provide care to patients who meet certain criteria under charity care policies without charge or at amounts less than established rates. Because the Corporation and its subsidiaries do not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue (see Note 5).

***Tax Status***

The Corporation and substantially all of its subsidiaries are nonprofit, tax-exempt organizations. Some subsidiaries are for-profit corporations. Income tax provisions are not material to the consolidated financial statements.

Management believes the Corporation is not subject to federal tax examinations for years prior to September 30, 2015.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

***Electronic Health Records Incentive Payments***

The American Recovery and Reinvestment Act of 2009 (AARA) established funding in order to provide incentive payments to hospitals and physicians that implement the use of electronic health record (EHR) technology by 2014. The Corporation has received incentive payments, which may continue for up to four years, provided the Corporation demonstrates meaningful use of certified EHR technology during the EHR reporting period. The revenue from the incentive payments is recognized ratably over the EHR reporting period when there is reasonable assurance that the Corporation will comply with eligibility requirements during the EHR reporting period and an incentive payment will be received. The amounts are recorded within other operating revenue, as the incentive payments are related to the Corporation's ongoing and central activities, yet not directly linked to the delivery of patient service. The Corporation recorded incentive payments totaling approximately \$5 million for the year ended September 30, 2017. The incentive payments received during 2017 were the result of meeting specific requirements related to its meaningful use of EHR technology.

***Recently Adopted Accounting Pronouncement***

In May 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-09, *Financial Services - Insurance (Topic 944): Disclosures about Short Duration Contracts*. This guidance expands the disclosures that an insurance entity must provide about its short-duration insurance contracts. It increases the transparency of significant estimates for unpaid claims and claim adjustment expenses. The new guidance was effective for the fiscal year ended September 30, 2018.

**Note 2 - Significant Accounting Policies (Continued)**

***Upcoming Accounting Pronouncements***

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which will supersede the current revenue recognition requirements in Topic 605, *Revenue Recognition*. The ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The new guidance will be effective for the Corporation's year ending September 30, 2019. The ASU permits application of the new revenue recognition guidance to be applied using one of two retrospective application methods. The Corporation has not yet determined which application method it will use. Management does not expect that this standard will have a significant impact on the timing and recognition pattern of the Corporation's main revenue streams. However, the Corporation has not completed its assessment of the standard on all its revenue streams.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*, which will supersede the current lease requirements in ASC 840. The ASU requires lessees to recognize a right-of-use asset and related lease liability for all leases, with a limited exception for short-term leases. Leases will be classified as either finance or operating, with the classification affecting the pattern of expense recognition in the statement of operations. Currently, leases are classified as either capital or operating, with only capital leases recognized on the balance sheet. The reporting of lease-related expenses in the statements of operations and cash flows will be generally consistent with the current guidance. The new lease guidance will be effective for the Corporation's year ending September 30, 2020 and will be applied using a modified retrospective transition method. The new lease standard is expected to have a significant effect on the Corporation's consolidated balance sheet as a result of the leases disclosed in Note 18, which are currently classified as operating leases. The effects on the results of operations are not expected to be significant, as recognition and measurement of expenses and cash flows for leases will be substantially the same under the new standard.

In August 2016, the FASB issued ASU No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. ASU No. 2016-14 requires significant changes to the financial reporting model of organizations that follow FASB not-for-profit rules, including changing from three classes of net assets to two classes: net assets with donor restrictions and net assets without donor restrictions. The ASU will also require changes in the way certain information is aggregated and reported by the Corporation, including required disclosures about the liquidity and availability of resources. The new standard is effective for the Corporation's year ending September 30, 2019 and thereafter, and must be applied on a retrospective basis. The standard is expected to have an impact on the presentation of net assets and to result in enhanced disclosures related to liquidity and availability.

In March 2017, the FASB issued ASU No. 2017-07, *Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This standard requires the presentation of the service cost component of net benefit cost to be in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. All other components of net benefit cost should be presented separately from the service cost component and outside of income from operations. The standard is effective for fiscal years beginning after September 30, 2019 and must be adopted retrospectively. Adoption of the new standard will reduce operating income and increase nonoperating income by approximately \$14,500,000 for 2018.

Notes to Consolidated Financial Statements

September 30, 2018 and 2017

**Note 2 - Significant Accounting Policies (Continued)**

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*, which primarily removes and modifies Level 3 fair value measurement disclosures. ASU No. 2018-13 is effective for fiscal years beginning after September 30, 2020. Early adoption is permitted for any removed or modified disclosures. Management does not expect the adoption of this ASU to have a significant impact on the Corporation's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-14, *Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans*, which removes, clarifies, and adds certain disclosure requirements for employers sponsoring defined benefit pension and other postretirement plans. ASU No. 2018-14 is effective for the Corporation for fiscal year ending September 30, 2022. Early adoption is permitted for all entities. Management does not expect the adoption of this ASU to have a significant impact on the Corporation's consolidated financial statements.

**Reclassification**

Certain 2017 amounts have been reclassified to conform to the 2018 presentation. On the consolidated balance sheet, healthcare insurance receivable has been reclassified to its own line from accounts receivable. In addition, medical claims payable has been reclassified to its own line item from accounts payable.

**Change in Accounting Method**

In 2018, the Corporation elected to change its method of accounting for Medicaid pass-through payments for MHP. The Corporation considers revenue and expenses from Medicaid related to the pass-through payments as net reimbursement and, therefore, records the expense as a reduction to premium revenue, whereas in prior years, the pass-through payments were reflected as an expense within purchased services and other. Comparative financial statements of prior years have been adjusted to apply the new method retrospectively.

The premium revenue and purchased services and other as shown within the consolidated statement of operations for fiscal year 2017 were reduced by approximately \$230,170,000.

**Subsequent Events**

The consolidated financial statements and related disclosures include evaluation of events up through and including January 8, 2019, which is the date the consolidated financial statements were available to be issued.

**Note 3 - Accounts Receivable**

The details of accounts receivable are set forth below (in thousands):

	2018	2017
Patient accounts receivable	\$ 1,293,390	\$ 1,250,624
Less:		
Allowance for uncollectible accounts	120,430	105,688
Allowance for contractual adjustments	915,047	941,459
Net patient accounts receivable	257,913	203,477
Other	20,077	16,158
Total accounts receivable	\$ 277,990	\$ 219,635

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 3 - Accounts Receivable (Continued)**

Subsidiaries of the Corporation grant credit without collateral to patients, most of whom are local residents and are insured under third-party payor agreements. The composition of receivables from patients and third-party payors was as follows:

	2018	2017
Medicare	33 %	32 %
Blue Cross/Blue Shield of Michigan	11	11
Medicaid	16	16
Commercial insurance and HMOs	30	31
Self-pay	10	10
Total	100 %	100 %

**Note 4 - Third-party Payor Settlements**

Medical centers of the Corporation have agreements with third-party payors that provide for reimbursement at amounts different from the subsidiaries' established rates. A summary of the basis of reimbursement with these third-party payors is as follows:

***Medicare***

Inpatient, acute care, psychiatric, and rehabilitation services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Outpatient, physician, and homecare services related to Medicare beneficiaries are reimbursed based on a prospectively determined amount per episode of care or on an established fee-for-service methodology.

***Medicaid***

Inpatient, acute-care services rendered to Medicaid program beneficiaries are also paid at prospectively determined rates per discharge. The Corporation is reimbursed for outpatient and physician services on an established fee-for-service methodology.

***Blue Cross/Blue Shield of Michigan***

Inpatient, acute care services are reimbursed at prospectively determined rates per discharge. Outpatient services are reimbursed on fee-for-service and percentage-of-charge bases.

***Health Maintenance Organizations***

Services rendered to HMO beneficiaries are paid at predetermined rates or at a percentage of hospital charges.

Third-party payor settlements result from the adjustment of interim payments to final reimbursement under the Medicare, Medicaid, and Blue Cross/Blue Shield of Michigan programs and are subject to audit by fiscal intermediaries. Although these audits may result in some changes in previously recorded amounts, they are not expected to have a material effect on the accompanying consolidated financial statements.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 5 - Community Benefit

The Corporation and its subsidiaries accept all patients regardless of their ability to pay. The Corporation has established a formal policy whereby a patient may qualify as a charity patient if certain criteria are met. These policies define charity services as those services for which no payment is anticipated. In assessing a patient's ability to pay, the Corporation utilizes multiples of the Federal Poverty Guideline consistent with industry practice, but also includes certain cases where incurred charges are significant compared to the patient's available resources. In addition to providing services to the financially disadvantaged, the medical centers participate in county, state, and federal programs designed for the indigent and elderly, whereby the medical centers may be reimbursed at less than the cost of providing those services, provide other community services at no or nominal cost, and subsidize graduate medical education in the community. The estimated cost of providing charity services is based on a calculation that applies a ratio of cost to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the Corporation's total expenses divided by gross patient service revenue. An estimate of charity and other uncompensated care for the medical centers is as follows (in thousands):

	2018	2017
Charity care cost	\$ 12,066	\$ 11,482
Cost in excess of reimbursement for county health plans (unaudited)	99	128
Cost in excess of reimbursement from government programs (unaudited)	194,079	195,238
Cost in excess of reimbursement for graduate medical education (unaudited)	22,519	20,952
Cost of community programs (unaudited)	19,419	18,481
Cost of bad debt	30,425	31,656
Total	<u>\$ 278,607</u>	<u>\$ 277,937</u>

### Note 6 - Property and Equipment

Property and equipment and depreciable lives are summarized as follows (in thousands):

	2018	2017	Depreciable Life - Years
Land	\$ 80,866	\$ 80,626	-
Land improvements	49,379	48,301	5-35
Buildings	1,050,646	995,847	20-40
Equipment	1,309,541	1,186,308	5-15
Construction in progress	337,321	294,848	-
Total cost	<u>2,827,753</u>	<u>2,605,930</u>	
Accumulated depreciation	<u>1,603,744</u>	<u>1,511,030</u>	
Net property and equipment	<u>\$ 1,224,009</u>	<u>\$ 1,094,900</u>	

Construction in progress consists primarily of a new patient care tower at Port Huron, an expansion of Northern, an outpatient cancer center at Karmanos, and various other new construction and renovation projects, and the implementation of information technology projects at the medical centers and MHC. At September 30, 2018, the Corporation had commitments of approximately \$67,340,000 related to various construction projects and financial and clinical information technology applications.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 7 - Other Assets

The detail of other assets is summarized in the following schedule (in thousands):

	2018	2017
Assets limited as to use and permanently or temporarily restricted assets:		
Funds held by trustees under bond indentures	\$ 42,896	\$ 102,059
Funds held in trust for payment of professional and other liability claims (Note 15)	89,639	89,115
Funds held in trust for the benefit of MHC and funds restricted by donors for specific purpose	126,603	123,598
Funds held in trust for payment of employee benefits	38,967	32,256
Amount for payment of current liabilities	<u>(1,807)</u>	<u>(1,569)</u>
Total assets limited as to use and permanently or temporarily restricted assets	296,298	345,459
Investment in joint ventures	18,640	19,401
Intangible assets	120,116	16,246
Goodwill	49,671	23,231
Pledges receivable - Net	19,670	15,931
Other	<u>46,305</u>	<u>34,466</u>
Total other assets	<u>\$ 550,700</u>	<u>\$ 454,734</u>

Investments, included within other assets above and investments, including internally designated amounts on the consolidated balance sheet, consist of the following (in thousands):

	2018	2017
Money market investments	\$ 69,784	\$ 120,320
Certificates of deposit and cash equivalents	20,343	26,825
Government securities	53,467	30,312
Mortgage-backed securities	5,983	215
Mutual funds	988,585	931,295
Corporate bonds	61,084	39,367
Common and preferred stocks	195,892	176,502
Due from trusts (Note 13)	42,811	42,206
Other investments	<u>1,268</u>	<u>2,038</u>
Total	<u>\$ 1,439,217</u>	<u>\$ 1,369,080</u>

Funds held by the trustee under bond indenture are held for the purpose of making future bond principal and interest payments and payments for certain construction projects. Investment income accrues to the funds as earned.

Investment income and gains and losses are composed of the following for the years ended September 30, 2018 and 2017 (in thousands):

	2018	2017
Unrestricted investment income	\$ 40,276	\$ 49,015
Investment income on temporarily and permanently restricted investments	1,613	2,598
Change in net unrealized gains and losses on unrestricted investments	34,841	77,001
Change in net unrealized gains and losses on restricted investments	<u>699</u>	<u>1,617</u>
Total investment income	<u>\$ 77,429</u>	<u>\$ 130,231</u>

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 7 - Other Assets (Continued)**

The Corporation participates in the JPMorgan Chase Bank, N.A. Security Lending Program for its U.S. and non-U.S. securities held in custody at JPMorgan Chase Bank, N.A. (JPMorgan Chase). These securities are loaned to certain unrelated third-party brokers in exchange for collateral, usually in the form of cash. Both the collateral and the securities loaned are marked-to-market on a daily basis so that all loaned securities are more than fully collateralized at all times. Collateral received is invested in a segregated account managed by JPMorgan Chase, which consists of high-quality short-term investments. In the event that the loaned securities are not returned by the borrower, JPMorgan Chase will, at its own expense, either replace the loaned securities or, if unable to purchase those securities on the open market, credit the Corporation's accounts with cash equal to the fair value of the loaned securities.

The Corporation receives 40 percent of any residual income earned on the securities held as collateral. JPMorgan Chase receives the remainder of the income.

Although the Corporation's securities lending activities are collateralized as described above, and although the terms of the securities lending agreement with JPMorgan Chase require JPMorgan Chase to comply with government rules and regulations related to the lending of securities held by the Corporation, the securities lending program involves both market and credit risk. In this context, market risk refers to the possibility that the borrower of securities will be unable to collateralize its loan upon a sudden material change in the fair value of the loaned securities or the collateral, or that JPMorgan Chase's investment of collateral received from the borrowers of the Corporation's securities may be subject to unfavorable market fluctuations. Credit risk refers to the possibility that counterparties involved in the securities lending program may fail to perform in accordance with the terms of their contracts.

At September 30, 2018 and 2017, the fair value of securities loaned in the portfolio was approximately \$2,257,000 and \$6,958,000, respectively, while the collateral held was approximately \$2,208,000 and \$6,784,000, respectively. Collateral received consists of cash and fixed-income securities. The value of the collateral held and a corresponding liability to return the collateral have been reported on the accompanying consolidated balance sheet.

On January 1, 2018, the Corporation purchased MDwise for approximately \$253 million, of which \$169 million represents the purchase price and the remainder was used to fund capital requirements and remained within the Corporation (Note 18). As part of that transaction, the Corporation recorded \$110 million of intangible assets for plan member relationships, state contracts, trade names, and provider networks that will be amortized at various rates between 7 and 20 years. In addition, the Corporation recognized approximately \$26 million of goodwill, which is considered to have an indefinite useful life and, therefore, is not being amortized but is tested for impairment on an annual basis.

The Corporation has recognized intangible assets of approximately \$120,116,000 and \$16,246,000 at September 30, 2018 and 2017, respectively. The Corporation has recorded approximately \$116,866,000 and \$12,996,000 of net intangible assets for plan members, state contracts, trade names and provider networks that is being amortized over 7 to 20 years at September 30, 2018 and 2017, respectively. In addition, the Corporation recognized intangible assets related to Medicare Advantage contracts of approximately \$3,250,000 at September 30, 2018 and 2017. These assets are considered to have an indefinite useful life and, therefore, are not being amortized but are tested for impairment on an annual basis.

**Notes to Consolidated Financial Statements**

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**September 30, 2018 and 2017**

**Note 8 - Fair Value Measurements**

Accounting standards require certain assets and liabilities be reported at fair value in the financial statements and provide a framework for establishing that fair value. The framework for determining fair value is based on a hierarchy that prioritizes the inputs and valuation techniques used to measure fair value.

The following tables present information about the Corporation's assets and liabilities measured at fair value on a recurring basis at September 30, 2018 and 2017 and the valuation techniques used by the Corporation to determine those fair values.

Fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets and other inputs, such as interest rates and yield curves, that are observable at commonly quoted intervals.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability. These Level 3 fair value measurements are based primarily on management's own estimates using pricing models, discounted cash flow methodologies, or similar techniques taking into account the characteristics of the asset or liability.

In instances whereby inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

The Corporation's policy is to recognize transfers between levels of the fair value hierarchy as of the actual date of the event of change in circumstances that caused the transfer. There were no significant transfers between levels of the fair value hierarchy during 2018 and 2017.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 8 - Fair Value Measurements (Continued)

	Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2018 (in thousands)			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2018
<b>Assets</b>				
Mutual funds:				
Fixed-income investments	\$ 177,321	\$ 22,548	\$ -	\$ 199,869
Equity investments	730,320	44,606	-	774,926
Balanced investments	13,757	-	-	13,757
Short-term investments	33	-	-	33
Total mutual funds	921,431	67,154	-	988,585
Common stocks:				
U.S. securities	153,956	27	-	153,983
Foreign securities	41,909	-	-	41,909
Total common stocks	195,865	27	-	195,892
Debt securities:				
U.S. government and agencies	789	52,678	-	53,467
Corporate bonds and notes	-	61,084	-	61,084
Residential mortgage-backed securities	-	1,534	-	1,534
Foreign government and agencies	-	4,449	-	4,449
Total debt securities	789	119,745	-	120,534
Money market investments:				
Short-term investments	57,972	4,538	-	62,510
Fixed-income investments	343	-	-	343
Equity investments	6,931	-	-	6,931
Total money market investments	65,246	4,538	-	69,784
Other				
Collateral on securities lending arrangements	1,268	-	-	1,268
Due from trusts	-	2,208	-	2,208
	-	42,811	-	42,811
Total assets	\$ 1,184,599	\$ 236,483	\$ -	\$ 1,421,082
<b>Liabilities</b>				
Obligations on secured lending arrangements	\$ -	\$ 2,257	\$ -	\$ 2,257
Interest rate swap agreements	-	5,973	-	5,973
Total liabilities	\$ -	\$ 8,230	\$ -	\$ 8,230

# McLaren Health Care Corporation and Subsidiaries

## Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 8 - Fair Value Measurements (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2017 (in thousands)				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2017
<b>Assets</b>				
Mutual funds:				
Fixed-income investments	\$ 109,759	\$ 22,820	\$ -	\$ 132,579
Equity investments	742,795	46,100	-	788,895
Balanced investments	4,297	-	-	4,297
Short-term investments	5,524	-	-	5,524
Total mutual funds	862,375	68,920	-	931,295
Common and preferred stocks:				
U.S. securities	138,144	1	-	138,145
Foreign securities	38,321	9	-	38,330
Short-term investments	-	27	-	27
Total common and preferred stocks	176,465	37	-	176,502
Debt securities:				
U.S. government and agencies	1,001	29,061	-	30,062
Corporate bonds and notes	-	39,367	-	39,367
Residential mortgage-backed securities	-	215	-	215
Foreign government and agencies	-	250	-	250
Total debt securities	1,001	68,893	-	69,894
Money market investments:				
Short-term investments	114,403	4,320	-	118,723
Fixed-income investments	315	-	-	315
Equity investments	1,282	-	-	1,282
Total money market investments	116,000	4,320	-	120,320
Other	2,038	-	-	2,038
Collateral on securities lending arrangements	-	6,784	-	6,784
Due from trusts	-	42,206	-	42,206
Total assets	\$ 1,157,879	\$ 191,160	\$ -	\$ 1,349,039
<b>Liabilities</b>				
Obligations on secured lending arrangements	\$ -	\$ 6,958	\$ -	\$ 6,958
Interest rate swap agreements	-	22,005	-	22,005
Total liabilities	\$ -	\$ 28,963	\$ -	\$ 28,963

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 8 - Fair Value Measurements (Continued)**

Collateral from securities lending, assets whose use is limited or restricted, and investments on the consolidated balance sheet, as further discussed in Note 7, at September 30, 2018 and 2017 included cash and certificates of deposit of approximately \$20,343,000 and \$26,825,000, respectively.

The Corporation holds fixed-income and equity mutual funds, common stocks, debt securities, money market investments, securities lending, due from trusts, and interest rate swap agreements at September 30, 2018 and 2017 in which the fair value was based on Level 2 inputs. The Corporation estimates the fair value of these investments using quoted prices for similar assets in active markets. The fair value of the assets was determined primarily based on quoted market prices from the investment custodians. The Level 2 inputs used in estimating the fair value of the swap agreements include the notional amount, effective interest rate, and maturity date.

**Note 9 - Medical Claims Payable**

MHP and MDwise (collectively, the "insurance companies") contract with various healthcare providers for the provision of certain medical care related to their members. The insurance companies compensate those providers on a variety of bases, including capitation, fixed fee for service, and discounted charges. Medical expenses include all amounts incurred by the insurance companies under membership contracts with individual members and employer groups. Contracts with providers for medical services are executed between the providers and the insurance companies.

Cost of medical claims represents expenses incurred under contracts with healthcare providers; such costs are charged to expense in the month in which the service is rendered. These expenses include liabilities for incurred and reported claims, and an estimate of incurred but not reported claims using past experience adjusted for current trends.

Activity in medical claims payable expense for the years ended September 30, 2018 and 2017 is summarized as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Balance - Beginning of year	\$ 82,416	\$ 69,833
Incurred related to:		
Current year	1,305,386	662,457
Prior years	<u>(8,227)</u>	<u>(6,829)</u>
Total incurred	1,297,159	655,628
Paid related to:		
Current year	(1,131,961)	(580,041)
Prior years	<u>(173,108)</u>	<u>(63,004)</u>
Total paid	(1,305,069)	(643,045)
Purchased through acquisitions	<u>102,624</u>	<u>-</u>
Balance - End of year	<u>\$ 177,130</u>	<u>\$ 82,416</u>

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 9 - Medical Claims Payable (Continued)**

The insurance companies estimate the amount of the accrued claims liability costs IBNR in accordance with generally accepted accounting principles and using standard actuarial developmental methodologies based upon historical data, including the period between the date services are rendered and the date claims are received and paid, denied claim activity, expected medical cost inflation, seasonality patterns, and changes in membership, among other things. The insurance companies' IBNR best estimate also includes a provision for adverse deviation, which is an estimate for known environmental factors that are reasonably likely to affect the required level of IBNR reserves. This provision for adverse deviation is intended to capture the potential adverse development from factors, such as changes in current payment patterns versus historical payment patterns, potential unknown high cost cases, increased usage of higher cost services, accelerated utilization of services, and/or exceptional situations that require judgmental adjustments in setting the reserves for claims.

The following presents information about incurred and paid claims development as of September 30, 2018, net of reinsurance, as well as IBNR and cumulative reported claims by loss year for MHP and MDwise. The information relates to incurred and paid claims development and is presented as supplemental information.

Incident Year	Incurred Claims and Claims Adjustment Expenses, Net of Reinsurance for the Years Ended September 30 (in thousands)			As of September 30, 2018	
	2016	2017	2018	Total IBNR and Bulk Reserves (in thousands)	Cumulative Number of Reported Claims
2016	\$ 630,394	\$ 623,565	\$ 623,565	\$ -	\$ 2,723
2017	-	662,457	659,498	3,706	2,847
2018	-	-	1,305,384	173,424	4,900
<b>Total</b>	<b>\$ 630,394</b>	<b>\$ 1,286,022</b>	<b>\$ 2,588,447</b>	<b>\$ 177,130</b>	<b>\$ 10,470</b>

Incident Year	Cumulative Paid Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance, for the Years Ended September 30 (in thousands)		
	2016	2017	2018
2016	\$ 560,156	\$ 623,156	\$ 623,565
2017	-	580,041	655,792
2018	-	-	1,131,960
<b>Total</b>	<b>\$ 560,156</b>	<b>\$ 1,203,197</b>	<b>\$ 2,411,317</b>

The total liability for medical claims and medical claim adjustment expense, net of reinsurance, is \$177,130 at September 30, 2018.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 10 - Long-term Debt

The following is the detail of long-term debt (in thousands):

	2018	2017
McLaren Health Care Series 2018A	\$ 300,000	\$ -
McLaren Health Care Series 2016A	154,140	154,140
McLaren Health Care Series 2015A	93,895	96,700
McLaren Health Care Series 2015B	65,605	66,430
McLaren Health Care Series 2015C	87,258	90,190
McLaren Health Care Series 2015D-1	72,497	74,880
McLaren Health Care Series 2015D-2	75,420	75,420
McLaren Health Care Series 2014A	21,539	25,161
McLaren Health Care Series 2012A	71,375	77,750
McLaren Health Care Series 2010	67,125	67,125
Promissory and other notes payable	35,826	29,252
Unamortized premium	21,461	23,780
Less bond issuance cost	(6,304)	(3,845)
	<u>1,059,837</u>	<u>776,983</u>
Long-term debt and unamortized discount/premium less debt issuance costs		
	1,059,837	776,983
Less current portion	23,500	32,455
	<u>1,036,337</u>	<u>744,528</u>
Long-term portion		
	<u>\$ 1,036,337</u>	<u>\$ 744,528</u>

The McLaren Health Care Series bonds are issued through MHC as credit group agent, on behalf of the credit group, which consists of the following medical centers: Bay, Flint, Karmanos Cancer Institute, Karmanos Cancer Center, Lansing, Oakland, Lapeer, Macomb, Northern, Central, and Port Huron (the "Credit Group"), along with the following foundations: McLaren Foundation, McLaren Macomb Healthcare Foundation, and McLaren Lapeer Region Foundation. As credit group agent, MHC has the power to cause any member of the Credit Group to make required principal and interest payments on the bonds issued by the Credit Group.

During 2018, the Corporation issued Taxable Bonds, Series 2018A totaling \$300,000,000. The bonds have a balloon payment of \$300,000,000 in 2048 with interest at 4.386 percent. The bonds are secured by the gross revenue of the Credit Group. The proceeds of the bonds were used to fund the acquisition of MDwise and to finance general corporate purposes of the Corporation and certain of its affiliates. The Series 2018 bonds are secured by the gross revenue of the Credit Group.

During 2016, the Michigan Finance Authority issued Hospital Revenue Bonds, Series 2016 totaling \$154,140,000. The term bonds have annual redemption requirements ranging from \$17,945,000 to \$24,735,000 beginning in 2040 through 2046 with interest at 4.40 percent. The series 2016 bonds are secured by the gross revenue of the Credit Group.

During 2015, the Michigan Finance Authority issued Hospital Revenue Refunding Bonds, Series 2015A, 2015B, 2015C, 2015D-1, and 2015D-2, as described below. The proceeds of the bonds were used to refund the following outstanding bonds: Michigan Finance Authority Revenue and Refunding Bonds McLaren Health Care Series 2005C, 2008A, and 2008B. The Series 2015 bonds are secured by the gross revenue of the Credit Group.

In May 2015, the Michigan Finance Authority issued Hospital Revenue Refunding Bonds, Series 2015A, totaling \$101,995,000. The 2015A bonds consist of serial bonds with interest ranging from 4 percent to 5 percent and annual maturities ranging from \$2,935,000 to \$6,125,000 through May 15, 2035 and a term bond in the amount of \$19,960,000, with interest at 5 percent and annual redemption requirements ranging from \$6,370,000 to \$6,940,000 through May 15, 2038.

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 10 - Long-term Debt (Continued)**

In March 2015, the Michigan Finance Authority issued Hospital Revenue Refunding Bonds, Series 2015B, totaling \$67,950,000. The 2015B bonds consist of serial bonds with interest ranging from 3 percent to 5 percent and annual maturities ranging from \$855,000 to \$14,095,000, through May 15, 2035.

In March 2015, Bank of New York Mellon issued McLaren Health Care Taxable Bonds, Series 2015C. The 2015C bonds consist of serial bonds with interest ranging from 2.39 percent to 4.23 percent and annual maturities ranging from \$3,150,000 in 2019 to \$4,805,000 in 2032 and a term bond in the amount of \$41,495,000, due on May 15, 2038, with interest at 4.534 percent. The bonds also have mandatory sinking fund payments ranging from \$4,070,000 in 2028 to \$6,085,000 in 2038.

In May 2015, the Michigan Finance Authority issued Hospital Revenue Refunding Bonds, Series 2015D-1 and D-2 (collectively, the "2015D bonds"), totaling \$154,160,000. The 2015D bonds consist of floating rate notes that bear interest at a floating rate that varies on a weekly basis, based on the one-month LIBOR. The bonds are secured by the gross revenue of the Credit Group. The 2015D-1 bonds have mandatory sinking fund payments ranging from \$2,410,000 in October 2018 to \$12,765,000 in 2030. The 2015D-2 bonds also have mandatory sinking fund payments ranging from \$2,915,000 in 2035 to \$20,295,000 in 2039. The 2015D-1 bonds were subject to a mandatory purchase date and were successfully repurchased during 2018. The 2015D-1 and 2015D-2 bonds shall be subject to a mandatory purchase date on October 15, 2021 and October 15, 2020, respectively. The Credit Group has entered into a remarketing agreement that requires the remarketing agent to utilize best efforts to offer for sale all of the 2015D bonds required to be purchased beginning on the mandatory purchase date. In the event the bonds cannot be remarketed, the Credit Group will be responsible for repurchasing the bonds.

In September 2014, the Michigan Finance Authority issued the Hospital Revenue Refunding Bonds, Series 2014A. The bonds bear interest at 1.99 percent with annual principal of \$3,622,000 through 2024.

In June 2012, the Michigan Finance Authority issued the Hospital Revenue Refunding Bonds, Series 2012A. The 2012A bonds consist of serial bonds with interest at 5.0 percent and annual maturities ranging from \$6,695,000 to \$7,385,000 through June 1, 2028, and term bonds in the amount of \$10,285,000 and \$660,000. The term bonds have annual redemption requirements ranging from \$100,000 to \$2,655,000, due on June 1, 2035, with interest at 5.0 percent and 4.0 percent, respectively. The bonds are secured by the gross revenue of the Credit Group.

McLaren Health Care Series 2010 bonds consist of revenue bonds issued by the Michigan Finance Authority on behalf of the Credit Group. The bonds are secured by the gross revenue of the Credit Group and are payable in annual installments beginning on December 1, 2021 of \$3,356,250, plus interest. The remaining outstanding principal is due on December 1, 2040. The bonds bear interest at 3.25 percent per annum until the initial optional tender date on December 1, 2020.

Under the terms of the revenue bond indentures, the revenue bonds are subject to certain financial covenants calculated on a quarterly basis. As of September 30, 2018, management believes that the Corporation was in compliance with financial covenants.

Karmanos has various promissory notes that are due to a financial institution, of which a portion of the promissory notes is guaranteed by various donors. Donors have committed to support and guarantee various components of donor-collateralized debt. These pledges are reflected as other assets in the consolidated balance sheet and follow the maturity schedules of the debt instruments. At September 30, 2018, interest was payable quarterly at an interest rate of 0.95 percent over the LIBOR-based rate, for an effective rate of 3.05. At September 30, 2017, interest was payable quarterly at an interest rate of 3.00 percent over the LIBOR-based rate, for an effective rate of 3.52 percent. The promissory notes mature in July 2023.

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 10 - Long-term Debt (Continued)**

Scheduled minimum principal payments on long-term debt to maturity as of September 30, 2018 are as follows (in thousands):

<u>Years Ending</u>	<u>Amount</u>
2019	\$ 23,500
2020	37,413
2021	22,129
2022	23,356
2023	28,844
Thereafter	909,438
Bond issue costs	(6,304)
Unamortized premium	21,461
Total	<u>\$ 1,059,837</u>

***Derivatives***

The derivative instruments used by the Corporation are interest rate swap agreements that are used to manage variability in interest rates.

***(a) Objectives and Strategies***

The Corporation's objectives with respect to its use of derivative instruments include managing the risk of increased debt service resulting from rising market interest rates, the risk of decreased surplus returns resulting from falling interest rates, and the management of the risk of an increase in the fair value of outstanding fixed rate obligations resulting from declining market interest rates.

Debt obligations expose the Corporation to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of a portion of its interest payments. To meet this objective, management enters into interest rate swap agreements to manage fluctuations resulting from interest rate risk.

By using derivative financial instruments to hedge exposure to changes in interest rates, the Corporation exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Corporation, which creates credit risk for the Corporation. When the fair value of a derivative contract is negative, the Corporation owes the counterparty and, therefore, it does not pose credit risk. The Corporation minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties.

Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate contracts is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

***(b) Risk Management Policies***

The Corporation assesses interest rate risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected future cash flows and by evaluating hedging opportunities. The Corporation maintains risk management control systems to monitor interest rate risk attributable to both the Corporation's outstanding or forecasted debt obligations, as well as the Corporation's offsetting hedge positions. The risk management control system involves the use of analytical techniques, including cash flow sensitivity analysis, to estimate the expected impact of changes in interest rates on the Corporation's future cash flows.

The Corporation does not use derivative instruments for speculative investment purposes.

**Note 10 - Long-term Debt (Continued)**

**(c) Transactions**

MHC has entered into five interest rate swap agreements to manage the overall variability in interest rates.

Under the terms of the ISDA master agreement, the Corporation is required to maintain collateral posted within the counterparty to secure a portion of the estimated value of the derivative instruments when said instruments are valued in favor of the counterparty, as periodically determined by the counterparty. The Corporation was not required to post collateral at September 30, 2018 or 2017. The Corporation's accounting policy is to not offset collateral amounts against fair value amounts recognized for derivative instrument obligations. Accordingly, any posted collateral would be included in cash and cash equivalents in the accompanying consolidated balance sheet.

The first swap agreement is for a notional amount of \$225,000,000. Under the terms of the agreement, MHC pays the counterparty a rate equal to the USD-SIFMA Municipal Swap Index rate and receives in exchange 61.3 percent of LIBOR plus 0.776 percent.

The second swap agreement is for a notional amount of \$70,020,000 and \$72,900,000 at September 30, 2018 and 2017, respectively. Under the terms of the agreement, MHC pays the counterparty a fixed rate of 3.355 percent and receives in exchange 65 percent of LIBOR plus 0.12 percent.

The third swap agreement is for a notional amount of \$75,000,000. Under the terms of the agreement, MHC pays the counterparty a fixed rate of 3.64 percent and receives in exchange 65 percent of LIBOR plus 0.12 percent.

The fourth swap agreement is for a notional amount of \$154,140,000. Under the terms of the agreement, MHC pays the counterparty a fixed rate of 1.996 percent and receives in exchange the USD SIFMA Municipal Swap Index rate through August 15, 2021. MHC will receive 68 percent of LIBOR beginning on September 15, 2021.

The fifth swap agreement is for a notional amount of \$154,140,000. Under the terms of the agreement, MHC pays the counterparty a variable rate of the USD SIFMA Municipal Swap Index plus 0.55 percent and receives in exchange a fixed rate of 4.40 percent.

During 2018, as part of the preparation for the 2018A bond issue, the Corporation entered into an interest rate swap agreement to protect itself from rising interest rates during the bond issuance period. Interest rates subsequently declined to a rate lower than the swap agreement. The Corporation terminated the swap and paid a fee of approximately \$16 million to take advantage of the lower interest rates.

These swap agreements are recorded on the consolidated balance sheet at their fair value. Changes in the fair value of the swap agreements are reported as a component of excess of revenue over expenses, as well as any settlements on the interest rate swaps. There were no settlements in 2018 or 2017, other than the swap termination described in the preceding paragraph.

The Corporation's interest rate swap liability was approximately \$5,973,000 and \$22,005,000 at September 30, 2018 and 2017, respectively. The amount of (loss) gain recognized in the consolidated statement of operations attributable to derivative instruments as changes in fair market value of interest rate swap agreements was approximately \$(315,000) and \$15,512,000 for the years ended September 30, 2018 and 2017, respectively.

**Note 11 - Notes Payable**

MHC negotiated, on behalf of the Corporation, a revolving line of credit agreement, secured by the gross revenue of the Credit Group, with a bank in the amount of \$250,000,000. The line of credit agreement expires on May 31, 2019.

There was no outstanding balance on the line of credit as of September 30, 2018 and 2017.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 12 - Accrued and Other Liabilities

The following is the detail of accrued liabilities (in thousands):

	2018	2017
Payroll and related items	\$ 91,104	\$ 85,139
Compensated absences	57,509	54,599
Professional liability claims - Current portion (Note 15)	5,152	6,821
Interest	8,964	6,821
Obligations under securities lending (Note 7)	2,257	6,958
Amounts due to others	9,978	10,614
Insurance payable due to providers	171,884	-
Other	53,292	28,978
Total accrued liabilities	<u>\$ 400,140</u>	<u>\$ 199,930</u>

Other accrued liabilities consist of various amounts owed by the Corporation, including certain liabilities for MDwise relating to escrow balances and amounts due to providers and networks for funds related to capitation receipts.

### Note 13 - Due from Trusts

McLaren Foundation is the sole beneficiary of the income from the Minnie I. Ballenger Trust and the William S. Ballenger Trust (collectively, the "Trusts"). The amount due from the Trusts (see Note 7) represents the fair value of the assets held in the Trusts. Since McLaren Foundation receives only the net interest and dividend income of the Trusts, this income is recorded as an increase in unrestricted net assets. Changes in the fair value of the investments in the Trusts are recorded as changes in permanently restricted net assets by McLaren Foundation.

The amounts receivable, representing the fair value of the trust assets, are as follows (in thousands):

	2018	2017
Minnie I. Ballenger Trust	\$ 41,784	\$ 41,192
William S. Ballenger Trust	1,027	1,014
Total	<u>\$ 42,811</u>	<u>\$ 42,206</u>

### Note 14 - Pension and Other Postretirement Benefit Obligation

MHC, Flint, MHP, MHG, MMG, Bay, Lansing, Lapeer, Macomb, Oakland, Port Huron, and Northern participate in a single defined benefit pension plan. The Corporation intends to annually contribute amounts deemed necessary, if any, to maintain the plans on a sound actuarial basis.

The defined benefit pension plans have taken steps to freeze accrual of future benefits or participation in the plans by new hires. Essentially all the defined benefit plans have been frozen for future benefit accruals.

Substantially all employees of the Corporation also participate in defined contribution pension plans that provide benefits to eligible participants as determined according to the provisions of the plan agreements.

Notes to Consolidated Financial Statements

September 30, 2018 and 2017

**Note 14 - Pension and Other Postretirement Benefit Obligation (Continued)**

MHC, Flint, Lansing, Macomb, and Bay also sponsor defined benefit postretirement plans that provide postretirement medical benefits summarized as follows:

**MHC and Flint**

The plan includes substantially all employees who have a minimum of 10 years of service after the age of 45. Employees who elect for early retirement can purchase benefits at the group rate through the plan. MHC and Flint currently fund the cost of these benefits as they are incurred. The retiree healthcare plan requires participant contributions and deductibles.

**Lansing**

The plan allows retirees to purchase health insurance coverage at group rates through Lansing. Individuals who retired before December 31, 1993 also receive a maximum monthly contribution for the purchase of health insurance coverage. Individuals who retire after January 1, 1994 and have attained the age of 65 do not receive postretirement medical benefits under this plan. Lansing does not prefund the plan and has the right to modify or terminate the plan in the future.

**Bay**

The plan provides certain health care and prescription drugs for employees who retired prior to October 1994. Bay funds the cost of these benefits as they are incurred. Benefits have been frozen for certain employee groups under this plan. As a result of collective bargaining during 2018, certain employees are no longer eligible for coverage upon retirement.

**Macomb**

The plan provides medical savings account plan benefits to substantially all employees who are subject to certain collective bargaining unit agreements.

**Obligations and Funded Status (in thousands)**

	Pension Benefits		Other Postretirement Benefits	
	2018	2017	2018	2017
Change in benefit obligation:				
Benefit obligation at beginning of year	\$ 1,317,903	\$ 1,379,827	\$ 14,622	\$ 24,803
Service cost	2,067	2,183	192	330
Interest cost	51,455	51,295	565	916
Plan participants' contributions	-	-	327	419
Amendments	-	-	(818)	-
Actuarial gain	(92,577)	(41,648)	(3,383)	(10,675)
Benefits and expenses	(94,238)	(73,754)	(944)	(1,171)
Benefit obligation at end of year	1,184,610	1,317,903	10,561	14,622
Change in plan assets:				
Fair value of plan assets at beginning of year	1,098,058	1,026,838	-	-
Actual return on plan assets	60,481	115,417	-	-
Employer contributions	30,075	29,557	617	752
Plan participants' contributions	-	-	327	419
Benefits paid	(94,238)	(73,754)	(944)	(1,171)
Fair value of plan assets at end of year	1,094,376	1,098,058	-	-
Funded status and accrued benefit obligation at end of year	\$ (90,234)	\$ (219,845)	\$ (10,561)	\$ (14,622)

Notes to Consolidated Financial Statements

September 30, 2018 and 2017

**Note 14 - Pension and Other Postretirement Benefit Obligation (Continued)**

The accumulated benefit obligation for all defined benefit pension plans was approximately \$1,180,839,000 and \$1,314,471,000 at September 30, 2018 and 2017, respectively.

Components of net periodic benefit cost (benefit) and other changes in plan assets and benefit obligations are as follows (in thousands):

	Pension Benefits		Other Postretirement Benefits	
	2018	2017	2018	2017
<b>Net Periodic Benefit Cost</b>				
Service cost	\$ 2,067	\$ 2,183	\$ 192	\$ 330
Interest cost	51,455	51,295	565	916
Expected return on plan assets	(79,240)	(80,076)	-	-
Amortization of prior service cost (credits)	15,384	16,145	(3,235)	(2,865)
Total net periodic benefit cost	<u>\$ (10,334)</u>	<u>\$ (10,453)</u>	<u>\$ (2,478)</u>	<u>\$ (1,619)</u>
<b>Other Changes in Plan Assets and Benefit Obligations</b>				
Net loss (gain)	\$ 468,479	\$ 557,728	\$ (15,600)	\$ (13,509)
Amortization of transition asset	(1)	(2)	-	-
Prior service credit	-	(47)	(10,659)	(11,808)
Total other changes in plan assets and benefit obligations	<u>\$ 468,478</u>	<u>\$ 557,679</u>	<u>\$ (26,259)</u>	<u>\$ (25,317)</u>

Weighted-average assumptions used to determine benefit obligations at September 30 are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2018	2017	2018	2017
Discount rate	4.50%	4.00%	4.00%	4.00%

Weighted-average assumptions used to determine net periodic benefit cost for the years ended September 30 are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2018	2017	2018	2017
Discount rate	4.00%	3.80%	4.00%	4.00%
Expected long-term return on plan assets	7.25%	7.25%	-	-

The actuarial assumption for rate of compensation increase is age graded for the benefit obligation and net periodic benefit cost at September 30, 2018 and 2017.

The overall expected rate of return on plan assets represents a weighted-average composite rate based on the historical rates of returns of the respective asset classes. Adjustments to historical returns have been made to reflect anticipated market movements. The determination is influenced by the asset allocation, as well as the Corporation's investment policy. The Corporation's investment strategy is of a long-term nature and is intended to ensure that funds are available to pay benefits as they become due and to maximize the trust's total return at an appropriate level of investment risk.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 14 - Pension and Other Postretirement Benefit Obligation (Continued)

#### Pension Plan Assets

The goals of the pension plan investment program are to fully fund the obligation to pay retirement benefits in accordance with the plan documents and to provide returns that, along with appropriate funding from the Corporation, maintain an asset/liability ratio that is in compliance with all applicable laws and regulations and assures timely payment of retirement benefits.

The target allocation asset categories are 60 percent global equity, 30 percent global fixed income, 5 percent real assets, and 5 percent diversifying strategies.

The fair values of the Corporation's pension plan assets by major asset classes are as follows (in thousands):

Asset Classes	Fair Value Measurements at September 30, 2018			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Mutual funds:				
Equity investments	\$ 695,433	\$ 34,817	\$ -	\$ 730,250
Fixed-income investments	117,003	78,331	-	195,334
Equity investments:				
Common stock	156,735	-	-	156,735
Foreign	2,539	-	-	2,539
Other:				
Money market fund	-	9,107	-	9,107
Fund of funds	411	-	-	411
<b>Total</b>	<b>\$ 972,121</b>	<b>\$ 122,255</b>	<b>\$ -</b>	<b>\$ 1,094,376</b>

Asset Classes	Fair Value Measurements at September 30, 2017			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Mutual funds:				
Equity investments	\$ 545,627	\$ 141,604	\$ -	\$ 687,231
Fixed-income investments	124,394	83,479	-	207,873
Equity investments:				
Common stock	187,711	-	-	187,711
Foreign	3,469	-	-	3,469
Other:				
Money market fund	-	11,217	-	11,217
Fund of funds	557	-	-	557
<b>Total</b>	<b>\$ 861,758</b>	<b>\$ 236,300</b>	<b>\$ -</b>	<b>\$ 1,098,058</b>

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets in active markets and other inputs, such as interest rates and yield curves, that are observable at commonly quoted intervals.

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 14 - Pension and Other Postretirement Benefit Obligation (Continued)**

The Corporation's policy is to recognize transfers between levels of the fair value hierarchy as of the actual date of the event of change in circumstances that caused the transfer. There were no significant transfers between levels of the fair value hierarchy during 2018 and 2017.

**Cash Flow**

**Contributions**

The Corporation expects to contribute approximately \$29,850,000 to its pension plan and approximately \$843,000 to its other postretirement benefit plan in 2019.

**Estimated Future Benefit Payments**

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands):

Year	Pension Benefits	Postretirement Benefits
2019	\$ 62,386	\$ 843
2020	64,777	861
2021	67,120	804
2022	68,366	792
2023	69,771	778
Thereafter	400,576	3,706

**Note 15 - Professional Liability Insurance**

The Corporation, with the exception of Thumb, has professional malpractice liability coverage provided by a multiprovider offshore captive insurance company (MICOL) on a retrospectively rated claims-made policy.

MICOL has agreements with various reinsurers. MICOL has coverage of \$5 million per claim in excess of \$30 million.

The Corporation records an estimate of the present value of the ultimate settlement cost of settling and defending professional liability claims based on projections from a consulting actuary. The estimate of losses is based on the covered entities' own past experience along with industry experience. This estimate includes a reserve for known claims and unreported incidents. A discount rate of 4 percent was used in determining the present value of the claims. Claims expected to be settled within one year and the related assets are recorded as a current liability and current asset, respectively, in the accompanying consolidated balance sheet.

The detail of accrued professional liability for the self-insurance plans and the MICOL claims is as follows (in thousands):

	2018	2017
Total professional liability claims	\$ 102,619	\$ 90,676
Less current portion (Note 12)	5,152	6,821
Long-term portion	\$ 97,467	\$ 83,855

Thumb is insured against medical malpractice claims under a claims-based policy, whereby only the claims reported to the insurance carrier during the policy period were covered regardless of when the incident giving rise to the claim occurred.

## McLaren Health Care Corporation and Subsidiaries

# Notes to Consolidated Financial Statements

September 30, 2018 and 2017

### Note 16 - Functional Expenses

The Corporation provides general healthcare services to residents within its geographic locations. Operating expenses, before nonrecurring impairment loss, related to providing these services are as follows (in thousands):

	2018	2017
Healthcare services	\$ 3,967,484	\$ 2,830,814
General and administrative	694,229	597,624
Total	<u>\$ 4,661,713</u>	<u>\$ 3,428,438</u>

### Note 17 - Operating Leases

The Corporation is obligated under certain operating leases, primarily for facilities and medical equipment. Total rent expense under these leases was approximately \$25,405,000 and \$21,126,000 for 2018 and 2017, respectively.

Future minimum annual commitments under operating leases that have initial or remaining lease terms in excess of one year are as follows (in thousands):

Years Ending September 30	Amount
2019	\$ 21,871
2020	14,566
2021	11,613
2022	9,809
2023	8,656
Thereafter	37,428
Total	<u>\$ 103,943</u>

### Note 18 - Acquisitions

#### ***Huron Medical Center***

On May 1, 2018, the Corporation acquired Huron Medical Center. At the time of acquisition, the Huron Medical Center name was changed to McLaren Thumb Region. The Corporation's board of directors provides governance oversight of McLaren Thumb Region's assets and operations. The accompanying consolidated financial statements represent the result of operations for the five-month period as of the acquisition date of May 1, 2018 and ending on September 30, 2018, the Corporation's fiscal year end.

The transaction has been accounted for as an acquisition in accordance with FASB Accounting Standards Codification Topic 958-805, *Not-for-Profit Entities: Mergers and Acquisitions*. The assets and liabilities of McLaren Thumb Region were adjusted to fair value as of May 1, 2018. The fair value of the net assets on May 1, 2018 acquired from Huron Medical Center was approximately \$16,408,000, which is reflected as inherent contribution due to the acquisition in the consolidated statements of operations and changes in net assets at May 1, 2018 as a result of a lack of financial contributions in the acquisition.

The amount of McLaren Thumb Region revenue and excess of revenue over expenses for the five-month period ended September 30, 2018 that is included in the Corporation's financial statements is approximately \$20,200,000 and \$(160,000), excluding the inherent contribution recognized. The amount of McLaren Thumb Region's operating revenue, excess of revenue over expenses, and changes in unrestricted net assets for the 12-month period ended September 30, 2018 was approximately \$46,959,000 and \$(258), respectively (unaudited).

**Notes to Consolidated Financial Statements**

**September 30, 2018 and 2017**

**Note 18 - Acquisitions (Continued)**

The Corporation acquired the following unrestricted and temporarily restricted assets and liabilities at May 1, 2018 (in thousands):

Cash and cash equivalents	\$	3,560
Other current assets		7,426
Property and equipment		12,571
Investments and other assets		11,382
Accounts payable		(2,228)
Other accruals		(6,944)
Long-term debt		(9,359)
		<hr/>
Total	\$	<u>16,408</u>

**Caro Community Hospital**

On January 1, 2018, the Corporation acquired Caro Community Hospital. At the time of acquisition, the Caro Community Hospital name was changed to McLaren Caro. The Corporation's board of directors provides governance oversight of McLaren Caro's assets and operations. The accompanying consolidated financial statements represent the result of operations for the nine-month period as of the acquisition date of January 1, 2018 and ending on September 30, 2018, the Corporation's fiscal year end.

The transaction has been accounted for as an acquisition in accordance with FASB Accounting Standards Codification Topic 958-805, *Not-for-Profit Entities: Mergers and Acquisitions*. The assets and liabilities of McLaren Caro were adjusted to fair value as of January 1, 2018. The fair value of the net assets on January 1, 2018 acquired from Caro Community Hospital was approximately \$2,567,000, which is reflected as inherent contribution due to the acquisition in the consolidated statement of operations and changes in net assets at January 1, 2018 as a result of a lack of financial contributions in the acquisition.

The amount of McLaren Caro patient revenue and excess of revenue over expenses for the nine-month period ended September 30, 2018 that is included in the Corporation's financial statements is approximately \$11,700,000 and \$(32,000), excluding the inherent contribution recognized. The amount of McLaren Caro's operating revenue, excess of revenue over expense and changes in unrestricted net assets for the 12-month period ended September 30, 2018 was approximately \$15,384,000 and \$(676,000), respectively (unaudited). It is impracticable to determine the amounts of excess of revenue over expenses for the year ended September 30, 2017.

The Corporation acquired the following unrestricted and temporarily restricted assets and liabilities at January 1, 2018 (in thousands):

Cash and cash equivalents	\$	1,430
Other current assets		2,842
Property and equipment		5,770
Investments		-
Accounts payable		(853)
Other current liabilities		(3,584)
Long-term debt		(2,053)
		<hr/>
Total	\$	<u>3,552</u>

**Note 18 - Acquisitions (Continued)**

***MDwise***

Effective January 1, 2018, the Corporation purchased 100 percent of MDwise, Inc. (MDW) and MDwise Medicaid Network, Inc. d/b/a MDwise Excel (Excel) for total consideration of approximately \$253,000,000, of which \$169,000,000 represents the purchase price and the remainder was used to fund capital requirements and remained with the Corporation, in a business combination accounted for as an acquisition. MDW is a licensed Indiana domestic health maintenance organization and administers risk-based managed care programs for certain Indiana Medicaid enrollees. Excel is a delivery system network that manages risk-based managed care contracts of MDW. The mission of Excel is to improve the health of its members and community through innovation and excellence in care, education, research and service. Total assets acquired were approximately \$528,000,000 including cash and investments of approximately \$241,000,000, goodwill of approximately \$27,000,000 and other intangibles of approximately \$110,000,000. Total liabilities assumed approximated \$408,000,000.

The amount of revenue for the nine-month period ended September 30, 2018 that is included in the consolidated financial statements is \$1.01 billion. The amount of MDwise's excess of revenue over expenses for the nine-month period ended September 30, 2018 that is included in the consolidated financial statements is a loss of \$8.5 million. It is impractical to determine the amount of MDwise's excess of revenue over expenses for the 12-month periods ended September 30, 2018 and 2017.

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## Additional Information

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## Independent Auditor's Report on Additional Information

To the Board of Directors  
McLaren Health Care Corporation  
and Subsidiaries

We have audited the consolidated financial statements of McLaren Health Care Corporation and Subsidiaries as of and for the years ended September 30, 2018 and 2017 and have issued our report thereon dated January 8, 2019, which contained an unmodified opinion on those consolidated financial statements. Our audits were performed for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information is presented for the purpose of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual companies and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

*Plante & Moran, PLLC*

January 8, 2019

## McLaren Health Care Corporation and Subsidiaries

# Consolidating Balance Sheet - Credit Group

September 30, 2018

(in thousands)

	McLaren Credit Group	Non-Credit Group Members	Eliminating Entries	Total
<b>Assets</b>				
<b>Current Assets</b>				
Cash and cash equivalents	\$ 376,483	\$ 448,204	\$ -	\$ 824,687
Collateral from securities lending	2,208	-	-	2,208
Accounts receivable:				
Patient account receivable	235,502	42,488	-	277,990
Healthcare insurance receivable	-	250,261	-	250,261
Third-party payor settlements receivable	14,492	-	(14,492)	-
Assets limited as to use for payment of current liabilities	1,119	688	-	1,807
Other current assets	358,303	43,073	(266,626)	134,750
Total current assets	988,107	784,714	(281,118)	1,491,703
<b>Investments, Including Internally Designated</b>	981,032	160,080	-	1,141,112
<b>Other Assets</b>	259,284	318,481	(27,065)	550,700
<b>Property and Equipment - Net</b>	1,143,113	80,896	-	1,224,009
Total assets	<b>\$ 3,371,536</b>	<b>\$ 1,344,171</b>	<b>\$ (308,183)</b>	<b>\$ 4,407,524</b>
<b>Liabilities and Net Assets</b>				
<b>Current Liabilities</b>				
Accounts payable	\$ 170,273	\$ 157,148	\$ -	\$ 327,421
Medical claims payable	-	177,130	-	177,130
Current portion of long-term debt	21,859	1,641	-	23,500
Third-party payor settlements payable	30,834	3,547	(14,492)	19,889
Accrued liabilities and other liabilities	200,397	477,304	(277,561)	400,140
Total current liabilities	423,363	816,770	(292,053)	948,080
<b>Long-term Debt - Net of current portion</b>	1,025,149	11,188	-	1,036,337
<b>Fair Value of Interest Rate Swap Agreements</b>	5,973	-	-	5,973
<b>Other Liabilities - Other long-term liabilities</b>	179,768	94,240	-	274,008
Total liabilities	1,634,253	922,198	(292,053)	2,264,398
<b>Net Assets</b>				
Unrestricted	1,641,009	370,215	(16,130)	1,995,094
Temporarily restricted	33,342	38,113	-	71,455
Permanently restricted	62,932	13,645	-	76,577
Total net assets	1,737,283	421,973	(16,130)	2,143,126
Total liabilities and net assets	<b>\$ 3,371,536</b>	<b>\$ 1,344,171</b>	<b>\$ (308,183)</b>	<b>\$ 4,407,524</b>

## McLaren Health Care Corporation and Subsidiaries

### Consolidating Statement of Operations - Credit Group

Year Ended September 30, 2018

(in thousands)

	McLaren Credit Group	Non-Credit Group Members	Eliminating Entries	Total
<b>Unrestricted Revenue, Gains, and Other Support</b>				
Patient service revenue	\$ 2,681,487	\$ 248,779	\$ (44,276)	\$ 2,885,990
Provision for bad debts	(90,693)	(4,797)	-	(95,490)
Net patient service revenue less provision for bad debts	2,590,794	243,982	(44,276)	2,790,500
Premium revenue	-	1,830,965	(1,030)	1,829,935
Other	330,590	77,902	(259,658)	148,834
Net assets released from restrictions used for operations	7,238	3,496	-	10,734
Total unrestricted revenue, gains, and other support	2,928,622	2,156,345	(304,964)	4,780,003
<b>Expenses</b>				
Salaries	1,048,380	184,252	(44,342)	1,188,290
Employee benefits and payroll taxes	217,152	28,920	(25,089)	220,983
Supplies	542,423	58,291	(1,304)	599,410
Purchased services and other	823,559	539,516	(165,112)	1,197,963
Professional and other liability costs	14,207	18,107	(7,054)	25,260
Medical claims expense	-	1,334,522	(43,033)	1,291,489
Depreciation and amortization	118,467	16,580	(18,445)	116,602
Interest expense	16,414	5,887	(585)	21,716
Total expenses	2,780,602	2,186,075	(304,964)	4,661,713
<b>Operating Income (Loss)</b>	148,020	(29,730)	-	118,290
<b>Other Income (Expense)</b>				
Investment income	32,724	7,552	-	40,276
Change in interest rate swap agreements	(315)	-	-	(315)
Change in unrealized gains and losses on investments	27,680	7,161	-	34,841
Inherent contribution	-	19,584	-	19,584
Other	11,063	107	-	11,170
Total other income	71,152	34,404	-	105,556
<b>Excess of Revenue Over Expenses</b>	219,172	4,674	-	223,846
<b>Net Assets Transferred (to) from Affiliate</b>	(36,725)	36,725	-	-
<b>Other Changes in Net Assets</b>	(550)	164	-	(386)
<b>Pension-related Changes Other than Net Periodic Benefit Cost</b>	87,040	3,103	-	90,143
<b>Net Assets Released from Restriction</b>	2,157	4,743	-	6,900
<b>Increase in Unrestricted Net Assets</b>	<b>\$ 271,094</b>	<b>\$ 49,409</b>	<b>\$ -</b>	<b>\$ 320,503</b>