



# Consolidated Financial Report and Supplementary Information

Years Ended August 31, 2019 and 2018  
With Reports of Independent Auditors

Northwestern Memorial HealthCare and Subsidiaries

**NORTHWESTERN MEMORIAL HEALTHCARE AND  
SUBSIDIARIES**

**Consolidated Financial Statements  
and Supplementary Information**

**Years Ended August 31, 2019 and 2018**

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## Report of Independent Auditors

The Board of Directors  
Northwestern Memorial HealthCare

We have audited the accompanying consolidated financial statements of Northwestern Memorial HealthCare and Subsidiaries, which comprise the consolidated balance sheets as of August 31, 2019 and 2018, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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

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

### **Auditor's Responsibility**

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

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

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



## Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Northwestern Memorial HealthCare and Subsidiaries at August 31, 2019 and 2018, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

*Ernst & Young LLP*

December 5, 2019

**Northwestern Memorial HealthCare and Subsidiaries**

**Consolidated Balance Sheets**

*(In thousands)*

	<b>August 31</b>	
	<b>2019</b>	<b>2018</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 329,646	\$ 407,249
Short-term investments	189,444	51,998
Current portion of investments, including assets limited as to use	171,227	148,848
Patient accounts receivable	791,667	769,567
Current portion of pledges and grants receivable, net	17,393	16,107
Current portion of insurance recoverable	17,433	12,642
Inventories	89,147	71,565
Other current assets	158,763	131,284
<b>Total current assets</b>	<b>1,764,720</b>	<b>1,609,260</b>
Investments, including assets limited as to use, less current portion	6,359,161	5,980,955
Property and equipment, at cost:		
Land	379,989	353,975
Buildings	4,406,214	3,970,145
Equipment and furniture	1,515,862	1,353,766
Construction in progress	150,896	126,535
	<b>6,452,961</b>	<b>5,804,421</b>
Less accumulated depreciation	<b>2,487,009</b>	<b>2,221,667</b>
	<b>3,965,952</b>	<b>3,582,754</b>
Prepaid pension cost	71,872	180,063
Pledges and grants receivable, less current portion	49,179	44,856
Insurance recoverable, less current portion	112,040	89,224
Other assets, net	205,207	175,739
<b>Total assets</b>	<b>\$ 12,528,131</b>	<b>\$ 11,662,851</b>

	<b>August 31</b>	
	<b>2019</b>	<b>2018</b>
<b>Liabilities and net assets:</b>		
Current liabilities:		
Accounts payable	\$ 264,896	\$ 239,682
Accrued salaries and benefits	323,647	285,043
Grants and academic support payable, current portion	28,869	33,932
Accrued expenses and other current liabilities	132,905	130,799
Due to third-party payors	598,020	545,759
Current accrued liabilities under self-insurance programs	116,161	105,659
Current maturities of long-term debt	20,735	24,571
Long-term debt subject to short term remarketing	73,836	—
Short-term debt	77,697	27,466
Total current liabilities	<b>1,636,766</b>	1,392,911
Long-term debt, less current maturities	<b>1,636,857</b>	1,394,396
Accrued liabilities under self-insurance programs, less current portion	<b>586,472</b>	541,589
Grants and academic support payable, less current portion	<b>65,120</b>	76,954
Interest rate swaps	<b>120,755</b>	73,350
Other liabilities	<b>208,114</b>	150,502
Total liabilities	<b>4,254,084</b>	3,629,702
Net assets:		
Without donor restrictions:		
Controlling interest	<b>7,819,189</b>	7,607,295
Non-controlling interest in subsidiaries	<b>635</b>	626
Total net assets without donor restrictions	<b>7,819,824</b>	7,607,921
With donor restrictions	<b>454,223</b>	425,228
Total net assets	<b>8,274,047</b>	8,033,149
Total liabilities and net assets	<b>\$ 12,528,131</b>	\$ 11,662,851

*See accompanying notes to the consolidated financial statements.*

Northwestern Memorial HealthCare and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets  
(In thousands)

	Year Ended August 31	
	2019	2018
<b>Revenue</b>		
Patient service revenue	\$ 5,665,736	\$ 4,877,616
Rental and other revenue	355,335	318,660
Net assets released from donor restrictions and federal and state grants	30,957	35,290
Total revenue	<b>6,052,028</b>	5,231,566
<b>Expenses</b>		
Salaries	2,411,575	2,099,172
Employee benefits	350,024	345,548
Supplies	1,230,830	1,000,194
Purchased services	667,198	552,525
Depreciation and amortization	372,310	310,948
Insurance	122,764	112,834
Rent and utilities	105,078	100,814
Repairs and maintenance	131,256	101,960
Interest	60,634	41,027
Illinois Hospital Assessment	154,117	110,339
Other	162,713	180,926
Total expenses	<b>5,768,499</b>	4,956,287
Operating income	<b>283,529</b>	275,279
<b>Nonoperating gains (losses)</b>		
Investment return	57,836	490,971
Contribution of Centegra net assets	74,555	—
Change in fair value of interest rate swaps	(47,405)	31,353
Loss on extinguishment of long term debt	—	(23,990)
Grants and academic support provided	(46,904)	(61,307)
Other	26,133	32,617
Total nonoperating gains, net	<b>64,215</b>	469,644
Excess of revenue over expenses	<b>347,744</b>	744,923
Net gain attributable to non-controlling interest in subsidiaries	<b>1,193</b>	775
Excess of revenue over expenses attributable to NMHC and Subsidiaries	<b>\$ 346,551</b>	\$ 744,148

**Northwestern Memorial HealthCare and Subsidiaries**

**Consolidated Statements of Operations and Changes in Net Assets (continued)**

*(In thousands)*

	<b>Year Ended August 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>Net assets without donor restrictions, controlling interest</b>		
Excess of revenue over expenses	<b>\$ 346,551</b>	\$ 744,148
Net assets released from restrictions used for property and equipment additions	<b>12,567</b>	7,672
Postretirement-benefit-related changes other than net periodic pension cost	<b>(146,907)</b>	33,863
Other	<b>(317)</b>	(10,827)
Increase in net assets without donor restrictions, controlling interest	<b>211,894</b>	774,856
<b>Net assets without donor restrictions, noncontrolling interest</b>		
Excess of revenue over expenses	<b>1,193</b>	775
Distribution to non-controlling interest	<b>(1,118)</b>	(1,243)
Other	<b>(66)</b>	4,693
Increase in net assets without donor restrictions, noncontrolling interest	<b>9</b>	4,225
<b>Net assets with donor restrictions</b>		
Contributions	<b>57,321</b>	55,776
Investment return	<b>16,400</b>	15,389
Net assets released from restrictions used for:		
Operating expenses, charity care, and research and education	<b>(36,142)</b>	(32,208)
Property and equipment additions	<b>(12,567)</b>	(7,672)
Change in fair value of split-interest agreements	<b>(246)</b>	936
Contribution of Centegra net assets with donor restrictions	<b>6,591</b>	—
Other	<b>(2,362)</b>	(2,990)
Increase in net assets with donor restrictions	<b>28,995</b>	29,231
Change in net assets	<b>240,898</b>	808,312
Net assets, beginning of period	<b>8,033,149</b>	7,224,837
Net assets, end of period	<b>\$ 8,274,047</b>	\$8,033,149

*See accompanying notes to the consolidated financial statements.*

**Northwestern Memorial HealthCare and Subsidiaries**

**Consolidated Statements of Cash Flows**  
*(In thousands)*

	<b>Year Ended August 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>Operating activities</b>		
Change in net assets	\$ 240,898	\$ 808,312
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Postretirement benefit-related changes other than net periodic pension cost	146,907	(33,863)
Change in fair value of interest rate swaps	47,405	(31,353)
Loss on extinguishment of long-term debt	—	23,990
Net unrestricted realized investment return and net change in unrestricted and restricted unrealized investment gains/losses	(58,821)	(492,730)
Restricted contributions, change in fair value of split interest agreements, and realized investment return	(72,489)	(70,342)
Contribution of Centegra net assets	(81,146)	—
Depreciation and amortization	372,310	310,948
Changes in operating assets and liabilities:		
Patient accounts receivable	44,127	(53,290)
Due to third-party payors	(1,745)	115,152
Grants and academic support payable	(16,897)	(7,336)
Other operating assets and liabilities	(52,191)	(58,669)
Net cash provided by operating activities	<b>568,358</b>	510,819
<b>Investing activities</b>		
Purchase of investments	(2,947,680)	(2,028,729)
Sale of investments	2,447,463	1,791,936
Cash received from contribution of Centegra	12,406	—
Net unrestricted realized investment return	188,186	205,285
Capital expenditures, net	(386,047)	(432,084)
Net cash used in investing activities	<b>(685,672)</b>	(463,592)
<b>Financing activities</b>		
Proceeds from line of credit	50,231	—
Proceeds from issuance of long-term debt	55,000	790,240
Payments of commercial paper	—	(59,833)
Payments of long-term debt	(138,009)	(699,190)
Restricted contributions, change in fair value of split interest agreements, and realized investment return	72,489	70,342
Net cash provided by financing activities	<b>39,711</b>	101,559
Net (decrease) increase in cash and cash equivalents	<b>(77,603)</b>	148,786
Cash and cash equivalents, beginning of period	407,249	258,463
Cash and cash equivalents, end of the period	<b>\$ 329,646</b>	<b>\$ 407,249</b>

*See accompanying notes to the consolidated financial statements.*

**Notes to Consolidated Financial Statements**

*(In thousands)*

**1. Organization and Summary of Significant Accounting Policies**

Northwestern Memorial HealthCare (NMHC) is the parent of an integrated nonprofit health care organization, anchored by Northwestern Memorial Hospital (NMH) and Northwestern Medical Group (NMG), that provides health care services to communities in northern Illinois. NMHC partners with Northwestern University's Feinberg School of Medicine (FSM) to form an academic medical center, branded as Northwestern Medicine, that is shaping the future of medicine through outstanding patient care, research and training of resident physicians.

**Basis of Presentation**

The accompanying consolidated financial statements include the accounts of NMHC and its subsidiaries (collectively referred to herein as Northwestern Memorial). All significant intercompany transactions and balances have been eliminated in consolidation.

**Charity Care and Community Benefit**

Northwestern Memorial provides care to patients regardless of their ability to pay. Northwestern Memorial developed a Free and Discounted Care Program (the Program) for both the uninsured and the underinsured. Under the Program, patients are offered discounts of up to 100% of charges on a sliding scale, which is based on income as a percentage of the federal poverty level guidelines (up to 600%). The Program also contains provisions that are responsive to those patients subject to catastrophic health care expenses and uninsured patients not covered by the provisions above. Since Northwestern Memorial does not pursue collection of these amounts, they are not reported as Patient service revenue, and the cost of providing such care is recognized within operating expenses.

Northwestern Memorial estimates the direct and indirect costs of providing charity care by applying a cost to gross charges ratio to the gross uncompensated charges associated with providing charity care to patients. The cost of providing charity care was \$71,461 and \$67,146 for the years ended August 31, 2019 and 2018, respectively. Northwestern Memorial also received certain funds of \$426 and \$392 for the years ended August 31, 2019 and 2018, respectively, to offset or subsidize charity care services provided. These funds are primarily received from investment return on free care endowment funds. In the Annual Non Profit Hospital Community Benefits Plan Report filed with the Illinois Attorney General for the year ended August 31, 2018, Northwestern Memorial reported total community benefit of \$846,538 (unaudited), including unreimbursed cost of charity care of \$65,929 (unaudited), which is calculated using a different methodology than that used for the consolidated financial statements. Management is currently collecting the information needed to file the 2019 report; however, it does not expect a material change from the prior year.

**Use of Estimates**

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

**Cash and Cash Equivalents**

Cash and cash equivalents include highly liquid short-term investments with maturities of 90 days or less from the date of purchase.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**1. Organization and Summary of Significant Accounting Policies (continued)**

**Patient Accounts Receivable**

Patient accounts receivable are based upon the estimated amounts expected to be paid from patients and third-party payors.

**Assets Limited as to Use**

Assets limited as to use consist primarily of investments designated for certain medical education and health care programs. The particular Northwestern Memorial corporation that controls these investments makes such designations and may, at its discretion, subsequently use them for other purposes. In addition, assets limited as to use include investments held by trustees under debt agreements and for self-insurance and collateral related to interest rate swaps.

**Investments**

Investments in equity securities with readily determinable fair values and all investments in debt securities are reported at fair value based on quoted market prices. Unless in pension plan assets, alternative investments are reported using the equity method. Alternative investments can include common collective trusts, commingled funds, 103-12 entities and other limited partnership interests in hedge funds, private equity, venture capital and real estate funds. Alternative investments in the pension plan are reported at fair value based on net asset value (NAV) per share or equivalent.

**Derivative Instruments**

Derivative instruments, specifically interest rate swaps, are recorded in the accompanying consolidated balance sheets at fair value. The change in the fair value of derivative instruments is recorded in Nonoperating gains (losses).

**Inventories**

Inventories, consisting primarily of pharmaceuticals and other medical supplies, are stated at the lower of cost on the first-in, first-out method or fair value.

**Property and Equipment**

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets. Generally, buildings and building service equipment have a composite life of approximately 40 years and equipment and furniture have useful lives of 3-20 years. Interest incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

**Other Intangible Assets**

Intangible assets are stated at fair value at time of purchase and are amortized using the straight-line method over the estimated life based on terms of the underlying agreement giving rise to the intangible.

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**1. Organization and Summary of Significant Accounting Policies (continued)**

**Asset Impairment**

Northwestern Memorial considers whether indicators of impairment are present and performs the necessary tests to determine if the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating income at the time the impairment is identified. There were no impairments of long-lived assets for the years ended August 31, 2019 and 2018.

**Deferred Charges**

Deferred finance charges and bond discounts or premiums are amortized or accreted using the effective interest method or the bonds outstanding method, which approximates the effective interest method, over the life of the related debt and are netted within Long-term debt, less current maturities in the accompanying consolidated balance sheets.

**Net Assets**

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

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

Net Assets With Donor Restrictions - Net assets subject to donor imposed restrictions. Some donor-imposed restrictions are temporary in nature, such as those that will be met by the passage of time or other events specified by the donor. Other donor imposed restrictions are perpetual in nature, where the donor stipulates that resources be maintained in perpetuity. Gifts of long-lived assets and gifts of cash restricted for the acquisition on long-lived assets are recognized as revenue when received. Donor imposed restrictions are released when a restriction expires, that is, when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both.

Any changes in donor restrictions that change the net asset category of previously recorded contributions are recorded as Other in the accompanying consolidated statements of operations and changes in net assets in the period communicated by the donor.

**Patient Service Revenue**

Northwestern Memorial has agreements with third-party payors that provide for payments to Northwestern Memorial at amounts different from its established rates. Payment arrangements include prospectively determined rates per admission or visit, reimbursed costs, discounted charges and per diem rates. Patient service revenue is reported at the estimated amount due from patients and third-party payors for services rendered, including estimated adjustments under reimbursement agreements with third-party payors, certain of which are subject to audit by administering agencies. These adjustments are accrued on an estimated basis and are adjusted, as needed, in future periods.

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**1. Organization and Summary of Significant Accounting Policies (continued)**

**Rental and Other Revenue**

Rental and other revenue is recognized at an amount that reflects the consideration Northwestern Memorial expects to be entitled to in exchange for providing goods and services. The amounts recognized reflect consideration due from customers, third-party payors and others. Primary categories of other revenue include pharmacy revenue, grant revenue, corporate billing, rent and lease revenue and other.

**Contributions**

Unrestricted gifts, other than long-lived assets, are included within Rental and other revenue in the accompanying consolidated statements of operations and changes in net assets. Unrestricted gifts of long-lived assets, such as land, buildings or equipment, are recorded at fair value as an increase in net assets without donor restrictions. Contributions are reported as assets with donor restrictions if they are received with donor restrictions. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, assets with donor restrictions are reclassified as assets without donor restrictions and reported in the accompanying consolidated statements of operations and changes in net assets as net assets released from restrictions.

Unconditional promises to give cash or other assets are reported as pledges receivable and contributions within the appropriate net asset category. An allowance for uncollectible pledges receivable is estimated based on historical experience and other collection indicators. Pledges receivable with payment terms extending beyond one year are discounted using market rates of return reflecting the terms and credit of the pledges at the time a pledge is made.

Northwestern Memorial is a beneficiary of several split-interest agreements, primarily perpetual trusts held by others, and recognizes its interest in these perpetual trusts as net assets with donor restrictions based on its percentage of the fair value of the trusts' assets.

**Nonoperating Gains (Losses)**

Nonoperating gains (losses) consist primarily of investment returns (including realized and unrealized gains and losses, changes in Northwestern Memorial's equity interest in alternative investments, interest and dividends), contributions of net assets without donor restrictions in excess of consideration paid (where applicable), grants and academic support provided to external organizations, net assets released from restrictions and used for grants and academic support, changes in fair value of interest rate swaps and loss on extinguishment of debt.

**Excess of Revenue Over Expenses**

The accompanying consolidated statements of operations and changes in net assets include the Excess of revenue over expenses. Changes in net assets without donor restrictions, which are excluded from the Excess of revenue over expenses, consist primarily of contributions of long-lived assets (including assets acquired using contributions, which, by donor restriction, are to be used for the purposes of acquiring such assets), transfers between net asset categories based on changes in donor restrictions and Postretirement benefit-related changes other than net periodic pension cost.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**1. Organization and Summary of Significant Accounting Policies (continued)**

**New Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 converged and replaced existing revenue recognition guidance, including industry specific guidance, and requires an entity to 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. An entity should disclose sufficient information to enable the financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. On September 1, 2018, this standard was adopted by Northwestern Memorial on a full retrospective basis. The adoption of the new accounting standard impacted the presentation of the consolidated statement of operations for a significant component of its provision for bad debts. Subsequent to the adoption of the new standard, the majority of what was previously classified as the provision for bad debts is now reflected as an implicit price concession, as defined in the standard, and therefore a reduction to patient revenue. Northwestern Memorial will consider certain changes in collectibility of its self-pay patient accounts receivable resulting from certain credit and collection issues not assessed at the date of service and recognize such amounts in the provision for bad debts included in Other operating expenses on the consolidated statement of operations and changes in net assets. The prior year consolidated financial statements presented were adjusted to reflect these changes. The adoption of the standard resulted in no material impact to the financial position, results of operations or cash flows.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which will require lessees to put most leases on their balance sheets but recognize expenses on their income statements in a manner similar to existing accounting standards. The guidance also eliminates current real estate-specific provisions for all entities. This new guidance is effective for the fiscal years and interim periods within those fiscal years beginning after December 15, 2018, with early adoption permitted. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is prohibited. Northwestern Memorial is finalizing its analysis of certain key assumptions that will be utilized to transition to this guidance on the effective date, including discount rates. The primary effect of adopting this guidance will be the recognition of right-of-use assets and obligations for current operating leases.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. ASU 2016-14 will change certain financial statement requirements for not-for-profit (NFP) entities in the scope of Topic 958 in an effort to make the information more meaningful to users and make reporting less complex. NFP entities will no longer be required to distinguish between resources with temporary and permanent restrictions on the face of the financial statements. Additionally, NFP entities will be required to present expenses by their natural and functional classification, present investment returns net of external and direct internal investment expenses, and add additional disclosures. On August 31, 2019, this standard was adopted by Northwestern Memorial on a retrospective basis, having no impact to the financial position, results of operations or cash flows.

In March 2017, the FASB issued ASU 2017-07, *Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which changes the presentation of periodic benefit cost components. Under ASU 2017-07, service costs will continue to be presented within operating expenses but amortization of prior service credits and other components of net periodic benefit cost will be presented within Nonoperating gains (losses) in the consolidated statements of operations and changes in net assets. Northwestern Memorial has evaluated the effect of this guidance on the

Notes to Consolidated Financial Statements (continued)

(In thousands)

**1. Organization and Summary of Significant Accounting Policies (continued)**

consolidated financial statements and has determined that this guidance will reduce Operating income but will have no effect on Excess of revenue over expenses. On September 1, 2018, this standard was adopted by Northwestern Memorial on a retrospective basis having restated the prior period consolidated statement of operations and changes in net assets.

In June 2018, the FASB issued ASU 2018-08, *Not-for-Profit Entities (Topic 958) - Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made*. ASU 2018-08 provides a more robust framework to determine when a transaction should be accounted for as a contribution or as an exchange transaction and provides additional guidance about how to determine whether a contribution is conditional. On September 1, 2018, this statement was adopted by Northwestern Memorial on a modified prospective basis resulting in no impact to the financial position, results of operations or cash flows.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. ASU 2018-13 eliminates certain disclosure requirements for fair value measurements for all entities, requires public entities to disclose certain new information and modifies some disclosure requirements. This new guidance is effective for fiscal years beginning after December 15, 2019. This guidance is to be applied retrospectively and early adoption is permitted. Northwestern Memorial is currently evaluating the impact this guidance will have on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-14, *Compensation - Retirement Benefits - Defined Benefit Plans (Subtopic 715-20): Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans*. ASU 2018-14 makes minor changes to the disclosure requirements for employers that sponsor defined benefit and other postretirement benefit plans. This guidance is effective in fiscal years beginning after December 15, 2021. This guidance is to be applied retrospectively and early adoption is permitted. Northwestern Memorial is currently evaluating the impact this guidance will have on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-15, *Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract*. ASU 2018-15 requires customers in a cloud computing agreement that is a service contract to follow the internal use software guidance Accounting Standards Codification (ASC) 350-40 to determine which implementation costs to capitalize as assets. This guidance is effective in fiscal years beginning after December 15, 2021. This guidance is to be applied prospectively and early adoption is permitted. Northwestern Memorial is currently evaluating the impact this guidance will have on its consolidated financial statements.

**2. Reclassifications**

Certain reclassifications have been made to the 2018 consolidated financial statements to conform with classifications used in 2019. The reclassifications had no effect on total assets, total liabilities, total revenue or total revenue in excess of expenses previously reported.

**3. Affiliation Agreement with Centegra**

On September 1, 2018, Centegra Health System (Centegra) became a wholly owned subsidiary of NMHC pursuant to an affiliation agreement between NMHC and Centegra. This affiliation positions Northwestern Memorial, under the Northwestern Medicine brand, to expand its integrated academic health delivery system to McHenry County, offering patients access to leading-edge care closer to where they live and work.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**3. Affiliation Agreement with Centegra (continued)**

The affiliation was effected through a membership substitution with no consideration paid. For accounting purposes, this transaction is considered an acquisition under ASC 958-805, *Not-for-Profit Entities: Business Combinations*, and a contribution was recorded for the estimated fair value of assets, net of liabilities of Centegra. Northwestern Memorial has reflected the results of all third party valuations received in the consolidated financial statements.

The acquisition-date estimated fair value of identifiable assets and liabilities of Centegra at September 1, 2018 consisted of the following:

Fair Value of identifiable net assets:	
Cash and cash equivalents	\$ 12,406
Other current assets	114,779
Property and equipment	362,312
Other long-term assets	161,038
Current liabilities	(129,273)
Long-term debt	(397,494)
Other long-term liabilities	(42,622)
Net assets with donor restrictions	(6,591)
Contribution of net assets without donor restrictions	<u>\$ 74,555</u>

The valuation of property and equipment; other current and long-term assets, including identifiable intangible assets and current and long-term liabilities has been completed. In valuing these assets and liabilities, fair values were based on, but not limited to, independent appraisals, discounted cash flows, replacement costs and actuarially determined values.

Operating expenses for the year ended August 31, 2019 include costs related to the integration of Centegra into Northwestern Memorial, including transition costs of benefit plans, incentive plans and operating programs with other health practitioners, as well as costs of valuation and integration consulting.

Following are the unaudited operating results and changes in net assets attributable to Centegra for the year ended August 31, 2019 included in the accompanying consolidated statement of operations and changes in net assets:

	<b>2019</b>
Total operating revenue	<u>\$ 541,837</u>
Deficiency of revenue over expenses	(9,373)
Change in net assets without donor restrictions	(3,482)
Change in net assets with donor restrictions	(734)

Notes to Consolidated Financial Statements (continued)

(In thousands)

**3. Affiliation Agreement with Centegra (continued)**

Following are the unaudited pro forma results as if the Centegra affiliation had occurred on September 1, 2017:

	<u>2018</u>
Total operating revenue	\$ 5,798,393
Operating income	221,825
Excess of revenue over expenses attributable to NMHC and subsidiaries	706,613

The pro forma information provided should not be construed to be indicative of Northwestern Memorial's results of operations had the acquisition been consummated on September 1, 2017, and is not intended to project Northwestern Memorial's results of operations for any future period.

**4. Patient Service Revenue**

Northwestern Memorial recognizes Patient service revenue at the amount that reflects the consideration expected to be paid for providing patient care. Patient service revenue is recognized as performance obligations based on the nature of the services provided by Northwestern Memorial are satisfied. Performance obligations satisfied over time relate to patients in Northwestern Memorial hospitals receiving inpatient acute care services from admission to the point when services are no longer required, which is generally at the time of discharge. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred in relation to total expected or actual charges. Outpatient services are performance obligations satisfied at a point in time and revenue is recognized when goods or services are provided and Northwestern Memorial does not believe it is required to provide additional goods or services. Management believes this method provides a fair depiction of the transfer of services over the term of performance obligations based on the inputs needed to satisfy the obligations.

Northwestern Memorial has elected to apply the optional exemption provided in FASB ASC 606-10-50-14(a) because all of its performance obligations relate to contracts with a duration of less than one year. Therefore, Northwestern Memorial is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially satisfied at the end of the reporting period. The unsatisfied or partially unsatisfied performance obligations referred to above are primarily related to inpatient acute care services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period.

Northwestern Memorial uses a portfolio approach to account for categories of patient contracts as a collective group rather than recognizing revenue on an individual contract basis. The portfolios consist of major payor classes for inpatient revenue and major payor classes and types of services provided for outpatient revenue. Based on the historical collection trends and other analysis, Northwestern Memorial believes that revenue recognized by utilizing the portfolio approach approximates the revenue that would have been recognized if an individual contract approach were used.

Northwestern Memorial determines the transaction price, which involves significant estimates and judgment, based on standard charges for goods and services provided, reduced by explicit and implicit price concessions, including contractual adjustments provided to third-party payors, discounts provided to uninsured and underinsured patients in accordance with policy and/or implicit price concessions based on the historical

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 4. Patient Service Revenue (continued)

collection experience of patient accounts. Northwestern Memorial determines the transaction price associated with services provided to patients who have third-party payor coverage with Medicare, Medicaid, Blue Cross, other managed care programs and other third-party payors based on reimbursement terms per contractual agreements, discount policies and historical experience. Payment arrangements with those payors include prospectively determined rates per admission or visit, reimbursed costs, discounted charges per diem rates and value based care agreements. Reported costs and/or services provided under certain of the arrangements are subject to retroactive audit and adjustment. Patient service revenue decreased by \$9,630 and increased by \$7,176 in 2019 and 2018, respectively, as a result of changes in estimates due to settlements of prior fiscal years' cost reports and the disposition of other payor audits and settlements. Future changes in Medicare and Medicaid programs and reduction in funding levels could have an adverse effect on Northwestern Memorial. There were no other significant changes to the judgements used to determine the transaction price in prior periods.

Northwestern Memorial also provides care to self-pay patients. Under its Financial Assistance Policy (the Policy), Northwestern Memorial provides medically necessary care to patients in its community with inadequate financial resources at discounts of up to 100% of charges using a sliding scale that is based on patient household income as a percentage (up to 600%) of the federal poverty level guidelines. The Policy also contains a catastrophic financial assistance provision that limits a patient's total financial responsibility to Northwestern Memorial. Since Northwestern Memorial does not pursue collection of these amounts, the values are reported net of price concessions. Northwestern Memorial uses presumptive eligibility screening procedures for free care and recognizes Patient service revenue on services provided to self-pay patients at a reduced transaction price at the time services are rendered.

In certain instances, Northwestern Memorial receives payment in advance of the services provided and considers these amounts to represent contract liabilities. Contract liabilities at August 31, 2019 were not material.

Management has determined that the nature, amount, timing and uncertainty of revenue and cash flows are affected by the payors and line of business that renders services to patients. The composition of Patient service revenue by payor was as follows for the years ended August 31:

	<u>2019</u>	<u>2018</u>
Patient service revenue:		
Medicare	\$ 1,541,055	\$ 1,211,663
Medicaid	458,257	412,344
Blue Cross	2,224,456	1,854,197
Other managed care	1,257,371	1,229,246
Commercial and other	145,827	113,748
Self pay	38,770	56,418
Total Patient service revenue	<u>\$ 5,665,736</u>	<u>\$ 4,877,616</u>

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 4. Patient Service Revenue (continued)

The composition of the Patient service revenue by service line was as follows for the years ended August 31:

	<u>2019</u>	<u>2018</u>
Hospitals	\$ 4,412,120	\$ 3,777,877
Physician groups	1,190,264	1,011,102
Other	63,352	88,637
Total	<u>\$ 5,665,736</u>	<u>\$ 4,877,616</u>

Northwestern Memorial grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. At August 31, 2019 and 2018, patient accounts receivable, including patient co-pays and deductibles by major primary payor source, were as follows:

	<u>2019</u>	<u>2018</u>
Medicare	18%	18%
Medicaid	11	11
Blue Cross	23	22
Other managed care	22	25
Commercial and other	7	7
Self pay	19	17
	<u>100%</u>	<u>100%</u>

## 5. Illinois Hospital Assessment Program

In December 2008, the Illinois Hospital Assessment Program was approved by the Federal Centers for Medicare and Medicaid Services (CMS) for the period from July 1, 2008 through June 30, 2013. In July 2012, this program was extended to December 31, 2014 as part of the Save Medicaid Access and Resources Together (SMART) Act. In June 2014, this program was extended to June 30, 2018 as part of the Omnibus Medicaid Bill Senate Bill 741. In October 2013, the Enhanced Illinois Hospital Assessment Program as authorized under Illinois Public Act 97-688 was approved by CMS retroactive to June 10, 2012. Together, these two programs are referred to herein as (HAP). Under HAP, the state receives additional federal Medicaid funds for the State's healthcare system, administered by the Illinois Department of Healthcare and Family Services. HAP includes payments to NMHC hospitals from the state and assessments against NMHC hospitals, which are paid to the state in the same year.

In June 2014, Omnibus Medicaid Bill Senate Bill 741 authorized a new supplemental program (Access Program) to cover new Medicaid beneficiaries under the Affordable Care Act (ACA), which was approved by CMS in January 2015. In May 2016, the State of Illinois passed HB 4678 (Expanded Access Program), which implemented a framework to increase ACA access funds to Illinois hospitals. The new ACA access funds are attributable to the ACA adults enrolled in managed care products. In September 2016, the Illinois Department of Family and Healthcare Services submitted its certification of the new Medicaid managed care organization rates to CMS.

HAP and the Expanded Access Program were to end on June 30, 2018. In June 2018, the Illinois General Assembly approved SB 1773, which was signed by the Governor and is now Illinois Public Law 100-581; the law as amended redesigns both programs and were replaced with a new program approved by CMS on June 20, 2018. Supplemental payments for the new HAP program began in July 2018 and are reflected below. In addition to

## Notes to Consolidated Financial Statements (continued)

*(In thousands)***5. Illinois Hospital Assessment Program (continued)**

the supplemental payments, the new HAP program provides for increased Illinois Medicaid and Illinois Medicaid Managed Care inpatient rates.

A summary of the amounts recognized for the HAP and Access programs is as follows:

	<b>Year Ended August 31</b>	
	<b>2019</b>	<b>2018</b>
Patient service revenue:		
HAP	<b>\$ 193,262</b>	\$ 123,455
Access Program	—	15,843
Expanded Access Program	—	20,393
	<b>193,262</b>	159,691
Illinois Hospital Assessment	<b>154,117</b>	110,339
Net excess of HAP and ACA revenue over Illinois assessment	<b>\$ 39,145</b>	\$ 49,352

**Northwestern Memorial HealthCare and Subsidiaries**

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**6. Investments and Other Financial Instruments**

The composition of investments, including assets limited as to use, and cash and cash equivalents and short-term investments, at August 31 is as follows:

	<u>2019</u>	<u>2018</u>
Measured at fair value:		
Cash and cash equivalents and Short-term investments	\$ 831,630	\$ 502,382
Mutual funds	230,611	262,719
Corporate bonds	362,382	305,081
U.S. government and agency issues	293,987	258,970
Equity securities	48,794	222,356
Other fixed income	12,459	23,926
	<u>1,779,863</u>	<u>1,575,434</u>
Measured at net asset value as practical expedient:		
Common collective trusts and commingled funds	786,767	765,371
Interest in 103-12 investment entities	325,607	297,217
	<u>1,112,374</u>	<u>1,062,588</u>
Accounted for under the equity method:		
Alternative investments	4,157,241	3,951,028
	<u>\$ 7,049,478</u>	<u>\$ 6,589,050</u>

Investments, including assets limited as to use, and cash and cash equivalents and short-term investments, consist of the following at August 31:

	<u>2019</u>	<u>2018</u>
Assets limited as to use:		
Trustee-held funds	\$ 22,151	\$ 651
Self-insurance programs	651,177	627,438
Board-designated funds	202,649	190,188
Total assets limited as to use	<u>875,977</u>	<u>818,277</u>
Donor-restricted funds	387,665	360,442
Unrestricted, undesignated funds	5,266,746	4,951,084
Total investments, excluding short-term investments	<u>6,530,388</u>	<u>6,129,803</u>
Other financial instruments:		
Cash and cash equivalents and short-term investments	519,090	459,247
	<u>\$ 7,049,478</u>	<u>\$ 6,589,050</u>

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 6. Investments and Other Financial Instruments (continued)

The composition and presentation of investment returns are as follows for the years ended August 31:

	2019	2018
Interest and dividend income	\$ 46,425	\$ 27,373
Investment expenses	(4,741)	(4,683)
Realized gains on alternative investments, net	83,953	98,365
Realized gains on other investments, net	81,238	97,782
Net change in unrealized gains on alternative investments	1,495	246,963
Net change in unrealized gains on other investments	(130,836)	40,872
Change in value of joint ventures	1,820	77
	<u>\$ 79,354</u>	<u>\$ 506,749</u>
Reported as:		
Rental and other revenue	\$ 5,118	\$ 389
Nonoperating investment return	57,836	490,971
With donor restriction investment return	16,400	15,389
	<u>\$ 79,354</u>	<u>\$ 506,749</u>

Northwestern Memorial's investments measured at fair value include mutual funds; common equities; corporate and U.S. government debt issues; state, municipal and foreign government debt issues; commingled funds; common collective trusts; and 103-12 entities.

Commingled investments, common collective trusts and 103-12 entities are commingled funds formed from the pooling of investments under common management. Unlike a mutual fund, these investments are not registered investment companies and, therefore, are exempt from registering with the Securities and Exchange Commission.

The investment strategy for the mutual funds, commingled funds, common collective trusts and 103-12 entities involves maximizing the overall long-term return by investing in a wide variety of assets, including domestic large cap equities, domestic small cap equities, international developed equities, blended equities, (i.e., a mix of domestic and international equities), natural resources and private investment limited partnerships (LPs).

Northwestern Memorial's non-pension plan investments measured under the equity method of accounting include absolute return hedge funds, equity long/short hedge funds, real estate, natural resources and LPs, collectively referred to as alternative investments. Alternative investments in the pension plan assets are measured at fair value.

Absolute return hedge funds include funds with the ability to opportunistically allocate capital among several strategies. Generally, these funds diversify across strategies in an effort to deliver consistently positive returns regardless of the movement within global markets, exhibit relatively low volatility and are redeemable quarterly with a 60-day notice period. Equity long/short hedge funds include hedge funds that invest both long and short in U.S. and international equities. These funds typically focus on diversifying or hedging across particular sectors, regions or market capitalizations and are generally redeemable quarterly with a 60-day notice period. Absolute return and equity long/short managers are redeemable quarterly or annually with a 45- to 90-day notice period.

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**6. Investments and Other Financial Instruments (continued)**

Real estate includes LPs that invest in land and buildings and seek to improve property level operations by increasing lease rates, recapitalizing properties, rehabilitating aging/distressed properties, and repositioning properties to maximize revenue. Real estate LPs typically use moderate leverage. Natural resources include a diverse set of LPs that invest in oil and natural gas-related companies, commodity-oriented companies, and timberland. Private equity includes LPs formed to make equity and debt investments in operating companies that are not publicly traded. These LPs typically seek to influence decision-making within the operating companies. Investment strategies in this category may include venture capital, buyouts and distressed debt. These three categories of investments cannot be redeemed with the funds. Distributions from each fund will be received as the underlying assets of the fund are expected to be liquidated periodically over the lives of the LPs, which generally run 10 to 12 years.

Because of the timing of the preparation and delivery of financial statements for limited partnership investments, the use of the most recently available financial statements provided by the general partners results in a two month delay in the inclusion of the limited partnership results in Northwestern Memorial's consolidated statements of operations and changes in net assets due to results recorded based on June 30 investment statements. Due to this delay, these consolidated financial statements do not yet reflect the market conditions experienced in the last two months of the fourth quarter of fiscal 2019 or 2018 for the limited partnership investments.

As of August 31, 2019, \$2,942,236 of alternative investments is subject to various redemption limits and lockup provisions, of which \$2,512,996 expires within one year and \$429,240 expires after one year from the balance sheet date.

At August 31, 2019, Northwestern Memorial had commitments to fund approximately an additional \$789,885 to alternative investment entities. This funding is expected to occur over the next 12 years.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**7. Fair Value Measurements**

Northwestern Memorial follows the requirements of ASC 820, *Fair Value Measurement*, in regards to measuring the fair value of certain assets and liabilities, as well as disclosures about fair value measurements. ASC 820 defines fair value as the price that would be received for an asset or paid for a transfer of a liability in an orderly transaction on the measurement date.

The methodologies used to determine the fair value of assets and liabilities reflect market participant objectives and are based on the application of a three-level valuation hierarchy that prioritizes observable market inputs over unobservable inputs. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Examples of Level 2 inputs are quoted prices for similar assets or liabilities in inactive markets or pricing models with inputs that are observable for substantially the full term of the asset or liability.
- Level 3 – Inputs to the valuation methodology are significant to the fair value of the asset or the liability and less observable. These inputs reflect the assumptions market participants would use in the estimation of the fair value of the asset or liability.

**Fair Values**

A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement.

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 7. Fair Value Measurements (continued)

The following table presents the financial instruments measured at fair value on a recurring basis at August 31, 2019:

	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Cash and cash equivalents	\$ 329,646	\$ —	\$ —	\$ 329,646
Investments:				
Short-term investments:				
Currency	15,964	—	—	15,964
Fixed Income	173,480	—	—	173,480
Total short-term investments	189,444	—	—	189,444
Mutual funds:				
Fixed income	58,902	—	—	58,902
U.S. equities	171,709	—	—	171,709
Total mutual funds	230,611	—	—	230,611
Other fixed income	—	12,459	—	12,459
Bonds:				
Corporate bonds	—	362,382	—	362,382
U.S. government and agency issues	—	293,987	—	293,987
Total bonds	—	656,369	—	656,369
Equity securities	48,794	—	—	48,794
Cash equivalents in investment accounts	312,540	—	—	312,540
Total investments	781,389	668,828	—	1,450,217
Beneficial interest in trusts	—	16,987	—	16,987
Total assets	\$ 1,111,035	\$ 685,815	\$ —	1,796,850
Investments recorded at fair value based on NAV				1,112,374
Total assets measured at fair value				\$ 2,909,224
<b>Liabilities:</b>				
Interest rate swaps	\$ —	\$ 120,755	\$ —	\$ 120,755

Northwestern Memorial HealthCare and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(In thousands)

7. Fair Value Measurements (continued)

The following table presents the financial instruments measured at fair value on a recurring basis at August 31, 2018:

	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Cash and cash equivalents	\$ 407,249	\$ —	\$ —	\$ 407,249
Investments:				
Short-term investments:				
Currency	15,136	—	—	15,136
Fixed Income	36,862	—	—	36,862
Total short-term investments	51,998	—	—	51,998
Mutual funds:				
Fixed income	95,944	—	—	95,944
U.S. equities	166,775	—	—	166,775
Total mutual funds	262,719	—	—	262,719
Other fixed income	—	23,926	—	23,926
Bonds:				
Corporate bonds	—	305,081	—	305,081
U.S. government and agency issues	—	258,970	—	258,970
Total bonds	—	564,051	—	564,051
Equity securities	221,948	408	—	222,356
Cash equivalents in investment accounts	43,135	—	—	43,135
Total investments	579,800	588,385	—	1,168,185
Beneficial interest in trusts	—	15,048	—	15,048
Total assets	\$ 987,049	\$ 603,433	\$ —	1,590,482
Investments recorded at fair value based on NAV				1,062,588
Total assets measured at fair value				\$ 2,653,070
<b>Liabilities:</b>				
Interest rate swaps	\$ —	\$ 73,350	\$ —	\$ 73,350

There were no transfers into or out of Level 1 or Level 2 during the years ended August 31, 2019 or 2018.

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 7. Fair Value Measurements (continued)

## Reconciliation to the Consolidated Balance Sheets

A reconciliation of the fair value of financial assets to the consolidated balance sheets at August 31 is as follows:

	2019	2018
Short-term investments measured at fair value	\$ 189,444	\$ 51,998
Investments, including assets limited as to use measured at fair value	2,373,147	2,178,775
Total investments at fair value	2,562,591	2,230,773
Alternative investments accounted for under equity method included in investments, including assets limited as to use	4,157,241	3,951,028
Total investments	\$ 6,719,832	\$ 6,181,801
Pledges and grants receivable, less current portion:		
Beneficial interests in trusts at fair value	\$ 16,987	\$ 15,048
Pledges and grants receivable, less current portion, net	32,192	29,808
Total pledges and grants receivable, less current portion	\$ 49,179	\$ 44,856

## Valuation Techniques and Inputs

*Beneficial Interests in Trusts* - The fair value of beneficial interests in trusts is based on Northwestern Memorial Foundation's (the Foundation) percentage of the fair value of the trusts' assets adjusted for any outstanding liabilities (discounted using a rate per Internal Revenue Service (IRS) regulations), based on each trust arrangement.

*Interest Rate Swaps* - The fair value of interest rate swaps is based on generally accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative and quoted prices from dealer counterparties and other independent market sources. The valuation incorporates observable interest rates and yield curves for the full term of the swaps. The valuation is also adjusted to incorporate nonperformance risk for NMHC or the respective counterparty. The adjustment is based on the credit spread for entities with similar credit characteristics as NMHC or market-related data for the respective counterparty. Northwestern Memorial pays various fixed rates and receives cash flows based on rates equal to a percentage of the London Interbank Offered Rate (LIBOR) plus a spread for certain interest rate swaps.

*Investments* - The fair value of Level 1 investments, which consist of equity securities and mutual funds, is based on quoted market prices that are valued on a daily basis. Level 2 investments consist of U.S. equities, government and agencies' issues and corporate bonds, and fixed income instruments issued by municipalities and foreign government. The fair value of the U.S. government and agencies' issues and corporate bonds is established based on values obtained from nationally recognized pricing services that value the investments based on similar securities and matrix pricing of similar quality and maturity securities. The fair values of commingled funds, common collective trusts and 103-12 entities are based on the ownership interest in the NAV per share or its equivalent, of the respective fund.

Northwestern Memorial's investments are exposed to various kinds and levels of risk. Equity securities and equity mutual funds expose Northwestern Memorial to market risk, performance risk and liquidity risk. Market

Notes to Consolidated Financial Statements (continued)

(In thousands)

**7. Fair Value Measurements (continued)**

risk is the risk associated with major movements of the equity markets. Performance risk is the risk associated with a company's operating performance. Fixed income securities and fixed income mutual funds expose Northwestern Memorial to interest rate risk, credit risk and liquidity risk. As interest rates change, the value of many fixed income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness of market participants to buy and sell particular securities. Liquidity risk tends to be higher for equities related to small capitalization companies and certain alternative investments. Due to the volatility in the capital markets, there is a reasonable possibility of subsequent changes in fair value, resulting in additional gains and losses in the near term.

The carrying values of cash and cash equivalents, accounts receivable, current portion of pledges and grants receivable, accounts payable, accrued expenses and other current liabilities and short-term borrowings are reasonable estimates of their fair values due to their short-term nature.

The fair value of the long-term debt portfolio, including the current portion, was \$1,810,449 and \$1,434,210 at August 31, 2019 and 2018 respectively. The fair value of this Level 2 liability is based on quoted market prices for the same or similar issues and the relationship of those bond yields with various market indices. The market data used to determine yield and calculate fair value represents Aa/AA-rated tax-exempt municipal health care bonds. The effect of third-party credit valuation adjustments, if any, is immaterial.

The fair value of pledges receivable, a Level 2 asset, is based on discounted cash flow analysis and approximates the carrying value of \$44,992 and \$46,791 at August 31, 2019 and 2018, respectively.

**8. Investment in Joint Ventures**

Northwestern Memorial has joint venture and operating partnership investment interests, ranging from 25.5% to 50.0% in health-related businesses, as well as a 33.3% restricted interest in two non-health-related businesses that were donated to Northwestern Memorial. These investment interests are accounted for under the equity method of accounting, as Northwestern Memorial holds a 20% or more voting interest. The carrying value of the non-health-related investments of \$6,671 and \$6,919 at August 31, 2019 and 2018, respectively, is included in Investments, including assets limited to use, less current portion in the accompanying consolidated balance sheets.

The carrying value of the health-related investments of \$28,075 and \$21,733 at August 31, 2019 and 2018, respectively, is included in Other assets, net in the accompanying consolidated balance sheets. Net equity earnings from the health-related investments totaled \$1,820 and \$77 for the years ended August 31, 2019 and 2018, respectively, and are included in Investment return in the accompanying consolidated statements of operations and changes in net assets. The carrying value of these investments exceeds the underlying equity in net assets by \$10,809, reflecting the fair value change recorded at the time of acquisition of CDH-Delnor Health System (Cadence), KishHealth System (KishHealth) and Centegra.

**Northwestern Memorial HealthCare and Subsidiaries**

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**8. Investment in Joint Ventures (continued)**

The following is a summary of financial information as of and for the years ended August 31 relating to these investments:

	<b>2019</b>		<b>2018</b>
Current assets	\$ 61,712	\$	72,792
Current liabilities	<b>7,449</b>		31,884
Net working capital	<b>54,263</b>		40,908
Property, plant, and equipment	<b>37,548</b>		36,734
Other long-term assets	<b>636</b>		3,187
Long-term liabilities	<b>31,327</b>		32,665
Net assets	<b>\$ 61,120</b>	\$	48,164
Revenue	\$ 58,722	\$	38,584
Expenses	<b>48,273</b>		32,163
Excess of revenue over expenses	<b>\$ 10,449</b>	\$	6,421

Net equity earnings from the non-health-related investments totaled \$986 and \$1,758 for the years ended August 31, 2019 and 2018, respectively, and are included in Net assets with donor restrictions investment return in the accompanying consolidated statements of operations and changes in net assets. Northwestern Memorial made no capital contributions to such joint ventures for the years ended August 31, 2019 and 2018. Northwestern Memorial received cash distributions from such joint ventures of \$3,566 and \$3,478 for the years ended August 31, 2019 and 2018, respectively.

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 9. Long-Term Debt

Long-term debt consists of the following at August 31:

	<b>2019</b>	<b>2018</b>
Revenue Bonds, Series 2017A (NMHC), payable in annual installments through July 15, 2047 (fixed coupon rates range from 3.00% to 5.00%)	\$ <b>523,325</b>	\$ 538,225
Revenue Bonds, Series 2017B (NMHC), payable in annual installments beginning July 25, 2055 through July 25, 2057 (fixed coupon rate of 5.00% through December 15, 2022)	<b>162,380</b>	162,380
Revenue Bonds, Series 2015A and 2015B (NMHC), payable in monthly installments through March 1, 2035 (fixed coupon rate of 2.80% through March 1, 2020)	<b>10,150</b>	10,662
Revenue Bonds, Series 2014A (Centegra), payable in annual installments through September 1, 2042 (fixed coupon rates range from 4.63% to 5.00%)	<b>133,545</b>	—
Revenue Bonds, Series 2013 (NMHC), payable in annual installments beginning August 15, 2031 through August 15, 2043 (fixed coupon rates from 4.00% to 5.00%)	<b>111,235</b>	111,235
Revenue Bonds, Series 2012 (Centegra), payable in annual installments through September 1, 2038 (fixed coupon rates range from 4.00% to 5.00%)	<b>184,700</b>	—
Revenue Bonds, Series 2011A and 2011B (NMHC), with interest at a variable rate payable with annual installments through November 1, 2038, (weighted average interest rate of 2.46% and 1.78% for the twelve months ended August 31, 2019 and 2018, respectively)	<b>112,900</b>	114,600
Revenue Bonds, Series 2011C (Delnor), with interest at a variable rate payable with annual installments through November 1, 2038, (weighted average interest rate of 2.41% and 1.73% for the twelve months ended August 31, 2019 and 2018, respectively)	<b>55,440</b>	56,050
Revenue Bonds, Series 2014B (Centegra), with interest at a variable rate payable with annual installments through September 1, 2044, (weighted average interest rate of 3.97% for the twelve months ended August 31, 2019)	<b>33,490</b>	—
Revenue Bonds, Series 2014C (Centegra), with interest at a variable rate payable with annual installments through September 1, 2044 (weighted average interest rate of 4.18% for the twelve months ended August 31, 2019)	<b>24,250</b>	—

Northwestern Memorial HealthCare and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(In thousands)

9. Long-Term Debt (continued)

	2019	2018
Variable Rate Demand Revenue Bonds, Series 2008A (NMH), payable in annual installments through August 15, 2038 (weighted average interest rate of 1.72% and 1.30% for the twelve months ended August 31, 2019 and 2018, respectively)	\$ 64,210	\$ 69,330
Variable Rate Demand Revenue Bonds, Series 2007A (NMH), payable in annual installments through August 15, 2042 (weighted average interest rate of 1.53% and 1.17% for the twelve months ended August 31, 2019 and 2018, respectively)	202,000	203,400
NMHC variable rate note dated October 4, 2016, terminated August 29, 2019 (weighted average interest rate of 2.77% and 2.14% for the twelve months ended August 31, 2019 and 2018, respectively)	—	105,000
NMHC fixed rate note dated August 29, 2019, matures September 1, 2024 (fixed rate of 1.98%)	55,000	—
The Midland Surgical Center, LLC line of credit due October 10, 2019, interest payments required monthly at a variable rate not less than 3.75%, and loan with maturity date of December 10, 2018	321	330
NMHC commercial paper dated October 4, 2016 (weighted average interest rate of 2.31% and 1.53% for the twelve months ended August 31, 2019 and 2018, respectively)	77,697	27,466
	<b>1,750,643</b>	<b>1,398,678</b>
Less:		
Unamortized premium and debt issuance costs	(58,482)	(47,755)
Long-term debt subject to short-term remarketing	73,836	—
Current maturities	20,735	24,571
Commercial paper, included in Short-term debt	77,697	27,466
	<b>\$ 1,636,857</b>	<b>\$ 1,394,396</b>

Per the Second Amended and Restated Master Trust Indenture dated as of December 1, 2017, as supplemented and amended (the NMHC Master Indenture), the Obligated Group includes NMHC, NMH, Northwestern Lake Forest Hospital (NLFH), Central DuPage Hospital (CDH), Delnor-Community Hospital (Delnor), Cadence Physician Group (CPG) d/b/a Northwestern Medicine Regional Medical Group (NMRMG), the Foundation, Northwestern Medical Faculty Foundation d/b/a Northwestern Medical Group (NMG), Lake Forest Health and Fitness Institute (HFI), KishHealth, Kishwaukee Community Hospital, Valley West Community Hospital, Kishwaukee Physician Group, Inc. (KPG), Marianjoy Rehabilitation Hospital & Clinic, Inc., and Rehabilitation Medicine Clinic, Inc, with Wells Fargo Bank, N.A., as master trustee.

On September 1, 2018, NMHC implemented a number of actions to streamline its organizational structure some of which impacted members of the Obligated Group. Cadence was merged into NMHC; KPG was merged into CPG; and KishHealth Foundation was merged into the Foundation. None of these actions had a material impact on the Obligated Group or any impact on the accompanying consolidated financial statements.

Also effective September 1, 2018, Centegra, Northern Illinois Medical Center (as of August 31, 2018, d/b/a Centegra Hospital - McHenry, Centegra Hospital - Huntley and Centegra Hospital - Woodstock), Memorial

Notes to Consolidated Financial Statements (continued)

(In thousands)

9. Long-Term Debt (continued)

Medical Center - Woodstock, NIMED Corp., and Centegra Hospital - Huntley Holdings joined the NMHC Obligated Group. The First Supplemental Master Trust Indenture was executed to issue obligations pursuant to the NMHC Master Trust Indenture in order to secure all debt that was previously secured by obligations issued pursuant to the Centegra Master Trust Indenture prior to the release of the Centegra Master Trust Indenture in accordance with its terms.

Northwestern Memorial has lines of credit with multiple banks. Northwestern Memorial has the option to borrow at various rates expressed as an adjustment to LIBOR, prime rate or other bank-offered rates. Northwestern Memorial had two \$65,000 lines of credit that were to expire in October 2019. In August 2019, one of the lines was terminated and the other increased to \$100,000. Additionally, Northwestern Memorial has restricted certain lines of credit to secure letters of credit. The amounts available, outstanding, and restricted to secure letters of credit as of August 31, 2019 are as follows:

<u>Available</u>	<u>Outstanding</u>	<u>Restricted</u>
\$ 100,000	\$ —	\$ 556
15,000	—	—
7,000	—	878

Northwestern Memorial has standby bond purchase agreements (SBPAs) with multiple banks that cover certain variable rate demand revenue bonds (VRDBs). The short-term credit rating for each series of VRDBs is based on the respective bank’s short-term credit rating. The long-term credit rating for each series of VRDBs is based on Northwestern Memorial’s long-term credit rating. Changes in credit ratings may impact the interest paid on or remarketing of the VRDBs. As of August 31, 2019, the banks provided liquidity support in the event of a failed remarketing as follows:

	<u>Par Value</u>	<u>Expiration date</u>
Subseries 2007A-2, 2007A-4	\$ 101,000	September 2024
Subseries 2007A-1, 2007A-3	101,000	September 2023

The SBPAs include reporting and financial requirements and other covenants. If an SBPA is not renewed or replaced prior to its expiration, or if some portion, or all, of the related VRDBs are not successfully remarketed (failed remarketing) during the terms of the SBPAs, the related VRDBs convert to a term loan at the earlier of the expiration date of the related SBPA or after 90 consecutive days of failed remarketing. The principal payment on the term loan would then be payable over an amortization period per the SBPA. The earliest principal payment on any term loan associated with the bonds is 367 days from either the initial failed remarketing date or a day prior to the expiration date. Therefore, the VRDBs that have SBPAs are classified as long-term debt in the accompanying consolidated balance sheets.

The Series 2014B and 2014C Bonds are subject to put options, such that the bondholders have agreed to hold the 2014B and 2014C Bonds for initial private placement rate periods ending on July 1, 2024 and September 1, 2021, respectively, at which time the bonds are subject to redemption. The Obligated Group may provide written notice to the bondholder no sooner than 18 months and not later than four months prior to the end of the initial private placement rate period of its desire to request the bondholders to extend the initial private placement rate period. The bondholders must provide notice of acceptance of the request within 60 days of such request. In the event the initial private placement rate period is not extended, Northwestern Memorial

Notes to Consolidated Financial Statements (continued)

(In thousands)

9. Long-Term Debt (continued)

may be required to redeem the bonds unless the bonds can be remarketed prior to July 1, 2024 and September 1, 2021, respectively.

Scheduled principal repayments for the next five years, assuming remarketing of variable rate debt, on long-term debt are as follows:

Year ending August 31:		
2020	\$	25,745
2021		30,691
2022		31,916
2023		33,192
2024		34,513

The provisions under the respective debt agreements require the Obligated Group to maintain reporting, financial, and other covenants. At August 31, 2019, the Obligated Group was in compliance with these provisions.

Northwestern Memorial paid interest of \$60,363 and \$47,137 in 2019 and 2018, respectively (which includes \$4,271 and \$5,910, respectively, for net swap payments included in Interest expense in the accompanying consolidated statements of operations and changes in net assets). Northwestern Memorial capitalized interest of \$4,496 and \$12,027 in 2019 and 2018, respectively.

In December 2017 and January 2018, the following transactions occurred related to Northwestern Memorial's long- and short-term debt:

Revenue Bonds, Series 2002A-Series 2002D (Delnor); Revenue Bonds, Series 2003A-Series 2003C (Delnor) and Revenue Bonds, Series 2009B (NMH) with principal outstanding of \$35,000, \$19,950 and \$37,700, respectively, were fully legally defeased.

A portion of the Revenue Bonds, Series 2009A (NMH) and Revenue Bonds, Series 2009B bonds (CDH) were legally defeased in the amount of \$53,000 and \$28,000, respectively.

The Illinois Finance Authority issued tax-exempt fixed rate bonds, Series 2017A, in the aggregate amount of \$544,520 on behalf of NMHC as the borrower with varying maturities through 2047. The proceeds of these bonds were used to establish an escrow to legally defease the Revenue Bonds, Series 2009 (CDH) of \$81,985 and the remaining principal of the Revenue Bonds, Series 2009A (NMH) and Revenue Bonds, Series 2009B (CDH) in the amount of \$238,760 and \$180,730, respectively. Additionally, \$59,833 outstanding under the NMHC Commercial Paper program was redeemed.

The Illinois Finance Authority issued tax-exempt bonds, Series 2017B, in the aggregate amount of \$162,380 with a nominal maturity of 2057 and an interest rate initially fixed through December 14, 2022. The proceeds of these bonds were used to reimburse NMHC for a portion of the cost of the replacement Northwestern Lake Forest Hospital in Lake Forest, IL.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**9. Long-Term Debt (continued)**

In August 2019, the following transactions occurred related to Northwestern Memorial's long- and short-term debt:

The SBPA for the \$101,000 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Subseries 2007A-1 and Subseries 2007A-3 (NMH) was extended for four years. The SBPA for the \$101,000 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Subseries 2007A-2 and Subseries 2007A-4 (NMH) was replaced by a new standby bond purchase agreement for five years. The SBPA for the \$64,210 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2008A (NMH) was terminated and the bonds converted to self-liquidity mode and are included in Long-term subject to short-term remarketing in the accompanying consolidated balance sheets.

The Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2011A (NMHC) and 2011C (CDH-Delnor Health System) in the aggregate amount of \$111,890 were purchased by different banks at variable rates for a period of seven years and three years, respectively. The Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2011B (NMHC) in the amount of \$56,450 were extended with the current bank at a variable rate for a period of five years.

NMHC issued an additional tranche of commercial paper in the amount of \$50,231. The proceeds were used to partially pay off the NMHC variable rate note (Term Loan). The remaining \$55 million of the Term Loan was refinanced with a different bank at a fixed rate for a period of five years.

**10. Derivatives**

Northwestern Memorial's only derivative financial instruments are interest rate swaps approximately equal to its Series 2007A and Series 2011A-C variable rate bonds for the sole purpose of risk management. These bonds expose Northwestern Memorial to variability in interest payments due to changes in interest rates. To manage fluctuations in cash flows resulting from interest rate risk, Northwestern Memorial entered into various interest rate swap agreements. These swaps limit the variable-rate cash flow exposure on the variable rate bonds to synthetically fixed cash flows. By using interest rate swaps to manage the risk of changes in interest rates, Northwestern Memorial exposes itself to credit risk and market risk. Credit risk is the risk that a counterparty will fail to perform under the terms of a derivative contract. When the fair value of a swap is positive, the counterparty owes Northwestern Memorial, which creates credit risk for Northwestern Memorial. When the fair value of a swap is zero or negative, the counterparty does not owe Northwestern Memorial. Northwestern Memorial minimizes the credit risk in its swap contracts by entering into transactions that either require the counterparty to post collateral for the benefit of Northwestern Memorial based on the credit rating of the counterparty and the fair value of the swap contract or whose cash flows are insured by a third party. For certain interest rate swaps, Northwestern Memorial is required to post collateral for the benefit of the counterparty when the negative fair value of the swap exceeds a defined threshold. The aggregate fair value liability of the swaps on the consolidated balance sheets reflects a reduction of \$2,780 and \$2,134 for non-performance risk at August 31, 2019 and 2018, respectively. 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 changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. Management also mitigates risk through periodic reviews of its swap positions in the context of their total blended cost of capital.

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 10. Derivatives (continued)

The following is a summary of the outstanding positions under existing interest rate swap agreements at August 31:

Notional Amount		Maturity Date	Rate Paid	Rate Received
2019	2018			
\$ 101,000	\$ 101,700	August 2042	3.89%	63% of 1-Month LIBOR + 28 bps
101,000	101,700	Agusut 2042	3.89	63% of 1-Month LIBOR + 28 bps
60,575	61,113	November 2038	3.82	67% of 3-Month LIBOR
60,575	61,113	November 2038	3.52	67% of 3-Month LIBOR
<u>\$ 323,150</u>	<u>\$ 325,626</u>			

The fair value of derivative instruments at August 31 is as follows:

	Derivative Liabilities	
	Balance Sheet Location	
	2019	2018
Derivatives not designated as hedging instruments:		
Interest rate contracts	Interest rate swap liabilities \$ 120,755	\$ 73,350

The effects of derivative instruments on the accompanying consolidated statements of operations and changes in net assets for August 31 are as follows:

	Amount of (Loss) Income Recognized in Excess of Revenue Over Expenses	
	2019	2018
Derivatives not designated as hedging instruments:		
Operating expense - interest	\$ (4,271)	\$ (5,910)
Nonoperating - change in fair value of interest rate swaps	(47,405)	31,353

Northwestern Memorial's derivative instruments contain provisions that require Northwestern Memorial's debt to maintain an A- or better credit rating from Standard & Poor's and an A3 or better rating from Moody's. If Northwestern Memorial's debt were to fall below those levels, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. Northwestern Memorial has posted collateral of \$7,130 and \$0 as of August 31, 2019 and 2018, respectively. If the credit-risk-related contingent features underlying the agreement were triggered to the fullest extent on August 31, 2019, Northwestern Memorial would be required to post \$123,535 of additional collateral to its counterparties.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**10. Derivatives (continued)**

In February 2018, Northwestern Memorial terminated two of its existing swaps with notional amounts of \$35,000 and \$19,950, which did not have a material impact on the consolidated statements of operations and changes in net assets.

**11. Goodwill and Other Intangible Assets**

Goodwill has been recorded for the excess of purchase price over fair value of assets purchased in business acquisitions of several medical practices. Northwestern Memorial has goodwill of \$30,353 and \$25,306, included in Other assets, net at August 31, 2019 and 2018, respectively. There were no impairments of goodwill in the years ended August 31, 2019 or 2018.

The fair value of in-place leases is the present value associated with re-leasing the in-place lease as if the property was vacant. The value of at market in-place leases is amortized as amortization expense over the expected life of the lease. Above-market and below-market lease values for acquired properties are recorded based upon the present value of the difference between the contractual amounts to be paid pursuant to the in-place leases and management's estimates of the fair market lease rates for comparable leases. The values of above- and below-market leases are recorded as an adjustment to rental revenue over the remaining terms of the leases.

The following table summarizes Northwestern Memorial's identifiable intangible asset balances as of August 31, which are included in Other assets, net on the accompanying consolidated balance sheets:

	<b>2019</b>		
	<b>Gross Carrying Value</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Amortized intangible assets:			
In-place Leases	\$ 10,420	\$ (7,967)	\$ 2,453
Above-market leases	1,944	(46)	1,898
Total intangible assets	<u>\$ 12,364</u>	<u>\$ (8,013)</u>	<u>\$ 4,351</u>
Below-market lease intangibles	<u>\$ (6,274)</u>	<u>\$ 1,667</u>	<u>\$ (4,607)</u>
	<b>2018</b>		
	<b>Gross Carrying Value</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Amortized intangible assets:			
In-place Leases	\$ 12,672	\$ (7,921)	\$ 4,751
Above-market leases	104	(6)	98
Total intangible assets	<u>\$ 12,776</u>	<u>\$ (7,927)</u>	<u>\$ 4,849</u>
Below-market lease intangibles	<u>\$ (3,194)</u>	<u>\$ 871</u>	<u>\$ (2,323)</u>

Amortization expense, which is included in Depreciation and amortization, was \$2,548 and \$2,554 for the years ended August 31, 2019 and 2018, respectively. The estimated amortization expense for intangible assets subject to amortization for each of the years ending August 31, 2020 through 2024 is as follows: \$1,210, \$770, \$296, \$50 and \$50, respectively.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**12. Income Tax Status**

ASC 740, *Income Taxes*, requires the realization of an uncertain income tax position to be more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it is recognized in the financial statements as the amount most likely to be realized, assuming a review by tax authorities having all relevant information and applying current conventions. This interpretation also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. No amount was recorded for the years ended August 31, 2019 or 2018.

Each of the NMHC not-for-profit entities is qualified under the Internal Revenue Code (the Code) as a tax-exempt organization and is exempt from tax on income related to its tax-exempt purposes under Section 501(a) of the Code. Accordingly, no income taxes are provided for the majority of the income in the accompanying consolidated financial statements for these corporations. Certain corporations had unrelated business income (UBI) generated primarily from the sale of certain services that are not directly related to patient care and through limited partnerships within the investment portfolio. Certain corporations have unused net operating loss carryforwards available to offset the UBI tax. The net operating loss carryforwards expire through 2038. The deferred tax assets associated with these net operating loss carryforwards of \$12,812 and \$10,844 at August 31, 2019 and 2018, respectively, are offset by valuation allowances on the accompanying consolidated balance sheets of \$8,947 and \$10,844, respectively. The total net operating loss carryforwards at August 31, 2019 and 2018 were \$42,952 and \$33,113, respectively.

NMHC calculates income taxes for its taxable subsidiaries. Taxable income differs from pretax book income principally due to certain income and deductions for tax purposes being recorded in the consolidated financial statements in different periods. Deferred income tax assets and liabilities are recorded for the tax effect of these differences using enacted tax rates for the years in which the differences are expected to reverse. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible.

As it relates to the Northwestern Memorial captive insurance entities, the Cayman Islands government imposes no tax on income or capital gains. However, such corporations are subject to U.S. federal corporate taxation to the extent that they generate net income that is effectively connected with a U.S. trade or business. These corporations were not engaged in any such trade or business in the U.S. during fiscal year 2019 and have ceased as of August 31, 2019. Therefore, no income tax provision has been recorded related to these corporations and their operations.

Provisions for federal and state income taxes of \$6,369 and \$6,028 for the years ended August 31, 2019 and 2018, respectively, are included within Other nonoperating gains (losses) in the accompanying consolidated statements of operations and changes in net assets.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**13. Net Assets with Donor Restrictions**

Net assets with donor restrictions are available for the following purposes at August 31:

	<u>2019</u>	<u>2018</u>
Subject to expenditure for specified purpose:		
Purchase of property and equipment	\$ 22,746	\$ 27,948
Operating expenses and charity care	105,226	98,844
Research, education, and other	130,386	114,566
Total expenditure for specified purpose	<u>258,358</u>	241,358
Subject to passage of time:		
Pledges and trusts	2,107	1,238
Endowments:		
Perpetual in nature:		
Purchase of property and equipment	15,454	14,304
Operating expenses and charity care	74,835	66,803
Research, education, and other	103,469	101,525
Total perpetual in nature	<u>193,758</u>	182,632
Total net assets with donor restrictions	<u>\$ 454,223</u>	<u>\$ 425,228</u>

Net assets were released from donor restrictions by incurring expenditures for the following purposes in the years ended August 31:

	<u>2019</u>	<u>2018</u>
Health care services:		
Purchase of property and equipment	\$ 12,567	\$ 7,672
Clinical expenses and charity care	16,099	10,633
Research, education and other	20,043	21,575
	<u>\$ 48,709</u>	<u>\$ 39,880</u>

Net assets released from donor restrictions reported in the consolidated statements of operations and changes in net assets were recorded as follows for the years ended August 31:

	<u>2019</u>	<u>2018</u>
Net assets released from donor restrictions and federal and state grants	\$ 19,040	\$ 18,216
Nonoperating other	17,102	13,992
	<u>\$ 36,142</u>	<u>\$ 32,208</u>

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**13. Net Assets with Donor Restrictions (continued)**

Northwestern Memorial's endowment consists of individual donor-restricted funds established for a variety of purposes. Net assets associated with endowment funds are classified and reported based on the donor-imposed restrictions.

Northwestern Memorial has interpreted the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA), as adopted by the state of Illinois, as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, Northwestern Memorial classifies as net assets with restrictions, the original value of gifts donated to the permanent endowment, the original value of subsequent gifts to the permanent endowment, and accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time.

In accordance with UPMIFA, Northwestern Memorial considers the following factors in making a determination to appropriate or accumulate donor-restricted funds:

- The duration and preservation of the fund
- The purposes of Northwestern Memorial and the endowment fund
- General economic conditions
- The possible effects of inflation and deflation
- The expected total return from investment income
- Other resources of Northwestern Memorial
- The investment policies of Northwestern Memorial

Northwestern Memorial has adopted investment and spending policies for endowment assets designed to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that must be held in perpetuity or for a donor-specified period. Under this policy, endowment assets are allocated a fixed annual return, which is currently set at 6%.

Northwestern Memorial has a policy that generally limits annual spending from endowment funds to 4% of the endowment fund balance at the midpoint of the preceding fiscal year. In establishing this policy, Northwestern Memorial considered the long-term expected return on its endowment. Accordingly, over the long term, Northwestern Memorial expects the spending policy to allow its endowment to grow at an average annual rate of 2%. This is consistent with its objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specific term, as well as to provide additional real growth through new gifts and investment return.

**Northwestern Memorial HealthCare and Subsidiaries**

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**13. Net Assets with Donor Restrictions (continued)**

The changes in endowment net assets for the years ended August 31, 2019 and 2018 are summarized below:

	<b>Total</b>
Endowment net assets, August 31, 2017	\$ 233,902
Contributions	6,538
Change in value of trusts	525
Investment return	8,144
Appropriation for expenditure	(6,186)
Other	(4,488)
Endowment net assets, August 31, 2018	238,435
Contributions	<b>10,961</b>
Change in value of trusts	<b>(421)</b>
Investment return	<b>9,292</b>
Appropriation for expenditure	<b>(7,448)</b>
Other	<b>599</b>
Endowment net assets, August 31, 2019	<b>\$ 251,418</b>

**14. Pledges Receivable**

As of August 31, 2019, donor-restricted pledges, which are included in Current portion of pledges and grants receivable, net and Pledges and grants receivable, less current portion, are expected to be realized as follows:

Less than one year	\$ 12,801
One to five years	34,550
Thereafter	7,839
Total pledges receivable	55,190
Less allowances	(1,698)
Less present value discount	(8,500)
Net pledges receivable	<b>\$ 44,992</b>

**Northwestern Memorial HealthCare and Subsidiaries**  
**Notes to Consolidated Financial Statements (continued)**  
*(In thousands)*

**15. Liquidity and Availability**

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

	<b>2019</b>
Cash and cash equivalents	<b>\$ 329,646</b>
Accounts receivable	<b>791,667</b>
Promises to give	<b>12,801</b>
Grants receivable	<b>4,592</b>
Other receivables	<b>84,499</b>
Investments	<b>5,400,943</b>
Total financial assets available within one year	<b>\$ 6,624,148</b>

**16. Self-Insurance Liabilities and Related Insurance Recoverables**

Northwestern Memorial retains certain levels of professional and general liability risks. Northwestern Memorial also retain certain levels of workers' compensation risks through State of Illinois sanctioned self-insurance arrangements and through commercial insurance programs subject to large deductibles. For those self-insured risks, Northwestern Memorial has established revocable trust funds and two captive insurance companies to pay claims and related costs. In addition, various insurance policies have been purchased to provide coverage in excess of self-insured limits.

Northwestern Memorial's self-insurance liability and related amounts recoverable from reinsurers are reported in the accompanying consolidated balance sheets at present value based on an annual discount rate of 2.0% and 1.5% as of August 31, 2019 and 2018, respectively. This discount rate is based on several factors, including rolling averages of risk-free rates based on estimated payment patterns of the underlying liability. The undiscounted gross liabilities for the self-insured programs were \$754,469 and \$675,913 at August 31, 2019 and 2018, respectively. The undiscounted amounts recoverable from reinsurers were \$133,460 and \$107,927 at August 31, 2019 and 2018, respectively. Provisions for the professional and general liability risks are based on an actuarial estimate of losses using actual loss data adjusted for industry trends and current conditions and on an evaluation of claims by Northwestern Memorial's legal counsel. The provision for estimated self-insured claims includes estimates of ultimate costs for both reported claims and claims incurred but not reported.

In the opinion of management, based in part on the advice of outside actuaries, adequate provision has been made at August 31, 2019 for all claims incurred to date. Although there is considerable variability inherent in such estimates, management further believes that the ultimate disposition of these claims will not have a material adverse effect on the consolidated financial position of Northwestern Memorial.

Notes to Consolidated Financial Statements (continued)

(In thousands)

**17. Employee Benefit Obligations**

There are two noncontributory defined benefit pension plans: Northwestern Memorial Hospital and Lake Forest Hospital (the Plans), maintained within Northwestern Memorial that cover specified employee groups. The sponsors for the Plans approved resolutions to amend the Plans effective at the end of the day on December 31, 2012. The amendments implemented a hard freeze, such that no participant will earn any additional or new benefits under the Plans on and after January 1, 2013.

The following table summarizes the change in the projected benefit obligation for the years ended August 31:

	<u>2019</u>	<u>2018</u>
Projected benefit obligation, beginning of year	\$ 606,385	\$ 629,775
Interest cost	23,067	20,141
Net actuarial loss (gain)	100,000	(16,875)
Benefits paid	(28,419)	(26,656)
Projected benefit obligation, end of year	<u>\$ 701,033</u>	<u>\$ 606,385</u>

The net actuarial gain in 2019 was caused primarily by the change in the discount rate used compared to prior years.

The following table summarizes the changes in the Plans' assets for the years ended August 31:

	<u>2019</u>	<u>2018</u>
Plan assets at fair value, beginning of year	\$ 786,448	\$ 748,337
Actual return on the Plans' assets, net of expenses	(2,766)	64,767
Benefits paid	(28,419)	(26,656)
	<u>\$ 755,263</u>	<u>\$ 786,448</u>

The following table sets forth the Plans' funded status, as well as recognized amounts in the accompanying consolidated balance sheets as of August 31:

	<u>2019</u>	<u>2018</u>
Plan assets at fair value	\$ 755,263	\$ 786,448
Projected benefit obligation	701,033	606,385
Funded status recognized as prepaid pension cost	<u>\$ 54,230</u>	<u>\$ 180,063</u>

The funded status of the Northwestern Memorial Hospital plan was \$71,872 and \$159,137 for the years ended August 31, 2019 and 2018, respectively. The funded status for the Northwestern Lake Forest Hospital plan was (\$17,642) and \$20,926 for the years ended August 31, 2019 and 2018, respectively. When the projected benefit obligation is greater than the plan assets, the net liability is recorded in Other liabilities.

Northwestern Memorial HealthCare and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(In thousands)

17. Employee Benefit Obligations (continued)

Included in net assets without donor restrictions are the Plans' amounts that have not yet been recognized in net periodic pension cost at August 31, as follows:

	2019	2018
Unrecognized actuarial loss	\$ 245,456	\$ 98,717

Changes in the Plans' assets and benefit obligations recognized in net assets without donor restrictions for the years ended August 31 include the following:

	2019	2018
Current year actuarial (loss) gain	\$ (147,357)	\$ 32,071
Recognized actuarial loss	616	1,752
	<u>\$ (146,741)</u>	<u>\$ 33,823</u>

The Plans' prior service cost and net actuarial loss included in net assets without donor restrictions expected to be recognized in net periodic pension cost during the year ending August 31, 2020 are \$0 and \$5,441, respectively.

Net periodic pension benefit included in operating results for the years ended August 31 consists of the following:

	2019	2018
Plan expenses	\$ 1,323	\$ 1,541
Interest cost of projected benefit obligation	23,067	20,141
Expected return on the Plans' assets	(45,913)	(51,112)
Recognized actuarial loss	616	1,752
Net periodic pension benefit	<u>\$ (20,907)</u>	<u>\$ (27,678)</u>

The following table sets forth the discount rate assumptions used to determine the projected benefit obligation and benefit cost as of August 31:

	2019	2018
<b>Used to determine projected benefit obligation</b>		
Discount rate - Northwestern Memorial Hospital	3.17%	4.24%
Discount rate - Northwestern Lake Forest Hospital	3.12	4.28
<b>Used to determine benefit cost</b>		
Discount rate - Northwestern Memorial Hospital	4.24%	3.86%
Discount rate - Northwestern Lake Forest Hospital	4.28	3.90
Expected long-term rate of return on the Plans' assets	6.00	6.00

Notes to Consolidated Financial Statements (continued)

(In thousands)

**17. Employee Benefit Obligations (continued)**

The expected long-term rate of return on assets is determined based on a capital market asset model, which assumes that future returns are based on long-term, historical performance as adjusted for contemporary dividend yields. The adjusted historical returns were weighted by the current long-term asset allocation targets and reduced by 100 basis points to produce a more normal risk premium. Northwestern Memorial's investment advisor assisted with the analysis.

The Plans' asset allocation and investment strategies are designed to earn returns on plan assets consistent with a reasonable and prudent level of risk. Investments are diversified across classes, sectors and manager style to minimize the risk of loss. Northwestern Memorial uses professional investment managers specializing in each asset category and, where appropriate, provides the investment managers with specific guidelines that include allowable and/or prohibited investment types. Northwestern Memorial regularly monitors manager performance and compliance with investment guidelines.

The target allocation of the Plans' assets as of August 31 is as follows:

	<b>2019</b>	<b>2018</b>
Equity securities	<b>51%</b>	51%
Alternative investments	<b>37</b>	37
Fixed income	<b>12</b>	12
	<b>100%</b>	100%

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 17. Employee Benefit Obligations (continued)

The following table presents the Plans' financial instruments as of August 31, 2019, measured at fair value on a recurring basis by the valuation hierarchy described in Note 7:

	Level 1	Level 2	Level 3	Total
U.S. government securities	—	6,294	—	\$ 6,294
Corporate debt:				
Other	—	17,287	—	17,287
Total corporate debt	—	17,287	—	17,287
Equity securities:				
International equities	281	—	—	281
Mutual funds:				
Fixed income	69,516	—	—	69,516
U.S. equities	24,326	—	—	24,326
Total mutual funds	93,842	—	—	93,842
Other fixed income	—	119	—	119
Total assets measured on a recurring basis at fair value	\$ 94,123	\$ 23,700	\$ —	117,823
Investments recorded at fair value based on NAV				637,440
Total assets measured at fair value				\$ 755,263

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 17. Employee Benefit Obligations (continued)

The following table presents the Plans' financial instruments as of August 31, 2018, measured at fair value on a recurring basis by the valuation hierarchy described in Note 7:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 105	\$ —	\$ —	\$ 105
U.S. government securities	—	5,882	—	5,882
Corporate debt:				
Other	—	16,312	—	16,312
Total corporate debt	—	16,312	—	16,312
Equity securities:				
U.S. equities	20,662	99	—	20,761
International equities	81	—	—	81
Total equity securities	20,743	99	—	20,842
Mutual funds:				
Fixed income	63,226	—	—	63,226
U.S. equities	23,561	—	—	23,561
Total mutual funds	86,787	—	—	86,787
Other fixed income	—	392	—	392
Total assets measured on a recurring basis at fair value	<u>\$ 107,635</u>	<u>\$ 22,685</u>	<u>\$ —</u>	<u>130,320</u>
Investments recorded at fair value based on NAV				<u>656,128</u>
Total assets measured at fair value				<u>\$ 786,448</u>

The fair value of Level 1 investments, which consist of equity securities and certain mutual funds, is based on quoted market prices that are valued on a daily basis. Level 2 investments consist of U.S. government securities, corporate bonds and U.S. equities. The fair value of the U.S. government securities and corporate bonds is established based on values obtained from nationally recognized pricing services that value the investments based on similar securities and matrix pricing of similar quality and maturity securities.

Included in the other pension investments are commingled funds, common collective trusts, 103-12 entities and alternative investments (principally limited partnership interests in hedge, private equity, real estate and natural resources funds) for which the fair values are based on NAV. The fair values of the commingled funds, common collective trusts, and 103-12 entities are based on the Master Trust's ownership interest in the NAV per share of its equivalent of the respective fund.

The fair values of the securities held by limited partnerships that do not have readily determinable fair values are determined by the general partner taking into consideration, among other things, the financial performance

## Notes to Consolidated Financial Statements (continued)

*(In thousands)***17. Employee Benefit Obligations (continued)**

of underlying investments, recent sales prices of underlying investments and other pertinent information. In addition, actual market exchanges at period-end provide additional observable market inputs of the exit price. NAV is calculated by the investment's management monthly for all of the Master Trust's alternative investments other than limited partnerships, whose NAV is calculated on a quarterly basis. The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Plans' 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.

Investments in LPs, which cannot be redeemed on request, totaled \$38,711 as of August 31, 2019. Certain marketable alternative investments are subject to various redemption restrictions. As of August 31, 2019, \$422,312 of alternative investments is subject to various redemption limits and lockup provisions, of which \$377,121 expires within one year and \$45,191 expires after one year from the balance sheet date.

The Plans' assets are managed solely in the interest of the Plans' participants and their beneficiaries. The assets are invested with the investment objective of funding the accumulated and projected retirement benefit obligations of the Plans consistent with the Plans' long-term rate-of-return assumption. A time horizon of greater than five years is assumed; therefore, interim volatility in returns is regarded with appropriate perspective.

Northwestern Memorial has no current plans to contribute to the Plans during the year ending August 31, 2020.

Benefit payments, which reflect future service, as appropriate, are expected to be paid as follows:

Year ending August 31:	
2020	\$ 38,110
2021	35,522
2022	35,913
2023	36,928
2024	37,927
2025-2029	186,924

Northwestern Memorial also maintains defined contribution plans covering substantially all of its full-time and part-time employees. Participants can make voluntary tax-deferred contributions to the plans, subject to certain IRS limitations. Northwestern Memorial contributes a specified percentage of eligible compensation to the plans on behalf of each participant. Participants are always fully vested in their own tax-deferred contributions and related earnings and become fully vested in Northwestern Memorial contributions and related earnings upon completion of vesting service. Employer contributions related to these defined contribution plans, included in Employee benefits expense in the accompanying consolidated statements of operations and changes in net assets totaled \$123,129 and \$106,937 in 2019 and 2018, respectively.

NMHC also maintains other noncontributory postretirement benefit plans (the Noncontributory Plans) for certain executive employees.

Included in net assets without donor restrictions is an unrecognized actuarial loss of \$913 and \$672 at August 31, 2019 and 2018, respectively, for the Noncontributory Plans that has not yet been recognized in net periodic pension cost.

## Notes to Consolidated Financial Statements (continued)

*(In thousands)***17. Employee Benefit Obligations (continued)**

Changes in the Noncontributory Plans' assets and benefit obligations recognized in net assets without donor restrictions include the following:

	<b>2019</b>	<b>2018</b>
Current year actuarial (loss)	\$ (1,072)	\$ (1,002)
Recognized actuarial net loss	572	1,043
	<u>\$ (500)</u>	<u>\$ 41</u>

As of August 31, 2019 and 2018, the Noncontributory Plans' unfunded projected benefit obligation amounted to \$15,128 and \$14,188, respectively, and is included in Other liabilities in the accompanying consolidated balance sheets. The Noncontributory Plans' actuarial loss included in net assets without donor restrictions expected to be recognized in net periodic pension cost during 2020 is \$1,009.

The following table sets forth the discount rate assumptions used to determine the projected benefit obligation as of August 31:

	<b>2019</b>	<b>2018</b>
<b>Used to determine projected benefit obligation</b>		
Discount rate - Supplemental Retirement Plan	<b>1.74%</b>	2.74%
Discount rate - Executive Postretirement Health and Dental Plan	<b>2.57</b>	3.96

## Notes to Consolidated Financial Statements (continued)

(In thousands)

**18. Functional Expenses**

Northwestern Memorial provides general health care services primarily to residents within its geographic location and supports research and education programs. Operating expenses directly attributable to a specific functional area are reported as expenses of those functional areas. Expenses other than depreciation expense are directly allocated to functional departments at the time they are incurred. Depreciation expense is allocated on a pro rata basis. General, administrative and other expenses primarily include legal, finance, purchasing, human resources, information technology, management and governance. Expenses related to providing these services were as follows for the years ended August 31:

	<b>2019</b>				
	<b>Health Care Services</b>	<b>Research and Education</b>	<b>Fundraising</b>	<b>General, Administrative and Other</b>	<b>Total Expenses</b>
Salaries	\$ 1,931,227	\$ 795	\$ 8,157	\$ 471,396	\$ 2,411,575
Employee benefits	279,947	641	1,110	68,326	350,024
Supplies	1,211,298	65	656	18,811	1,230,830
Purchased services	149,467	13,391	555	503,785	667,198
Depreciation and amortization	285,792	5,200	699	80,619	372,310
Insurance	99,893	—	12	22,859	122,764
Rent and utilities	47,741	—	395	56,942	105,078
Repairs and maintenance	95,441	138	467	35,210	131,256
Interest	180	—	—	60,454	60,634
Illinois Hospital Assessment	154,117	—	—	—	154,117
Other	38,604	86,285	748	37,076	162,713
	<b>\$ 4,293,707</b>	<b>\$ 106,515</b>	<b>\$ 12,799</b>	<b>\$ 1,355,478</b>	<b>\$ 5,768,499</b>

## Notes to Consolidated Financial Statements (continued)

(In thousands)

## 18. Functional Expenses (continued)

	2018				
	Health Care Services	Research and Education	Fundraising	General, Administrative and Other	Total Expenses
Salaries	\$ 1,671,952	\$ 907	\$ 7,010	\$ 419,303	\$ 2,099,172
Employee benefits	272,703	611	1,044	71,190	345,548
Supplies	984,475	114	840	14,765	1,000,194
Purchased services	125,974	14,413	339	411,799	552,525
Depreciation and amortization	245,459	5,593	754	59,142	310,948
Insurance	46,445	—	40	66,349	112,834
Rent and utilities	43,728	7	479	56,600	100,814
Repairs and maintenance	80,438	22	192	21,308	101,960
Interest	92	—	—	40,935	41,027
Illinois Hospital Assessment	110,339	—	—	—	110,339
Other	39,090	65,587	914	75,335	180,926
	<u>\$ 3,620,695</u>	<u>\$ 87,254</u>	<u>\$ 11,612</u>	<u>\$ 1,236,726</u>	<u>\$ 4,956,287</u>

The research and education costs include \$3,382 and \$3,542 of expenses supported by federal, state, and corporate grants and \$16,560 and \$17,927 of expenses supported by other donor-restricted funds in 2019 and 2018, respectively.

## 19. Commitments and Contingencies

## Academic, Program and Other Support

Consistent with its mission, Northwestern Memorial provides academic, program and other support to other not-for-profit entities. The present value of the total remaining commitments related to this support is \$93,989 and \$110,886 at August 31, 2019 and 2018, respectively, which is reported as Grants and academic support payable, current portion and Grants and academic support payable, less current portion in the accompanying consolidated balance sheets.

Northwestern Memorial will provide continuing funding to Northwestern University in support of the research and education mission of the FSM. This continuing funding is based on the average net patient service revenue and operating results of Northwestern Memorial. The expense incurred of \$85,711 and \$65,178 for the years ended August 31, 2019 and 2018, respectively, is recorded in Other expense in the accompanying consolidated statements of operations and changes in net assets; and a related liability of \$499 and \$1,118 is reported in Accrued expenses and other current liabilities in the accompanying consolidated balance sheets as of August 31, 2019 and 2018, respectively.

Notes to Consolidated Financial Statements (continued)

(In thousands)

19. Commitments and Contingencies (continued)

Other

As of August 31, 2019, approximately 5% of Northwestern Memorial employees, on a full-time equivalent basis, were represented by a collective bargaining agreement. This collective bargaining agreement expires on January 27, 2020.

Capital and Leases

Various capital projects are currently being constructed and are expected to be placed in service over the next three years. The total estimated cost of these projects is \$1,487,000. As of August 31, 2019, project commitments totaled \$726,000, of which \$538,000 has been incurred.

Certain Northwestern Memorial buildings are located on land leased from Northwestern University under various lease agreements. The principal lease requires annual payments of \$314 through 2075. At August 31, 2019, minimum future rental payments under other noncancelable operating leases, which consist primarily of leases for office space and equipment, some of which include renewal options, are as follows:

Year ending August 31:		
2020	\$	30,653
2021		27,957
2022		22,811
2023		19,464
2,024		17,680
Thereafter		81,945

Rental expenses incurred for operating leases was \$43,276 and \$44,537 for the years ended August 31, 2019 and 2018, respectively.

Regulatory

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is a reasonable possibility that recorded amounts will change by a material amount in the near term. During the last few years, as a result of nationwide investigations by governmental agencies, various healthcare organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, and potential exclusion from the Medicare and Medicaid programs.

In addition, an increasing number of the operations and practices of not-for-profit healthcare providers has been challenged or questioned to determine if they are consistent with the regulatory requirements for nonprofit tax-exempt organizations. These challenges are broader than concerns about compliance with federal and state statutes and regulations of core business practices of the health care organizations. The laws and regulations regarding these practices are also subject to interpretation and challenge. Areas that have come under examination have included pricing practices, billing and collection practices, charity care, community benefit, executive compensation, exemption of property from real property taxation and others. Northwestern Memorial expects that the level of review and audit to which it and other health care providers

**Notes to Consolidated Financial Statements (continued)**

*(In thousands)*

**19. Commitments and Contingencies (continued)**

are subject will increase. There can be no assurance that regulatory authorities will not challenge Northwestern Memorial's compliance with these laws and regulations or that the laws and regulations themselves will not be subject to challenge, and it is not possible to determine the impact, if any, such claims, penalties or challenges would have on Northwestern Memorial.

The U.S. Department of Health and Human Services (HHS) Office of Civil Rights (OCR) is responsible for enforcing the Health Insurance Portability and Accountability Act (HIPAA) and the Privacy and Security Rules. OCR has initiated a compliance review of Northwestern Memorial Hospital of certain privacy breaches related to inappropriate access of patient information. Northwestern Memorial is in the process of complying with the data requests for the review. In addition, Northwestern Memorial is aware of, has investigated, and made disclosure to OCR with respect to certain other privacy breaches. NMHC has responded to OCR's requests for information with respect to a breach related to the theft of a password-protected, unencrypted laptop that contained patient identifiable health information. NMHC has also responded to information requested by OCR on a matter relating to whether a NMHC affiliate had a Business Associate Agreement with a vendor that has been implicated in privacy breaches, not involving NMHC records. OCR has been taking a more aggressive enforcement position relating to similar privacy matters by comparable health care organizations, including multiple seven-figure settlements against the disclosing party. NMHC is unable to determine whether any corrective actions or fines might be imposed by OCR as a result of the compliance review or the disclosures provided to OCR.

**Litigation**

Northwestern Memorial is a defendant in various other lawsuits arising in the ordinary course of business. Although the outcome of these lawsuits cannot be predicted with certainty, management believes the ultimate disposition of such matters will not have a material effect on Northwestern Memorial's consolidated financial position or operations.

**20. Subsequent Events**

Northwestern Memorial evaluated events and transactions occurring subsequent to August 31, 2019 through December 5, 2019, the date of issuance of the accompanying consolidated financial statements. There were no recognized subsequent events and no unrecognized subsequent events requiring disclosure.

## Supplementary Information



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## Report of Independent Auditors on Supplementary Information

The Board of Directors  
Northwestern Memorial HealthCare

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

*Ernst + Young LLP*

Chicago, Illinois  
December 5, 2019

**Northwestern Memorial HealthCare and Subsidiaries**

**Consolidating Balance Sheet**  
*(in thousands)*

	<b>Year Ended</b>			
	<b>August 31, 2019</b>			
	<b>Obligated Group</b>	<b>Non-Obligated Group</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets</b>				
Current assets:				
Cash and cash equivalents	\$ 307,373	\$ 80,794	\$ (58,521)	\$ 329,646
Short-term investments	189,444	—	—	189,444
Current portion of investments, including assets limited as to use	85,306	85,921	—	171,227
Patient accounts receivable	780,285	11,382	—	791,667
Current portion of pledges and grants receivable, net	17,072	321	—	17,393
Current portion of insurance recoverable	91,571	11,894	(86,032)	17,433
Inventories	89,054	93	—	89,147
Other current assets	141,611	95,126	(77,974)	158,763
Due from affiliates	173,500	71,196	(244,696)	—
Total current assets	1,875,216	356,727	(467,223)	1,764,720
Investments, including assets limited as to use, less current portion	6,290,463	77,637	(8,939)	6,359,161
Property and equipment, at cost:				
Land	374,729	5,260	—	379,989
Buildings	4,336,969	69,245	—	4,406,214
Equipment and furniture	1,455,674	60,188	—	1,515,862
Construction-in-progress	150,676	220	—	150,896
	6,318,048	134,913	—	6,452,961
Less accumulated depreciation	2,447,534	39,475	—	2,487,009
	3,870,514	95,438	—	3,965,952
Prepaid pension cost	71,872	—	—	71,872
Pledges and grants receivable, less current portion	49,179	—	—	49,179
Insurance recoverable, less current portion	358,862	107,450	(354,272)	112,040
Other assets, net	235,710	377,299	(407,802)	205,207
Total assets	<u>\$ 12,751,816</u>	<u>\$ 1,014,551</u>	<u>\$ (1,238,236)</u>	<u>\$ 12,528,131</u>

**Northwestern Memorial HealthCare and Subsidiaries**

**Consolidating Balance Sheet**  
*(in thousands)*

**Year Ended**  
**August 31, 2019**

	<b>Obligated Group</b>	<b>Non-Obligated Group</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Liabilities and net assets</b>				
Current liabilities:				
Accounts payable	\$ 263,882	\$ 1,014	\$ —	\$ 264,896
Accrued salaries and benefits	321,433	2,214	—	323,647
Grants and academic support payable, current portion	28,869	—	—	28,869
Accrued expenses and other current liabilities	111,807	109,027	(87,929)	132,905
Due to third-party payors	593,246	4,774	—	598,020
Current accrued liabilities under self-insurance programs	186,647	91,603	(162,089)	116,161
Due to cash pool	58,521	—	(58,521)	—
Current maturities of long-term debt	20,414	321	—	20,735
Long-term debt subject to short term remarketing agreements	73,836	—	—	73,836
Short-term debt	77,697	—	—	77,697
Due to affiliates	71,196	173,500	(244,696)	—
<b>Total current liabilities</b>	<b>1,807,548</b>	<b>382,453</b>	<b>(553,235)</b>	<b>1,636,766</b>
Long-term debt, less current maturities	1,636,857	—	—	1,636,857
Accrued liabilities under self-insurance programs, less current portion	791,560	420,782	(625,870)	586,472
Grants and academic support payable, less current portion	65,120	—	—	65,120
Interest rate swaps	120,755	—	—	120,755
Due to investment pool participants	8,939	—	(8,939)	—
Other liabilities	205,210	2,904	—	208,114
<b>Total liabilities</b>	<b>4,635,989</b>	<b>806,139</b>	<b>(1,188,044)</b>	<b>4,254,084</b>
Net assets:				
Without donor restrictions				
Controlling interest	7,661,611	207,660	(50,082)	7,819,189
Non-controlling interest in subsidiaries	—	745	(110)	635
<b>Total net assets without donor restrictions</b>	<b>7,661,611</b>	<b>208,405</b>	<b>(50,192)</b>	<b>7,819,824</b>
With donor restrictions	454,216	7	—	454,223
<b>Total net assets</b>	<b>8,115,827</b>	<b>208,412</b>	<b>(50,192)</b>	<b>8,274,047</b>
<b>Total liabilities and net assets</b>	<b>\$ 12,751,816</b>	<b>\$ 1,014,551</b>	<b>\$ (1,238,236)</b>	<b>\$ 12,528,131</b>

**Northwestern Memorial HealthCare and Subsidiaries**

**Consolidating Statement of Revenue and Expenses**  
(in thousands)

	Year Ended August 31, 2019			
	Obligated Group	Non-Obligated Group	Eliminations	Consolidated
<b>Revenue</b>				
Net patient service revenue	\$ 5,605,617	\$ 99,522	\$ (39,403)	\$ 5,665,736
Rental and other revenue	327,738	169,984	(142,387)	355,335
Net assets released from donor restrictions and federal and state grants	29,471	1,486	—	30,957
<b>Total revenue</b>	<b>5,962,826</b>	<b>270,992</b>	<b>(181,790)</b>	<b>6,052,028</b>
<b>Expenses</b>				
Salaries	2,355,946	55,629	—	2,411,575
Employee benefits	341,938	10,297	(2,211)	350,024
Supplies	1,220,877	9,953	—	1,230,830
Purchased services	654,892	87,730	(75,424)	667,198
Depreciation and amortization	362,558	9,752	—	372,310
Insurance	132,181	88,870	(98,287)	122,764
Rent and utilities	102,474	8,593	(5,989)	105,078
Repairs and maintenance	122,642	8,614	—	131,256
Interest	60,620	14	—	60,634
Illinois Hospital Assessment	154,117	—	—	154,117
Other	156,034	6,558	121	162,713
<b>Total expenses</b>	<b>5,664,279</b>	<b>286,010</b>	<b>(181,790)</b>	<b>5,768,499</b>
<b>Operating income (loss)</b>	<b>298,547</b>	<b>(15,018)</b>	<b>—</b>	<b>283,529</b>
<b>Nonoperating gains (losses)</b>				
Investment return	49,264	12,194	(3,622)	57,836
Contribution of Centegra net assets	183,227	(108,672)	—	74,555
Change in fair value of interest rate swaps	(47,405)	—	—	(47,405)
Grants and academic support provided	(46,902)	(2)	—	(46,904)
Other	25,431	702	—	26,133
<b>Total nonoperating gains (losses), net</b>	<b>163,615</b>	<b>(95,778)</b>	<b>(3,622)</b>	<b>64,215</b>
<b>Excess (deficit) of revenue over expenses</b>	<b>462,162</b>	<b>(110,796)</b>	<b>(3,622)</b>	<b>347,744</b>
Net gain attributable to non-controlling interest in subsidiaries	—	534	659	1,193
<b>Excess (deficit) of revenue over expenses attributable to NMHC and Subsidiaries</b>	<b>\$ 462,162</b>	<b>\$ (111,330)</b>	<b>\$ (4,281)</b>	<b>\$ 346,551</b>

**Note to Supplementary Information**

**1. Obligated Group**

The supplementary financial information for the Obligated Group is in accordance with the Amended and Restated Master Trust between NMHC, the other Members of the Obligated Group (as defined in the New Master Indenture) and Wells Fargo Bank, National Association, dated as of December 1, 2017, as amended and supplemented by the Second Supplemental Master Trust Indenture dated as of August 1, 2019.