

COMBINED FINANCIAL STATEMENTS

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations
Years Ended December 31, 2017 and 2016
With Report of Independent Auditors

Ernst & Young LLP



Building a better
working world

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Combined Financial Statements

Years Ended December 31, 2017 and 2016

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Report of Independent Auditors

Board of Managers
Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

We have audited the accompanying combined financial statements of Memorial Sloan Kettering Cancer Center and Affiliated Corporations (the Institution), which comprise the combined balance sheets as of December 31, 2017 and 2016, and the related combined statements of unrestricted activities, changes in net assets, and cash flows for the years then ended, and the related notes to the combined financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of MSK Insurance US, Inc., a wholly owned subsidiary, which statements reflect total assets constituting 2.6% in 2017 and 2.5% in 2016, total liabilities constituting 6.8% in 2017 and 6.9% in 2016, and total revenues constituting 0.1% in 2017 and 2016 of the related combined totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for MSK Insurance US, Inc., is based solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express



no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, based on our audits and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the combined financial position of the Institution at December 31, 2017 and 2016, and the combined results of its operations, changes in its net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

March 29, 2018

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Combined Balance Sheets

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 900,411	\$ 698,872
Short-term investments – at fair value	239,472	177,868
Accounts receivable, less allowance for doubtful accounts (2017 – \$35,161; 2016 – \$31,569)	497,547	499,284
Pledges, trusts and estates receivable	170,567	183,185
Other current assets	129,786	112,086
Total current assets	1,937,783	1,671,295
Noncurrent assets:		
Assets whose use is limited:		
Investments in marketable securities – at fair value:		
Construction, debt service and repair reserve funds	212,581	63,843
Captive insurance funds	54,770	57,672
Employee benefit funds	83,846	74,464
Total investments in marketable securities whose use is limited	351,197	195,979
Investments – at fair value	3,149,107	3,140,818
Investments internally designated for major capital projects	867,658	1,037,988
Investments in nonmarketable securities	11,900	35,573
Property and equipment – net	3,855,532	3,359,348
Pledges, trusts and estates receivable	361,550	367,503
Other noncurrent assets	101,285	82,988
Total noncurrent assets	8,698,229	8,220,197
Total assets	\$ 10,636,012	\$ 9,891,492
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 489,603	\$ 430,739
Accrued expenses	387,955	298,619
Current portion of long-term debt	73,344	71,247
Total current liabilities	950,902	800,605
Noncurrent liabilities:		
Long-term debt, less current portion	2,715,704	2,544,709
Other noncurrent liabilities	864,303	815,201
Total liabilities	4,530,909	4,160,515
Net assets:		
Unrestricted:		
Undesignated	4,437,167	4,170,504
Board-designated	193,807	175,803
Total unrestricted	4,630,974	4,346,307
Temporarily restricted	798,880	757,725
Permanently restricted	675,249	626,945
Total net assets	6,105,103	5,730,977
Total liabilities and net assets	\$ 10,636,012	\$ 9,891,492

See notes to combined financial statements.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Combined Statements of Unrestricted Activities

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Undesignated operating revenues		
Hospital care and services	\$ 3,580,449	\$ 3,094,461
Grants and contracts	296,493	257,893
Contributions	191,843	161,245
Net assets released from restrictions	86,800	86,850
Royalty and other income	159,458	242,934
Investment returns allocated to operations	137,750	136,979
Total operating revenues	<u>4,452,793</u>	<u>3,980,362</u>
Operating expenses		
Compensation and fringe benefits	2,335,132	2,131,070
Purchased supplies and services	1,491,154	1,311,764
Depreciation and amortization	287,145	263,964
Provision for bad debts and regulatory assessments	54,254	35,003
Interest	45,343	48,724
Total operating expenses	<u>4,213,028</u>	<u>3,790,525</u>
Income from operations	<u>239,765</u>	<u>189,837</u>
Nonoperating income and expenses, net		
Net assets released from restrictions for capital purposes	15,000	22,001
Investment returns, net of allocation to operations and transfers to temporarily restricted net assets	219,440	29,713
Pension settlement cost	(33,480)	-
Other nonoperating income and expenses, net	(53,581)	(61,372)
Total nonoperating income and expenses, net	<u>147,379</u>	<u>(9,658)</u>
Increase in unrestricted net assets before change in postretirement benefit obligation to be recognized in future periods and Board-designated activities	<u>387,144</u>	<u>180,179</u>
Board-designated		
Investment income and other additions	18,004	1,468
Increase in Board-designated	<u>18,004</u>	<u>1,468</u>
Increase in unrestricted net assets before change in postretirement benefit obligation to be recognized in future periods	405,148	181,647
Change in postretirement benefit obligation to be recognized in future periods	(120,481)	(30,222)
Increase in total unrestricted net assets	<u>\$ 284,667</u>	<u>\$ 151,425</u>

See notes to combined financial statements.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Combined Statements of Changes in Net Assets

Years Ended December 31, 2017 and 2016

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
	<i>(In Thousands)</i>			
Net assets at January 1, 2016	\$ 4,194,882	\$ 734,851	\$ 604,230	\$ 5,533,963
Increase in unrestricted net assets	151,425	–	–	151,425
Contributions, pledges, and bequests	–	137,038	18,986	156,024
Investment return on endowments	–	38,614	3,729	42,343
Impairment of investment	–	(43,927)	–	(43,927)
Net assets released from restrictions	–	(108,851)	–	(108,851)
Net assets at December 31, 2016	4,346,307	757,725	626,945	5,730,977
Increase in unrestricted net assets	284,667	–	–	284,667
Contributions, pledges, and bequests	–	88,741	37,800	126,541
Investment return on endowments	–	77,887	10,504	88,391
Impairment of investment	–	(23,673)	–	(23,673)
Net assets released from restrictions	–	(101,800)	–	(101,800)
Net assets at December 31, 2017	\$ 4,630,974	\$ 798,880	\$ 675,249	\$ 6,105,103

See notes to combined financial statements.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Combined Statements of Cash Flows

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Operating activities		
Change in net assets	\$ 374,126	\$ 197,014
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	287,145	263,964
Equity in earnings of investments, net	545	69
Unrealized net gains	(251,283)	(118,923)
Realized net gains	(165,244)	(33,649)
Accretion (amortization) of bond premium and issuance costs	37,132	(337)
Temporarily and permanently restricted contributions, pledges and bequests transferred to investing activities	(126,541)	(156,024)
Pension settlement cost	33,480	—
Change in postretirement benefit obligation to be recognized in future periods	120,481	30,222
Changes in assets:		
Accounts receivable, net	1,737	114,001
Pledges, trusts and estates receivable, net	18,571	(1,621)
Other current assets	(17,700)	(11,782)
Other noncurrent assets	(15,164)	9,712
Changes in liabilities:		
Accounts payable and accrued expenses	103,083	78,025
Other noncurrent liabilities	(105,106)	(70,173)
Net cash provided by operating activities	<u>295,262</u>	<u>300,498</u>
Investing activities		
Net acquisitions of property and equipment	(737,965)	(637,548)
Decrease in investments, net	385,419	367,581
Increase in mortgages and other loans receivable	(3,678)	(2,171)
Temporarily and permanently restricted contributions, pledges and bequests transferred from operating activities	126,541	156,024
Net cash used in investing activities	<u>(229,683)</u>	<u>(116,114)</u>
Financing activities		
Proceeds from financing	294,420	255,000
Repayment of debt	(158,460)	(162,842)
Net cash provided by financing activities	<u>135,960</u>	<u>92,158</u>
Net change in cash and cash equivalents	201,539	276,542
Cash and cash equivalents at beginning of year	698,872	422,330
Cash and cash equivalents at end of year	<u>\$ 900,411</u>	<u>\$ 698,872</u>

See notes to combined financial statements.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements

December 31, 2017

1. Organization and Significant Accounting Policies

The mission of Memorial Sloan Kettering Cancer Center and Affiliated Corporations is to provide leadership in the prevention, treatment and cure of cancer through excellence, vision and cost effectiveness in patient care, outreach programs, research and education. The accompanying financial statements are presented on a combined basis and include the accounts of the following tax exempt, Section 501(c)(3), incorporated affiliates: Memorial Sloan Kettering Cancer Center (the Center), Memorial Hospital for Cancer and Allied Diseases (the Hospital), Sloan Kettering Institute for Cancer Research (the Institute), S.K.I. Realty, Inc., MSK Insurance US, Inc. (MSKI), the Louis V. Gerstner Jr. Graduate School of Biomedical Sciences, Prostate Cancer Clinical Trials Consortium, LLC, Ralph Lauren Center for Cancer Care and Prevention, and MSK Proton, Inc. All of these entities are collectively referred to as the “Institution”.

The following is a summary of the Institution’s significant accounting policies:

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those where use by the Institution has been limited by donors because of a time or purpose restriction. Permanently restricted net assets have been restricted by donors to be maintained by the Institution in perpetuity.

Donor Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as either temporarily or permanently 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 a purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the combined financial statements as net assets released from restrictions or as net assets released from restrictions for capital purposes. Donor restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in the accompanying combined financial statements.

Contributions represent the utilization of donor funds which are intended to support the current period’s operations.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Total contributions and pledges raised through fund raising efforts were approximately \$318.4 million and \$317.3 million for 2017 and 2016, respectively.

Cash and Cash Equivalents

The Institution considers as cash and cash equivalents, all current investments, cash and certain highly liquid investments with original maturities of less than three months.

Investments

Investments in marketable securities are carried at fair value, based on quoted market prices.

Investments in nonmarketable securities consist of interests in businesses or other ventures acquired through donations. Investments received in which the Institution has a controlling interest are consolidated if the applicable requirements are met. For investments received in which the Institution does not have a controlling interest, carrying value is determined as fair value at date received and carrying value is evaluated for impairment annually. During 2017 and 2016, the Institution recorded an impairment of approximately \$23.7 million and \$43.9 million, respectively.

Alternative investments are stated in the accompanying combined balance sheets at fair value, which is estimated using the net asset values (NAV), a practical expedient, of each alternative investment. Financial information used by the Institution to evaluate its alternative investments is provided by the investment manager or general partner and may include fair value valuations (quoted market prices and values determined through other means) of underlying securities and other financial instruments held by the investee, and estimates that require varying degrees of judgment. The financial statements of the investee companies are audited annually by independent auditors, although the timing for reporting the results of such audits does not always coincide with the Institution's annual financial statement reporting.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Realized gains or losses on investments sold or redeemed, together with unrealized appreciation or depreciation on investments and investment income are distributed to all categories of net assets, as appropriate. The total investment return (investment income and realized and unrealized gains and losses) is reflected in the accompanying combined statements of unrestricted activities in two portions. The investment return allocated to operating revenues is determined by application of a 4% normal return to a three-year average market value of investments, excluding certain permanently restricted assets and certain other funds. In addition, actual investment earnings on short-term fixed income funds are included in operating revenues. The investment return classified as nonoperating represents the difference between the actual total investment return and the amount allocated to operating revenues less amounts transferred to temporarily restricted net assets for endowments. Investment expenses, other than fees paid directly to investment managers, amounted to \$8.4 million and \$11.3 million in 2017 and 2016, respectively, and are included in the combined statements of unrestricted activities in investment returns, net of allocation to operations and transfers to temporarily restricted net assets.

Investment returns, net of investment expenses, consist of the following:

	2017	2016
	<i>(In Thousands)</i>	
Investment income	\$ 8,385	\$ 14,004
Realized gains	165,244	33,649
Unrealized gains	251,283	118,923
Total	<u>\$ 424,912</u>	<u>\$ 166,576</u>

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Unconditional Promises to Give

Unconditional promises to give are recorded when the gift intent is made known in writing. A receivable has been established and net assets have been increased by the time-discounted value of the promises. Irrevocable trusts are recorded at the point of notification and are recorded as temporarily or permanently restricted as determined by the trust instruments. Estates are estimated and recorded at the conclusion of probate.

The Institution is aware of numerous unconditional promises to give and estimates the year of receipt to the extent possible. The anticipated present value of the receivable is as follows (in thousands):

2018	\$ 170,567
2019	82,408
2020	61,334
2021	49,454
2022	39,190
Thereafter	129,164
	<u>\$ 532,117</u>

The present value discount and allowance for doubtful accounts on unconditional promises to give is approximately \$56.5 million and \$73.6 million at December 31, 2017 and 2016, respectively.

Property and Equipment

Property and equipment is carried at cost, less accumulated depreciation and amortization. Depreciation on building components and equipment is computed on the straight-line method over the estimated useful service lives. Leasehold improvements are being amortized over the lesser of the term of the lease or estimated useful service life, based on the straight-line method.

The carrying amount of assets and the related accumulated depreciation or amortization are removed from the accounts when such assets are disposed of and any resulting gain or loss is included in operations.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

All eligible costs incurred for the development of computer software for internal use are capitalized and carried at cost, less accumulated amortization. Amortization of capitalized internal use software cost is based on the straight-line method over the estimated useful life of the software.

Charity Care and Community Benefit Programs

Consistent with its mission, the Institution invests significant amounts for the benefit of the worldwide community that is served through its patient care, education and research activities. Listed below are quantifiable benefits provided.

Charity care represents the cost of services provided to patients who cannot afford health care services due to inadequate resources and/or are uninsured or underinsured. A patient is classified as a charity care patient in accordance with the Institution's established policies and where insufficient payment for such services is anticipated. For the periods presented, the Institution considers patients for charity care if household income is less than 500% of the federal poverty guidelines. Services provided as charity care are not reported as revenue in the combined statements of unrestricted activities. Costs of providing charity care are estimated by multiplying the total charges incurred by patients that qualify for charity care by a ratio of historical expenses to charges as derived from the Institution's accounting records. The Institution receives payments from the New York State Public Goods Pool for charity care and such amounts totaled approximately \$11.9 million and \$11.6 million for the years ended December 31, 2017 and 2016, respectively. Payments made into the pool by the Institution were approximately \$8.3 million and \$8.7 million for the years ended December 31, 2017 and 2016, respectively.

The Institution provides services to patients who participate in government-sponsored health programs, such as Medicare and Medicaid. Payments received by the Institution for patient services provided under these programs are less than the actual cost of providing such services. Therefore, to the extent Medicare and Medicaid payments are less than the cost of care provided, the uncompensated cost of that care is considered to be a community benefit.

Research community benefit costs represent the Institution's costs for basic, translational and clinical research.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

The Institution is a preeminent provider of health training to health professionals who desire training in the skills necessary to treat cancer patients. The Institution trains physicians, radiology students, nursing students, social work students and individuals looking to create a career in the field of cancer biology. The amounts shown below represent costs in excess of amounts reimbursed by third-party payors such as training grant revenues and direct medical education payments from the Medicare program.

The following is a summary of the Institution's estimated costs of providing charity care and community benefit program services:

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Charity care	\$ 21,652	\$ 21,742
Unpaid cost of government sponsored healthcare	440,052	291,716
Research supported by governmental/voluntary agencies	193,933	169,422
Other research	422,518	430,709
Health training	224,158	218,397
Other	21,607	22,737
Charity care and community benefit programs	<u>\$ 1,323,920</u>	<u>\$ 1,154,723</u>

Use of Estimates

The preparation of the combined financial statements in conformity with U.S. generally accepted accounting principles requires management to make prudent and conservative estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the combined financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Endowments

The Institution follows the New York Prudent Management of Institutional Funds Act (NYPMIFA) which was enacted on September 17, 2010. The Institution has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while maintaining the historic dollar value of permanently restricted contributions. The Institution classifies as permanently restricted net assets (a) the original value of the gifts donated, (b) the original value of subsequent gifts, (c) the net realizable value of future payments in accordance with the donor's gift instrument (outstanding pledges, net of applicable discount) and (d) appreciation (depreciation), gains (losses) and income earned on the fund when the donor states that such increases or decreases are to be treated as changes in permanently restricted net assets. The endowment assets are pooled with unrestricted assets and invested in various diversified asset classes.

The Institution has a policy of appropriating for spending an annualized percentage of each permanently restricted fund's value, with certain exceptions. In establishing this policy, the Institution considered the long-term expected return on its investment portfolio and the impact of inflation. The spending rate appropriated by the Institution was 4% in 2017 and 2016.

The Institution's endowment investment returns in excess or deficit of the spending rate will be accumulated in a temporarily restricted net asset account, which is restricted by purpose. The temporarily restricted net asset account will be added to the permanently restricted fund's value in order to calculate the appropriation for spending.

To satisfy its long-term rate-of-return objectives, the Institution relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The Institution targets a diversified asset allocation (see Note 3) to achieve its long-term return objectives within prudent risk constraints. As a result of fluctuations in the investment markets, from time to time, the fair value of assets associated with individual donor restricted endowment funds may fall below the level that the donor requires the Institution to retain as a fund of perpetual duration. There were no deficiencies of this nature as of December 31, 2017 and 2016.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Changes in donor endowment funds for the years ended December 31, 2017 and 2016 consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted
	<i>(In Thousands)</i>		
Endowment funds at December 31, 2016	\$ —	\$ 201,323	\$ 626,945
Investment return on endowments	47,972	77,887	10,504
Contributions	—	—	37,800
Appropriations	(47,972)	—	—
Endowment funds at December 31, 2017	\$ —	\$ 279,210	\$ 675,249

	Unrestricted	Temporarily Restricted	Permanently Restricted
	<i>(In Thousands)</i>		
Endowment funds at December 31, 2015	\$ —	\$ 162,709	\$ 604,230
Investment return on endowments	39,688	38,614	3,729
Contributions	—	—	18,986
Appropriations	(39,688)	—	—
Endowment funds at December 31, 2016	\$ —	\$ 201,323	\$ 626,945

Included in permanently restricted net assets are amounts that represent the Institution's beneficial interest in certain perpetual trusts which are held by third-party trustees. The underlying assets of the perpetual trusts are included in other noncurrent assets on the combined balance sheets and consist of equity securities and mutual funds. The fair value at December 31, 2017 and 2016 was approximately \$20.5 million and \$7.1 million, respectively. The change in fair value of the beneficial interest in perpetual trusts held by third parties is included in the change in permanently restricted net assets.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Tax Status

The entities comprising the Institution are Section 501(c)(3) organizations exempt from Federal income taxes under Section 501(a) of the Internal Revenue Code. The entities are also exempt from New York State and City income taxes.

Income taxes from unrelated business activities of the tax-exempt entities are not significant to the accompanying combined financial statements.

As a result of the recent federal income tax reform enacted into law under the Tax Cuts and Jobs Act of 2017, certain provisions will impact tax-exempt organizations, including revisions to taxes on unrelated business activities, excise taxes on compensation of certain employees, and various other provisions. The regulations necessary to implement the law are expected to be promulgated throughout 2018 and the ultimate outcome of the regulations and impact to the Institution cannot be determined presently.

Subsequent Events

Subsequent events have been evaluated through March 29, 2018, which is the date the combined financial statements were issued. No subsequent events have occurred that require disclosure in or adjustment to the combined financial statements.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in ASU 2014-09 supersedes the FASB's current revenue recognition requirements in Accounting Standards Codification Topic 605, *Revenue Recognition*, and most industry-specific guidance. The FASB subsequently issued ASU 2015-14, *Revenue from Contracts with Customers*, which deferred the effective dates of ASU 2014-09. Based on ASU 2015-14, the provisions of ASU 2014-09 are effective for the Institution for fiscal years beginning after December 15, 2017, and interim periods within that fiscal year.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

Management plans to adopt ASU 2014-09 following the modified retrospective method of application. Subsequent to adoption, certain patient activity where collection is uncertain, which was previously reported as hospital care and services revenue and provision for bad debts and regulatory assessments in the Institution's combined statements of unrestricted activities, will no longer meet the criteria for revenue recognition and, accordingly, the provision for bad debts and regulatory assessments after the adoption date will be significantly reduced with a corresponding reduction to hospital care and services revenue. Such patient activity will be classified as an implicit price concession. The Institution's adoption of ASU 2014-09 will have other impacts to hospital care and services revenue, which include judgments regarding collection analyses and estimates of variable consideration and the addition of certain qualitative and quantitative disclosures. The impact of the adoption of ASU 2014-09 in relation to other applicable revenue activity is not expected to be significant to the Institution's combined financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which will require lessees to report most leases on their statement of financial position and recognize expenses on their income statement in a manner similar to current accounting. The guidance also eliminates current real estate-specific provisions. Lessors in operating leases continue to recognize the underlying asset and recognize lease income on either a straight-line or another systematic and rational basis. The provisions of ASU 2016-02 are effective for the Institution for annual periods beginning after December 15, 2018, and interim periods in the following year. Early adoption is permitted. The Institution has not completed the process of evaluating the impact of ASU 2016-02 on its combined financial statements.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Financial Statement Presentation*, which eliminates the requirement for not-for-profits (NFPs) to classify net assets as unrestricted, temporarily restricted and permanently restricted. Instead, NFPs will be required to classify net assets as net assets with donor restrictions or without donor restrictions. Among other things, the guidance also modifies required disclosures and reporting related to net assets, investment expenses and qualitative information regarding liquidity. NFPs will also be required to report all expenses by both functional and natural classification in one location. The provisions of ASU 2016-14 are effective for the Institution for annual periods beginning after December 15, 2017 and interim periods thereafter. Early adoption is permitted. The Institution will adopt ASU 2016-14 as of December 31, 2018.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments*, which addresses the following eight specific cash flow issues in order to limit diversity in practice: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. The provisions of ASU 2016-15 are effective for the Institution for annual periods beginning after December 15, 2018 and interim periods thereafter. Early adoption is permitted. The Institution does not believe the impact of ASU 2016-15 will be significant on its combined financial statements.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows – Restricted Cash*, which requires that the statement of cash flows explain the change during the period in the total of cash, cash *equivalents*, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The provisions of ASU 2016-18 are effective for the Institution for annual periods beginning after December 15, 2018 and interim periods thereafter. Early adoption is permitted. The Institution does not believe the impact of ASU 2016-18 will be significant on its combined financial statements.

In March 2017, the FASB issued ASU 2017-07, *Compensation – Retirement Benefits: Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. ASU 2017-07 addresses how employers that sponsor defined benefit pension and/or other postretirement benefit plans present the net periodic benefit cost in the income statement. Employers are required to present the service cost component of net periodic benefit cost in the same income statement line item as other employee compensation costs arising from services rendered during the period. Employers present the other components of the net periodic benefit cost separately from the line item that *includes* the service cost and outside of any subtotal of operating income, if one is presented. The Institution adopted ASU 2017-07 retrospectively as of January 1, 2017. Upon adoption of ASU 2017-07, the Institution reclassified the 2016 other expense components of the

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

1. Organization and Significant Accounting Policies (continued)

benefit plans from compensation and fringe benefits expense to other nonoperating income and expenses, net, in the amount of approximately \$11.7 million for the year ended December 31, 2016.

Reclassifications

Certain reclassifications have been made to 2016 amounts previously reported in order to conform with the current year presentation. On the combined balance sheets, mortgages and other loans receivable are included in other noncurrent assets. On the combined statements of unrestricted activities, medical practice revenues are included in hospital care and services revenues; royalty income and other income are combined into royalty and other income; salaries and wages, physician practice compensation, and employee fringe benefits are combined into compensation and fringe benefits; pharmaceuticals expense is included in purchased supplies and services.

2. Third-Party Reimbursement Programs

Hospital care and service revenues are recorded at established rates when patient services are provided. Reimbursement by third-party payor programs can be less than published charges, with adjustments for such differences recorded as contractual allowances deducted directly from accounts receivable and operating revenues in the year incurred. Adjustments from established rates are also recorded for potential retrospective adjustments, which are an inherent component of the health care revenue recognition process.

Non-Medicare Reimbursement

In New York State, hospitals and all non-Medicare payors, except Medicaid, workers' compensation and no-fault insurance programs, negotiate hospitals' payment rates. If negotiated rates are not established, payors are billed at hospitals' established charges. Medicaid pays hospital rates promulgated by the New York State Department of Health. Payments to the Hospital for Medicaid inpatient services are based on a prospective payment system, with retroactive adjustments. Outpatient services are paid based on a statewide prospective system. Medicaid rate methodologies are subject to approval at the Federal level by the Centers for Medicare & Medicaid Services (CMS), which may routinely request information about such methodologies prior to approval. Revenue related to specific rate

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

2. Third-Party Reimbursement Programs (continued)

components that have not been approved by CMS are not recognized until the Hospital is reasonably assured that such amounts are realizable. Adjustments to the current and prior years' payment rates for those payors will continue to be made in future years.

Medicare Reimbursement

The Hospital is exempt from the national prospective payment system used to reimburse hospitals for inpatient services provided to Medicare beneficiaries and instead is paid using a cost-based methodology. These payments are subject to a limit that is based on costs from the mid 2000s for rate years beginning on or subsequent to January 1, 2007, which are then updated based on annual trend factors calculated by CMS. Prior to January 1, 2007, the limit was based on costs from the early 1990s. The Hospital is paid for outpatient services under the national prospective payment system and other methodologies of the Medicare program for certain other services. The outpatient payments are subject to a floor that ensures the Hospital receives at least 89% of its Medicare defined allowable outpatient costs effective January 1, 2014. In 2016, the floor was increased to 92% and subsequently lowered to 91% in 2017. Federal regulations provide for certain adjustments to current and prior years' payment rates, based on hospital-specific data.

The Hospital has established estimates, based on information presently available, of amounts due to or from Medicare and non-Medicare payors for adjustments to current and prior years' payment rates. The current Medicaid, Medicare and other third-party payor programs are based upon extremely complex laws and regulations that are subject to interpretation. Medicare cost reports, which serve as the basis for final settlement with the Medicare program, have been audited by the Medicare fiscal intermediary and settled through the year ended December 31, 2011. Other years remain open for audit and subsequent settlement, as are numerous issues related to the New York State Medicaid program for prior years. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount when open years are settled. Changes in these estimates could also affect the amounts reported as the unpaid cost of government sponsored healthcare (see Note 1). Approximately (0.16)% of operating revenues in 2017 and 0.79% of operating revenues in 2016 are due to adjustments of prior year operating revenues. Additionally, noncompliance with such laws and regulations could result in fines, penalties and exclusion from such programs. The Hospital is not aware of any allegations of noncompliance that could have a material adverse effect on the combined financial statements and believes that it is in compliance with all applicable laws and regulations.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

2. Third-Party Reimbursement Programs (continued)

There are various Federal proposals that could, among other things, reduce payment rates or modify payment methods. The ultimate outcome of these proposals and other market changes, including the potential effects of health care reform by the Federal government, cannot presently be determined. Future changes in Medicare and Medicaid programs could have an impact, positive or negative, on the Hospital. Additionally, Medicare payment rates for various years have been appealed by the Hospital. If the appeals are successful, additional income applicable to those years might be realized.

Significant concentrations of accounts receivable at December 31, 2017, include 24% from government-related programs, 17% from Empire Health Choice and 16% from UnitedHealthcare (23%, 15% and 17%, respectively, at December 31, 2016).

3. Cash, Cash Equivalents, and Investments at Fair Value

For assets and liabilities required to be measured at fair value, the Institution measures fair value based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are applied based on the unit of account from the Institution's perspective. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements.

The Institution follows a valuation hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

- *Level 1:* Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.
- *Level 2:* Observable inputs are based on inputs not quoted in active markets, but corroborated by market data.
- *Level 3:* Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

3. Cash, Cash Equivalents, and Investments at Fair Value (continued)

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. In determining fair value, the Institution uses valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and considers nonperformance risk in its assessment of fair value. Any investments valued based upon the NAV are not subject to classification in the valuation hierarchy.

Mutual funds are valued based on the quoted market prices of the securities as reported on national securities exchanges.

United States-based and international equities consist of individually held securities and commingled funds. Individual securities and certain commingled funds are valued based on the quoted market prices of the securities as reported on national securities exchanges. Commingled funds primarily are valued based on the NAV of shares held by the Institution at year end.

Fixed income securities include corporate bonds, U.S. government securities, and commingled funds. Corporate bonds and U.S. government securities are valued based on readily available market quotations received from commercial pricing services. Such pricing services and brokers will generally provide bid-side quotations. Commingled funds are valued based on quoted market prices as reported on national securities exchanges, if applicable, or the NAV of shares held by the Institution at year end.

Alternative investments include absolute return funds, long/short funds, global macro funds, inflation hedging funds, opportunistic funds, hard assets, private equity funds and venture capital. Alternative investment interests generally are structured such that the Institution holds a limited partnership interest. The Institution's ownership structure does not provide for control over the related investees and the Institution's financial risk is limited to the funded and unfunded commitment for each investment. As of December 31, 2017, the Institution had outstanding commitments to provide additional capital of approximately \$506.3 million to various alternative investment managers.

Individual investment holdings within the alternative investments include nonmarketable and market-traded debt and equity securities and interests in other alternative investments. The Institution may be exposed indirectly to securities lending, short sales of securities and trading in futures and forward contracts, options and other derivative products. Alternative investments often

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

3. Cash, Cash Equivalents, and Investments at Fair Value (continued)

have liquidity restrictions under which the Institution's capital may be divested only at specified times. The Institution's liquidity restrictions range from several months to ten years for certain private equity investments. Liquidity restrictions may apply to all or portions of a particular invested amount.

There is uncertainty in determining fair values of alternative investments arising from factors such as lack of active markets (primary and secondary), lack of transparency into underlying holdings, time lags associated with reporting by the investee companies and the subjective evaluation of liquidity restrictions. As a result, the estimated fair values reported in the accompanying combined balance sheets might differ from the values that would have been used had a ready market for the alternative investment interests existed and there is at least a reasonable possibility that those estimates will change.

The following is a description of the Institution's valuation methodologies for assets measured at fair value. Fair value for Level 1 is based upon quoted market prices. Fair value for Level 2 is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Fair value for Level 3 is based on unobservable inputs when little or no market data is available, which include estimates and risk-adjusted value ranges. Inputs are obtained from various sources including market participants, dealers and brokers. The methods described above may produce a fair value that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Institution believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

3. Cash, Cash Equivalents, and Investments at Fair Value (continued)

Financial instruments, other than pension plan assets (see Note 7), carried at fair value as of December 31, 2017, are classified in the table below as described above:

	Level 1	Level 2	Level 3	Total
	<i>(In Thousands)</i>			
Investments measured at fair value				
Cash, cash equivalents, and short-term investments	\$ 1,588,348	\$ —	\$ —	\$ 1,588,348
Mutual funds	83,846	—	—	83,846
United States-based equity securities	40,256	244,803	—	285,059
International equity securities	220,744	11,261	—	232,005
Fixed income investments:				
Corporate bonds	—	554,541	—	554,541
U.S. government and other	201,295	64,825	—	266,120
	<u>\$ 2,134,489</u>	<u>\$ 875,430</u>	<u>\$ —</u>	<u>3,009,919</u>
Investments measured at NAV as a practical expedient				
Commingled funds:				
United States-based equity				239,488
International equity				242,905
Alternative investments:				
Marketable:				
Absolute return funds				327,030
Long/short funds				569,650
Global macro funds				201,228
Inflation hedging funds				72,785
Nonmarketable:				
Venture capital				343,531
Private equity				206,402
Opportunistic funds				143,002
Hard assets				151,905
Total investments at fair value				<u>\$ 5,507,845</u>

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

3. Cash, Cash Equivalents, and Investments at Fair Value (continued)

Financial instruments, other than pension plan assets (see Note 7), carried at fair value as of December 31, 2016, are classified in the table below as described above:

	Level 1	Level 2	Level 3	Total
	<i>(In Thousands)</i>			
Investments measured at fair value				
Cash, cash equivalents, and short-term investments	\$ 1,069,765	\$ —	\$ —	\$ 1,069,765
Mutual funds	74,464	—	—	74,464
United States-based equity securities	67,647	259,759	—	327,406
International equity securities	312,714	15,015	—	327,729
Fixed income investments:				
Corporate bonds	—	986,026	—	986,026
U.S. government and other	52,608	61,875	—	114,483
	<u>\$ 1,577,198</u>	<u>\$ 1,322,675</u>	<u>\$ —</u>	<u>2,899,873</u>
Investments measured at NAV as a practical expedient				
Commingled funds:				
United States-based equity				165,422
International equity				181,995
Fixed income				2,773
Alternative investments:				
Marketable:				
Absolute return funds				413,891
Long/short funds				494,740
Global macro funds				171,828
Inflation hedging funds				164,150
Nonmarketable:				
Venture capital				287,238
Private equity				186,563
Opportunistic funds				136,658
Hard assets				146,394
Total investments at fair value				<u>\$ 5,251,525</u>

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

3. Cash, Cash Equivalents, and Investments at Fair Value (continued)

Other financial instruments that are not required to be carried at fair value include debt (see Note 5), pledges and mortgages receivable. Pledges and mortgages receivable are recorded at carrying value, net of applicable discounts in the accompanying combined balance sheets which approximates fair value.

4. Property and Equipment

Property and equipment consists of the following:

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Land	\$ 380,703	\$ 380,703
Buildings and leasehold improvements	3,754,578	3,525,251
Equipment	1,563,597	1,448,311
Construction-in-progress	1,058,869	648,354
	6,757,747	6,002,619
Less accumulated depreciation and amortization	2,902,215	2,643,271
	\$ 3,855,532	\$ 3,359,348

The Institution wrote off approximately \$27.4 million and \$27.8 million of fully depreciated assets in 2017 and 2016, respectively.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

5. Long-Term Debt

Long-term debt consists of the following:

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
DASNY Series 1998, tax-exempt bonds maturing through 2023 at various fixed interest rates ranging from 5.25% to 5.75%	\$ 135,400	\$ 137,000
DASNY Series 2008, tax-exempt bonds maturing through 2036 at various fixed interest rates ranging from 4.00% to 5.00%	333,730	368,020
DASNY Series 2010, tax-exempt bonds maturing through 2023 at a fixed interest rate of 2.18%	46,000	54,000
Series 2011A taxable bonds maturing in 2042 at a fixed interest rate of 5.00%	400,000	400,000
DASNY Series 2012, tax-exempt bonds maturing through 2041 at various fixed interest rates ranging from 3.00% to 5.00%	82,350	84,245
DASNY 2012 Series 1, tax-exempt bonds maturing through 2034 at various fixed interest rates ranging from 4.00% to 5.00%	262,265	262,265
Series 2012A taxable bonds maturing in 2052 at a fixed interest rate of 4.125%	400,000	400,000
Series 2015A taxable bonds maturing in 2055 at a fixed interest rate of 4.20%	550,000	550,000
DASNY 2015 Series 1, tax-exempt bonds repaid through 2027 at a fixed interest rate of 2.31%	–	94,692
DASNY Series 2016-1, tax-exempt bonds repaid through 2028 at a fixed interest rate of 1.97%	105,944	109,427
NJEDA Series 2016-2, tax-exempt bonds maturing through 2026 at a fixed rate interest rate of 1.43%	130,500	145,000
DASNY Series 2017-1, tax-exempt bonds maturing between 2018 and 2047 at various fixed interest rates ranging from 4.00% to 5.00%	294,420	–
Unamortized bond premiums, discounts and issuance costs	48,439	11,307
	2,789,048	2,615,956
Less current portion	73,344	71,247
	\$ 2,715,704	\$ 2,544,709

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

5. Long-Term Debt (continued)

In December 2017, the Institution issued \$294.4 million of Series 2017-1 tax-exempt bonds (the 2017 Bonds) through the Dormitory Authority of the State of New York (DASNY). The 2017 Bonds mature between 2018 and 2047 at fixed interest rates ranging from 4.00% to 5.00%. A portion of the proceeds were used to advance refund the DASNY 2015 Series 1 tax-exempt bonds. The remaining proceeds will be used to pay costs for ambulatory care expansion, equipment and to pay for costs of issuance of the 2017 Bonds. The new debt was issued at a premium of approximately \$41.1 million, which lowered the Institution's effective interest rates and the all-in yield.

In April 2016, the Institution issued \$110.0 million of Series 2016-1 tax-exempt bonds (the 2016 Bonds) through DASNY. The 2016 Bonds, which are privately placed with a sole bondholder, will be paid through 2028 at a fixed interest rate of 1.97%. The proceeds will be used to pay costs for ambulatory care expansion, expansion of lab services, medical equipment, clinical renovations and for costs of issuance.

In September 2016, the Institution issued \$145.0 million of Series 2016-2 tax-exempt bonds (the 2016-2 Bonds) through the New Jersey Economic Development Authority (NJEDA). The 2016-2 Bonds, which are privately placed with a sole bondholder, will be paid through 2026 at a fixed interest rate of 1.43%. The proceeds will be used to pay costs for ambulatory care expansion, medical equipment, clinical renovations and for costs of issuance.

Annual maturities on all long-term debt as of December 31, 2017 for the years 2018 through 2022 are as follows (in thousands):

2018	\$ 73,344
2019	69,271
2020	78,823
2021	80,198
2022	83,234

Total interest paid in 2017 and 2016 (including portions supporting capitalized costs) was approximately \$104.1 million and \$106.1 million, respectively. Interest expense related to the Series 2011A, the Series 2012A and the 2015 Bonds will be included in other nonoperating income and expenses, net until the related capital projects are placed into service. Nonoperating interest expense was approximately \$30.2 million and \$38.0 million during 2017 and 2016, respectively.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

5. Long-Term Debt (continued)

The Institution capitalized interest of approximately \$29.8 million and \$21.9 million during 2017 and 2016, respectively.

Certain of the above debts are secured by a pledge of revenues from certain facilities, bond insurance and springing collateral, which would require the Institution to mortgage a substantial portion of real property if certain financial covenants and ratios are not maintained. The Institution was in compliance with all such financial requirements during 2017 and 2016.

At December 31, 2017 and 2016, the Institution had unsecured lines of credit available with banks totaling \$300.0 million, with varying renewable terms and interest based on the London Interbank Offered Rate. There were no amounts drawn at December 31, 2017 and 2016.

The Institution's long-term debt obligations are reported in the accompanying combined balance sheets at carrying value which totaled approximately \$2.79 billion and \$2.62 billion at December 31, 2017 and 2016, respectively. The fair value of long-term debt obligations at December 31, 2017 and 2016, as determined by quoted market prices, totaled approximately \$2.99 billion and \$2.69 billion, respectively. These fair values are categorized as Level 2 in the fair value hierarchy described in Note 3.

6. Other Noncurrent Liabilities

Other noncurrent liabilities consist of the following:

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Pension obligations <i>(Note 7)</i>	\$ 301,464	\$ 257,096
Postretirement obligation <i>(Note 7)</i>	134,738	142,285
Insurance reserves <i>(Note 8)</i>	292,601	285,197
Deferred compensation <i>(Note 7)</i>	70,299	62,030
Asset retirement obligations <i>(Note 12)</i>	38,621	38,374
Deferred gift annuity	19,187	22,458
All other	7,393	7,761
	\$ 864,303	\$ 815,201

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans

The Institution has a retirement annuity plan which provides eligible staff members with retirement income through individual deferred annuity contracts purchased in each participant's name. In addition, the Institution maintains a nonqualified deferred compensation plan which is used for employer contributions in excess of those allowed by the retirement annuity plan. The effective date of this plan was January 1, 1983, and it has been grandfathered from the changes made by the Tax Reform Act of 1986. The plans' assets are included in assets whose use is limited in the combined balance sheets and consist of money market and mutual funds. The Institution contributes a fixed percentage of an individual's compensation to these plans.

Effective January 1, 2013, the Institution amended an existing 403(b) plan (composed of the basic plan and the voluntary plan) to have a new plan design and be renamed as the Memorial Sloan Kettering Cancer Center Retirement Savings Plan (the RSP). Under the RSP, all Institution employees are eligible to make voluntary employee contributions (salary deferrals), subject to IRS limits. Mandatory employee contributions are not required.

The Institution makes base contributions to the RSP for eligible employees, which depend on the employee's age (determined as of the preceding December 31). Additionally, the Institution matches contributions for voluntary employee contributions made by eligible employees. The Institution's cost for these plans was approximately \$72.9 million and \$63.7 million in 2017 and 2016, respectively.

The Institution also maintains a trustee defined benefit plan (the Plan) for employees not covered by the above retirement annuity plan. The benefits are based on years of service, the employee's average compensation during the highest five of the last ten years of employment and a pension formula. The Plan has been amended and is frozen to new participants hired on or after December 16, 2012.

In October 2017, the Institution entered into a contract and sold approximately \$100.0 million of its anticipated defined benefit pension liabilities to an insurance company via an annuity buy-out. The funding was paid from the Plan assets and only impacted a select group of retirees. These affected participants had no impact to their retirement benefits. In addition, certain participants of the Plan were offered the opportunity to receive the present value of their accrued plan benefits in a single lump-sum payment. The payments reflected a full settlement of all plan liabilities to such participants. These combined activities resulted in a reduction of the Plan liability of \$149.6 million and a \$33.5 million settlement cost for 2017.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

The Institution offers retirees and their spouses hospital and basic medical coverage which supplements any available Medicare coverage. The plan pays the balance of charges not paid by Medicare up to Medicare allowable charges. All employees become eligible for postretirement health care if they retire at age 60 or older, with at least 10 years of service, or under age 60 with 30 years of service. The accounting for the health care plans anticipates future retiree contributions increasing by annual health care cost increases plus 2%. Employees hired after December 31, 2006 are required to pay 100% of the coverage cost.

Effective January 1, 2016, the Institution provides each Medicare-eligible retiree and spouse with a defined contribution amount that can be used to purchase individual Medicare supplemental coverage. This defined contribution replaces the Institution's hospital and basic medical coverage for all Medicare-eligible participants who retire subsequent to December 31, 2006.

The Institution recognizes the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of the defined benefit plans in its combined balance sheets. Net unrecognized actuarial losses and the net unrecognized prior service costs at the reporting date will be subsequently recognized in the future as net periodic benefit cost pursuant to the Institution's accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods will be recognized as a component of unrestricted net assets. Included in unrestricted net assets at December 31, 2017 and 2016 are the following amounts that have not yet been recognized in net periodic benefit cost: unrecognized prior service credit of \$56.7 million and \$63.2 million, respectively, and unrecognized actuarial losses of \$420.2 million and \$306.2 million, respectively. The prior service credit and actuarial loss included in unrestricted net assets and expected to be recognized in net periodic benefit cost during the year ending December 31, 2018 are approximately \$9.0 million and \$16.7 million, respectively.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

The following tables provide a reconciliation of the change in the benefit obligations and fair value of plan assets and funded status of the Institution's pension and postretirement plans:

	Pension Benefits		Postretirement Health	
	December 31		December 31	
	2017	2016	2017	2016
	<i>(In Thousands)</i>			
Reconciliation of benefit obligations				
Benefit obligations at beginning of year	\$1,443,274	\$1,276,912	\$ 146,486	\$ 157,339
Service cost	65,762	61,698	3,997	4,635
Interest cost	67,477	62,821	6,023	7,506
Plan participants' contributions	625	602	1,582	1,751
Actuarial losses (gains)	291,469	81,427	(14,399)	(8,413)
Plan amendment	(2,143)	–	–	(11,687)
Plan settlements	(149,613)	–	–	–
Benefits paid	(26,630)	(38,252)	(4,518)	(4,645)
Expenses paid	(2,329)	(1,934)	–	–
Benefit obligations at end of year	<u>\$1,687,892</u>	<u>\$1,443,274</u>	<u>\$ 139,171</u>	<u>\$ 146,486</u>

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

	Pension Benefits		Postretirement Health	
	December 31		December 31	
	2017	2016	2017	2016
	<i>(In Thousands)</i>			
Reconciliation of fair value of plan assets				
Fair value of plan assets at beginning of year	\$1,186,178	\$ 969,900	\$ —	\$ —
Actual return on plan assets	193,197	89,862	—	—
Employer contributions	185,000	166,000	2,936	2,894
Plan participants' contributions	625	602	1,582	1,751
Plan settlements	(149,613)	—	—	—
Benefits paid	(26,630)	(38,252)	(4,518)	(4,645)
Expenses paid	(2,329)	(1,934)	—	—
Fair value of plan assets at end of year	<u>1,386,428</u>	<u>1,186,178</u>	<u>—</u>	<u>—</u>
Unfunded status at end of year	<u>\$ (301,464)</u>	<u>\$ (257,096)</u>	<u>\$ (139,171)</u>	<u>\$ (146,486)</u>
Current portion of obligation	\$ —	\$ —	\$ (4,433)	\$ (4,201)
Noncurrent portion of obligation	(301,464)	(257,096)	(134,738)	(142,285)
Total	<u>\$ (301,464)</u>	<u>\$ (257,096)</u>	<u>\$ (139,171)</u>	<u>\$ (146,486)</u>

The accumulated benefit obligation for the plans as of December 31, 2017 and 2016 was approximately \$1.45 billion and \$1.29 billion, respectively.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

The following table provides the components of the net periodic cost for pension and postretirement benefit cost for the plans for the years ended December 31:

	Pension Benefits		Postretirement Health	
	2017	2016	2017	2016
	<i>(In Thousands)</i>			
Components of net periodic cost				
Service cost	\$ 65,762	\$ 61,698	\$ 3,997	\$ 4,635
Interest cost	67,477	62,821	6,023	7,506
Expected return on assets	(73,141)	(59,810)	–	–
Settlement cost	33,480	–	–	–
Amortization of net loss	7,132	5,011	2,431	3,545
Amortization of prior service cost (credit)	657	657	(9,310)	(8,160)
Total net periodic cost	\$ 101,367	\$ 70,377	\$ 3,141	\$ 7,526

Actuarial Assumptions

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

	Pension Benefits		Postretirement Health	
	December 31		December 31	
	2017	2016	2017	2016
Discount rate	4.00%	4.75%	3.80%	4.30%
Rate of compensation increase	3.83	3.83	–	–

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

Weighted-average assumptions used to determine net periodic benefit cost are as follows:

	Pension Benefits		Postretirement Health	
	December 31		December 31	
	2017	2016	2017	2016
Discount rate	4.75%	5.00%	4.30%	4.70%
Rate of compensation increase	3.83	3.83	–	–
Expected long-term return on plan assets	5.90	5.90	–	–

The expected return of the portfolio was arrived at using the weighted-average of the expected returns of the underlying benchmark asset classes.

The health care cost trend rate assumptions for the postretirement hospital and basic medical coverage plan at December 31 are as follows:

	2017	2016
Health care cost trend rate assumed for next year	7.25%	7.50%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00	5.00
Year that the rate reaches the ultimate trend rate	2025	2022

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

Effect of Change in Health Care Trends

Assumed health care cost trend rates have a significant effect on the postretirement health amounts reported. A 1% change in assumed health care cost trend rates would have the following effects on postretirement benefit costs:

	2017		2016	
	1% Increase	1% Decrease	1% Increase	1% Decrease
	<i>(In Thousands)</i>			
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	\$ 2,215	\$ (1,720)	\$ 2,576	\$ (1,997)
Effect on the health care component of the accumulated postretirement benefit obligation	24,718	(19,591)	26,165	(20,698)

Plan Assets

The following table presents the weighted-average long-term target asset allocations and the percentages of the fair value of pension plan assets as of December 31:

	Target Allocation 2017	Percentage of Plan Assets	
		2017	2016
U.S.-based equity securities	25%	25%	24%
International equity investments	15	19	18
Fixed income investments	35	33	28
Alternative investments	25	23	30

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

The Plan assets consist of cash and cash equivalents, U.S. equities, fixed income securities, commingled funds, and alternative investments. Alternative investments are listed by their corresponding strategy and holdings include relative value funds, long/short equity funds, merger arbitrage/event driven funds, real estate, credit funds, private debt, and private equity. These investments pursue multiple strategies to diversify risk and reduce volatility.

Equities and real estate investment trusts are valued based on the quoted market prices of the securities as reported on national securities exchanges. Fixed income securities are valued based on readily available market quotations received from commercial pricing services. Such pricing services and brokers will generally provide bid-side quotations. Commingled funds are valued based on the NAV of shares held by the pension plan at year end. Alternative investments are stated at fair value as determined by Morgan Guaranty Trust Company of New York or by the investees. Value may be based on historical cost, appraisals, or other estimates that require varying degrees of judgment. Generally, fair value is stated at NAV, which reflects net contributions to the investee and an ownership share of realized and unrealized investment income and expenses.

The financial statements of the investees are audited annually by independent auditors. These investments may indirectly expose the pension plan to securities lending, short sales of securities, and trading in futures and forward contracts, options, swap contracts and other derivative products. While these financial instruments may contain varying degrees of risk, the pension plan's risk with respect to such transactions is limited to its capital balance in each investment.

The Plan's assets could have liquidity restrictions that range from several months to ten years for certain alternative investments. Liquidity restrictions may apply to all or portions of a particular invested amount. Unfunded commitments for the alternative investments in the pension plan at December 31, 2017 are approximately \$253.9 million.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

Financial instruments of the Plan of the Institution, carried at fair value as of December 31, 2017, are classified in the table below as described in Note 3:

	Level 1	Level 2	Level 3	Total
	<i>(In Thousands)</i>			
Investments measured at fair value				
Cash, cash equivalents, and money market funds	\$ 31,972	\$ –	\$ –	\$ 31,972
U.S. equity investments:				
Equity securities	55,933	–	–	55,933
Real estate investment trusts	2,811	–	–	2,811
Fixed income investments:				
U.S. government and other	13,100	–	–	13,100
Private equity funds	–	–	7,528	7,528
	<u>\$ 103,816</u>	<u>\$ –</u>	<u>\$ 7,528</u>	<u>111,344</u>
Investments measured at NAV as a practical expedient				
Commingled funds:				
U.S. equity				261,536
International equity				268,575
Fixed income				440,986
Alternative investments:				
Relative value funds				4,233
Long/short equity funds				36,208
Merger arbitrage/event driven funds				7,323
Real estate				18,743
Credit funds				121,758
Private debt				17,096
Private equity funds				98,626
Total investments at fair value				<u><u>\$ 1,386,428</u></u>

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

Financial instruments of the Plan of the Institution, carried at fair value as of December 31, 2016, are classified in the table below as described in Note 3:

	Level 1	Level 2	Level 3	Total
	<i>(In Thousands)</i>			
Investments measured at fair value				
Cash, cash equivalents, and money market funds	\$ 21,097	\$ –	\$ –	\$ 21,097
U.S. equity investments:				
Equity securities	45,974	–	–	45,974
Real estate investment trusts	2,391	–	–	2,391
Fixed income investments:				
U.S. government and other	8,332	–	–	8,332
Private equity funds	–	–	3,199	3,199
	<u>\$ 77,794</u>	<u>\$ –</u>	<u>\$ 3,199</u>	<u>80,993</u>
Investments measured at NAV as a practical expedient				
Commingled funds:				
U.S. equity				213,305
International equity				215,422
Fixed income				325,566
Alternative investments:				
Relative value funds				6,062
Long/short equity funds				87,978
Merger arbitrage/event driven funds				16,096
Real estate				17,063
Credit funds				112,758
Private debt				8,211
Private equity funds				102,724
Total investments at fair value				<u><u>\$ 1,186,178</u></u>

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

The following table represents a rollforward of the total plan assets classified by the Institution within Level 3 of the valuation hierarchy defined in Note 3:

	2017	2016
	<i>(In Thousands)</i>	
Fair value at beginning of year	\$ 3,199	\$ 2,012
Acquisitions	3,523	1,250
Unrealized gains	806	(63)
Fair value at end of year	\$ 7,528	\$ 3,199

Plan Objectives and Guidelines

The overall investment objective of the pension trust fund is to outperform a composite benchmark (an asset-weighted series of market indices used to measure the performance of each asset class) over a market cycle, while maintaining similar risk to the benchmark.

The portfolio is diversified to reduce the impact of losses in individual investments in a manner that is responsive to fiduciary standards. Single issuers are limited to 5% of the portfolio's aggregate market value at time of purchase, with the exception of U.S. government and agency securities and commingled funds. The underlying products that comprise a diversified portfolio may have exposure to derivatives which are managed and controlled.

Cash Flows

Contributions: The Institution expects to contribute \$50.0 million to its pension plan in 2018.

Memorial Sloan Kettering Cancer Center
and Affiliated Corporations

Notes to Combined Financial Statements (continued)

7. Retiree Pension and Health Plans (continued)

Estimated future benefit payments: The Institution expects to pay the following benefit payments, which reflect expected future service, as appropriate:

	Pension Benefits	Postretirement Health
	<i>(In Thousands)</i>	
2018	\$ 38,107	\$ 4,433
2019	42,350	4,920
2020	46,682	5,340
2021	51,178	5,834
2022	55,823	6,245
2023 to 2027	361,903	36,057

8. Insurance Programs

MSKI, a domestic tax-exempt corporation, is the primary insurance company for certain insurable risks of the Institution. The primary coverages provided by MSKI to the Institution are health care professional liability, warranty coverage for covered health care equipment, terrorism and assumed coverage for workers' compensation, general liability and certain employee benefits of long-term disability and life insurance. The Institution's liability is limited, with catastrophic risk insured by commercial insurance carriers, or in the case of terrorism risk, by the U.S. Government under a formula established by Federal law.

Insurance reserves of MSKI represent estimated unpaid losses and loss adjustment expenses. Such amounts are established using management's estimates on the basis of claims records and independent actuarial reviews and include an amount for the adverse development of reported claims. Adjustments to the estimate of the liability for losses are reflected in earnings in the period in which the adjustment is determined. The insurance reserves are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may vary significantly from the amount provided. The estimated unpaid professional liability losses and loss adjustment expenses, including losses incurred but not reported at December 31, 2017 and 2016, were approximately \$262.2 million and \$244.5 million, respectively, and are recorded at the actuarially determined present value of approximately \$245.9 million and \$229.6 million, respectively, based on a discount rate of 2.1% in each year.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

9. Operating Leases

The Institution leases certain facilities and equipment which are accounted for as operating leases. Total rent expense for operating leases aggregated approximately \$37.0 million and \$36.5 million for 2017 and 2016, respectively. The future minimum lease commitments for noncancelable leases in excess of one year are as follows (in thousands):

2018	\$ 37,519
2019	35,896
2020	33,314
2021	30,586
2022	27,872
Thereafter	57,279
	<u>\$ 222,466</u>

There are provisions in certain leases which provide for rent escalation for inflation and other items.

In August 2017, the Institution entered into an agreement to lease a building for a 30-year term. The Institution will become liable to make payments upon possession, which is expected to take place in 2019. Total lease payments are approximately \$250.1 million and are excluded from the table above.

10. Grant Awards

The accompanying combined financial statements do not include amounts related to research grants (or portions thereof) that have been awarded to the Institute for which expenditures have not been incurred or cash has not been received. Such grant awards approximated \$116.2 million and \$126.8 million at December 31, 2017 and 2016, respectively.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

11. Royalty and Other Income

Royalty and other income consist of the following:

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Royalty income	\$ 81,491	\$ 167,731
Housing and parking	38,425	37,210
Cafeteria and food service	6,339	5,318
Services provided	5,776	6,013
Other	27,427	26,662
	\$ 159,458	\$ 242,934

12. Commitments and Contingencies

The Institution is involved in various litigation and claims that are not considered unusual given the complexity and size of the Institution's business. Management believes that the ultimate resolution of these matters will not have a material impact on the Institution's combined financial statements.

The Institution recognizes a liability for the future cost of conditional asset retirement obligations, including building modifications and lease end costs. The Institution removes contained asbestos and any applicable radioactive materials from facilities as facilities are being repaired and/or replaced. The Institution has recorded the estimated liability for the cost of asbestos remediation and radiation decommissioning for the Institution's current plans for building modifications and lease end costs of approximately \$38.6 million and \$38.4 million at December 31, 2017 and 2016, respectively.

Memorial Sloan Kettering Cancer Center
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Notes to Combined Financial Statements (continued)

13. Functional Expenses

The functional expenses related to the fulfillment of the Institution's mission for the years ended December 31, 2017 and 2016 are as follows (in thousands):

	Patient Care	Research	Education	Fundraising	Management and General	2017 Total
Compensation and fringe benefits	\$ 1,795,143	\$ 306,216	\$ 193,293	\$ 31,005	\$ 9,475	\$ 2,335,132
Purchased supplies and services	1,190,359	222,090	34,112	32,632	11,961	1,491,154
Depreciation and amortization	195,133	75,661	8,097	1,437	6,817	287,145
Provision for bad debts and regulatory assessments	54,254	-	-	-	-	54,254
Interest	27,991	12,483	-	-	4,869	45,343
Total	\$ 3,262,880	\$ 616,450	\$ 235,502	\$ 65,074	\$ 33,122	\$ 4,213,028

	Patient Care	Research	Education	Fundraising	Management and General	2016 Total
Compensation and fringe benefits	\$ 1,626,915	\$ 275,921	\$ 188,833	\$ 29,511	\$ 9,890	\$ 2,131,070
Purchased supplies and services	1,003,600	232,572	32,876	33,658	9,058	1,311,764
Depreciation and amortization	176,387	73,959	7,846	898	4,874	263,964
Provision for bad debts and regulatory assessments	35,003	-	-	-	-	35,003
Interest	30,616	17,678	-	-	430	48,724
Total	\$ 2,872,521	\$ 600,130	\$ 229,555	\$ 64,067	\$ 24,252	\$ 3,790,525

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