

April 20, 2018

Financial Highlights for the Year Ending December 31, 2017

Enclosed are the audited financial statements of Norton Healthcare, Inc. for the year ended December 31, 2017. Please note, a post close adjustment has been recorded subsequent to the issuance of our fourth quarter 2017 unaudited financial statements. This adjustment decreased patient service revenue before bad debt expense by \$1.0 million.

Revenues and Expenses

For the year ending December 31, 2017, total revenues grew \$96.3 million, or 5%, to \$2.2 billion. This increase was due to the growth of patient service revenue before bad debt expense of \$103.6 million, or 5%, and an increase in joint venture income of \$2.2 million, or 153%, partially offset by an increase in bad debt expense of \$8.8 million, or 13%, and a decline in other revenue of \$2.7 million, or 6%. When comparing 2017 to 2016, inpatient admissions increased 3,937, or 6%, hospital and total outpatient volumes improved 3%, and physician office visits improved 9%.

The increase in patient service revenue for 2017 compared to 2016 was due to:

- Increased volumes (8,796 or 6%) at Norton Cancer Institute (NCI),
- Increased volumes at Norton Women's and Children's Hospital (NWCH) (admissions increased 961, or 6%, outpatient visits increased 7,091, or 10%, inpatient surgeries increased 232, or 8%, and outpatient surgeries increased 366, or 4%) and Norton Brownsboro Hospital (NBH) (admissions increased 889, or 10%, outpatient visits increased 7,346, or 14%, Emergency Department visits increased 1,002, or 3%, outpatient surgeries increased 246, or 5%, and inpatient surgeries increased 217, or 6%),
- Norton Medical Group (NMG) hired additional specialists and primary care physicians and their practice office visits have increased 9%.

Bad debt expense for the year ending December 31, 2017 increased by \$8.8 million, or 13%, compared to the prior year but as a percentage of patient service revenue before bad debt expense, has increased slightly.

Other revenue declined \$2.7 million, or 6%, due to the receipt of settlement proceeds at Norton Children's Hospital (NCH) in 2016 that did not re-occur in 2017 and lower meaningful use monies at the physician practices partially offset by increased milestone revenue in the Research Office and technical service revenue at CPA Lab. Joint venture income increased \$2.2 million, or 153%, due to improved financial performance of The Regional Health Network of Kentucky and Southern Indiana, LLC partnership with LifePoint Hospitals, Inc.

Please note: In March 2017, the Financial Accounting Standards Board issued ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost* (ASU 2017-07), which changes how employers that sponsor defined benefit pension plans present the net periodic pension cost in the statement of operations. ASU 2017-07 requires employers to present the service cost component of net periodic pension cost in the same statement of operations line item as other employee compensation costs from services rendered during the period. Employers are to present the other components of net periodic pension cost separately from the line item that includes the service cost and outside of operating income. We adopted the provisions of ASU 2017-07 in the first quarter of 2017. The defined benefit pension plan was frozen effective January 1, 2010. As a result no service cost was incurred for the years ending December 31, 2017 and 2016, respectively. The other components of net periodic pension cost were \$11.9 million and \$5.5 million for the years ending December 31, 2017 and 2016, respectively, and are presented in the line item "net periodic pension cost" included in non-operating gains (losses) section in the combined income statement. The 2016 amounts, which were previously reported in employee benefits, have been reclassified to conform to the 2017 presentation in the combined income statement.

Direct expenses increased \$110.9 million, or 6%, compared to the same period in 2016. Major components of this expense growth were:

1. Labor and benefits rose by \$42.9 million, or 4%, broken down as follows:

(in millions)	2017	2016	% Change
Salary and Wages	\$ 954.2	\$ 906.8	5%
Contract Labor	10.2	10.2	-
Benefits	191.9	196.4	(2%)
Total	<u>\$1,156.3</u>	<u>\$1,113.4</u>	4%

Salary and wages increased at NMG (\$20.6 million), the System Office (\$7.6 million), NCI (\$3.7 million), NBH (\$3.3 million), NCH (\$3.2 million), Norton Audubon Hospital (Audubon) and NWCH (\$2.8 million), and Norton Hospital (\$2.3 million). NMG continued to hire additional specialists and primary care providers compared to the prior year. The System Office added positions in their Access Center, Nursing Institute Academic Program, Human Resources, Information Services, Quality Management, Managed Care, and Construction departments. The NCI, NBH, NCH, Audubon, NWCH, and Norton increases were volume related. Additionally, system wide general pay increases were given in the second and third quarters of 2017.

Benefit costs declined due to lower health insurance expense (\$11.5 million) partially offset by higher FICA expense (\$4.0 million), additional discretionary funding of the employer contributions to the 403(b)/401(k) benefit plans (\$1.9 million), increased parental leave expense (\$714,000), and increased Norton Scholars expense (\$602,000).

2. The increase in professional fees of \$5.6 million, or 9%, occurred at Norton (\$3.2 million) and NBH (\$1.4 million) as they incurred increased costs with their new anesthesia contracts.
3. Drug and supply costs increased \$54.9 million, or 13%; \$34.7 million in drug expense and \$20.2 million in supply expense. The increase in drug expense occurred at NCI (\$25.5 million), the Norton Healthcare Pharmacies (Norton Pharmacies) (\$2.9 million), NCH (\$2.7 million), NMG (\$1.4 million) and NWCH (\$1.3 million). The NCI, Norton Pharmacies, NCH, and NWCH variances were volume related. Also, in the third quarter NCH began treating patients with spinal muscular atrophy which were treated with a drug that costs \$96,000 per dose. NMG incurred increased costs for immunizations. The increase in supply expense occurred primarily at Norton (\$6.4 million), NWCH (\$5.2 million), NBH (\$3.7 million), and Audubon (\$2.9 million). Norton's increase occurred in Surgery and Invasive Cardiology where they incurred costs for chargeable supplies, other implants, spine implants, and reagents/chemicals; NWCH's was in Surgery for orthopedic implants, non-chargeable supplies, chargeable supplies, reagents/chemicals, and blood products; NBH's was in Surgery for neurologic implants, orthopedic implants, non-chargeable supplies, and chargeable supplies; and Audubon's was in Surgery, Interventional Radiology, and Invasive Cardiology for chargeable supplies, other implants, and orthopedic implants. These increases were volume related.
4. The increase in fees and special services of \$6.0 million, or 5%, occurred at the System Office (\$9.7 million) and NMG (\$5.5 million) partially offset by a decline at NCH (\$13.1 million). The System Office and NMG incurred costs for a productivity and operational efficiency review engagement. Also, the System Office incurred additional costs related to support services for clinical applications, Help Desk, desktop and network support, collection services, cyber security, document imaging, and marketing. In 2016 NCH incurred additional legal fees for the lawsuit with Kosair Charities Committee (KCC). This lawsuit was settled in June 2016 and no legal fees for this lawsuit were incurred in 2017. In addition, beginning in the third quarter of 2016 NCH incurred transition costs relating to the name change of the hospital. These transition costs were not incurred in 2017.
5. Repairs and maintenance increased \$3.9 million, or 8%, primarily at the System Office (\$3.0 million) as Information Services incurred costs for software licensing and maintenance contracts.

6. Insurance expense declined \$7.6 million, or 40%, primarily for self-insured malpractice insurance coverage. Malpractice insurance expense is determined by external actuaries, who calculate funding levels required to cover our malpractice claims. Based on their most recent report, lower funding levels are necessary due to favorable claims experience, primarily with our large dollar claim settlements, and our removal from most of the lawsuits related in the Infuse spine implant litigation. The result is lower insurance expense.
7. The increase in other expenses of \$2.2 million, or 13%, was primarily for program expenses, licenses and fees, property taxes, donated equipment, and sponsorships.
8. All other direct expenses increased by \$2.9 million, or 5%. We experienced increases for rents and leases, equipment rent, and utilities.

As a result of greater total direct expense growth than total revenue growth, EBITDA declined from \$219.5 million in 2016 to \$204.9 million in 2017.

Fixed expenses, which include depreciation and interest expense, increased \$6.3 million or 5%, \$4.3 million in depreciation expense and \$2.0 million in interest expense. The increase in depreciation expense occurred primarily at the System Office (\$2.2 million), Audubon (\$910,000), Properties (\$787,000), NWCH (\$684,000), and NMG (\$641,000). At the System Office a new laboratory system was purchased and various software packages were upgraded. Audubon and NWCH completed construction projects and made various equipment purchases. These projects/equipment purchases were completed in mid to late 2016 or early 2017 so depreciation expense started being recorded at various points in time during 2016 but were recorded during the entire year or most of 2017. Properties purchased a building next to the NWCH campus. NMG completed renovation projects on several practice locations and added new practice locations. The increase in interest expense was caused by higher interest on our bonds due to the 2016 bond issuances, partially offset by an increase in capitalized interest, which lowers interest expense.

Patient service margin declined from \$94.8 million in 2016 to \$74.0 million in 2017, or a decrease of \$20.8 million. Increases in salary and wages, drugs, supplies, bad debts, fees/special services, professional fees, depreciation and amortization, repairs and maintenance, other expenses, and interest and a decline in other revenue were partially offset by increased net patient service revenue before bad debt expense and joint venture income and lower insurance and employee benefits.

Investment income was \$76.9 million and \$36.0 million for the years ending December 31, 2017 and 2016, respectively. This improvement was caused by an increase in unrealized gains on the alternative investment segment of our investment portfolio, increased realized gains, and an increase interest and dividend income partially offset by realized losses on the alternative investment segment of our investment portfolio and increased investment manager fees.

Operating income was \$150.9 million in 2017 compared to \$130.9 million in 2016. This represents an improvement of \$20.0 million and was the result of improved investment results partially offset by lower patient service margin.

Other non-operating revenues and expenses show a gain of \$48.2 million in 2017, which is an improvement of \$36.3 million from the same period in 2016. Unrealized investment gains totaled \$60.0 million and \$23.4 million for the years ending December 31, 2017 and 2016, respectively. Market conditions improved significantly in 2017 compared to 2016. In August 2016, we issued three Series 2016 bond offerings. These bond offerings are a combination of variable and fixed rate debt. A portion of the proceeds were used to refund our Series 2006, Series 2011D, and Series 2013B debt. The gain on extinguishment of debt associated with the premium bond issues totaled \$5.6 million. There were no bond offerings in 2017. The change in mark to market on the swap agreements improved \$466,000 compared to a deterioration of \$10.3 million in the years ending December 31, 2017 and 2016, respectively. As discussed in the change in accounting paragraph above, net periodic pension cost was \$11.9 million and \$5.5 million for the years ending December 31, 2017 and 2016, respectively. Grants awarded by the Petersdorf Fund totaled \$300,000 and \$804,000 for the years ending December 31, 2017 and 2016, respectively.

Other equity transactions show a gain of \$14.1 million and \$961,000 for years ending December 31, 2017 and 2016, respectively. In 2017 we received a payment from the KCC for \$10.0 million. This payment was a condition of the Settlement Agreement reached between Norton Healthcare and KCC in 2016. This money is to be used for the Imaging Center at NCH. In 2017, restricted contributions (\$2.3 million) were used for equipment purchases at NCH, NBH, Norton, and NWCH, for heliport modernization and safety upgrades at NCH, and for office renovations at NMG. In 2016, restricted contributions (\$4.6 million) were recorded to close out projects at NWCH for construction in their Intensive Care and Pediatric Emergency Departments, for equipment purchases at NCH, and at NMG for the establishment of a pediatric urology clinic and pediatric orthopedic clinic expansion. In 2017 we recorded favorable adjustments of \$1.8 million to match the pension assets to the funded status of the plan as of December 31, 2017 compared to unfavorable adjustments of \$3.6 million in 2016.

Net assets increased by \$213.2 million and \$143.7 for the years ending December 31, 2017 and 2016, respectively, an improvement of \$69.5 million.

Balance Sheet – December 31, 2017 compared to December 31, 2016

Working capital increased \$87.5 million compared to the prior year end due to increases in marketable securities and other investments, patient accounts receivable, and prepaid expenses and a decline in accrued expenses and other partially offset by a decrease in cash and cash equivalents and current portion of assets limited as to use and an increase in accounts payable. Although our cash balances declined \$39.2 million, not all of this activity impacted working capital as funds (\$105.0 million) were transferred to marketable securities and other investments. Taking this into account, our cash position improved during 2017.

Significant items impacting cash were:

- Collections on hospital/physician practice patient receivables and other miscellaneous receipts,
- Reimbursement for capital projects funded by bond proceeds,
- Receipt of IOA payments from Passport and Kentucky Medicaid,

which were partially offset by:

- Payments made for trade payables, payroll and related taxes, and provider taxes,
- Purchase of capital assets,
- Transfer of funds to marketable securities,
- Employer contributions to the 403(b) and 401(k) savings plans,
- Bond principle deposits,
- Funding the semi-annual interest payments on our debt,
- Transfer of funds to restricted assets to match the settlement payment received from KCC.

The increase in patient receivables was due to higher net patient service revenue before bad debt expense the last quarter of 2017 compared to the same period in 2016. Prepaid expenses increased as we made an additional payment to increase our pharmacy deposit. Accrued expenses and other declined due to reductions in: physician reimbursement accruals, current portion of malpractice insurance liability, and health insurance accrual. The decrease in current portion of assets limited as to use was due a reduction in the malpractice insurance trust assets. The increase in accounts payable was due to timing.

Cash and investments available for debt service increased \$186.4 million, as follows:

(in millions)	12/31/2017	12/31/2016	Change
Operating Cash	\$ 122.7	\$ 162.0	\$(39.3)
Marketable Securities	124.8	18.8	106.0
Board Designated Funds	1,140.8	1,012.3	128.5
Bond Trustee Funds	21.6	30.4	(8.8)
Total	\$1,409.9	\$1,223.5	\$186.4

This increase was caused by positive cash flows generated from operations, reimbursement of capital projects from bond proceeds, and favorable investment results partially offset by spending on capital projects. As a result, consolidated days of cash on hand increased to 254 at December 31, 2017 from 234 at December 31, 2016. Accounts receivable days outstanding increased from 42.6 as of December 31, 2016 to 42.7 as of December 31, 2017 due to higher net patient service revenue before bad debt expense the last quarter of 2017 compared to the same period in 2016.

The increase in assets limited by Board of Trustees was due to favorable investment results. The decrease in assets limited by Bond Indenture Trust were the result of reimbursement of capital projects from bond proceeds and funding a portion of the October 1st bond principle payment, partially offset by favorable investment results. The decline in assets limited by Self Insurance Trust was caused by claims payments, partially offset by favorable investment results and a contribution to the trust. Restricted Funds increased due the receipt of a settlement payment from KCC, discussed in the other equity transaction section above, which was matched by Norton Healthcare and favorable investment results.

Property and equipment increased \$80.8 million to \$878.3 million. This was the result of capital spending, primarily for: construction at Audubon, energy savings initiatives at Audubon, design fees at NCH, construction at NWCH, EPIC system upgrade, a new laboratory system, equipment purchases at NCI and the hospitals, and construction projects at several physician practices partially offset by depreciation.

The increase in other assets of \$4.7million was caused by the vendor incentive with Premier partially offset by a decline in long-term pledges receivable, net of discount.

Other non-current liabilities increased \$1.9 million due to accruals made to the pension plan to record net periodic pension cost partially offset by adjustments to match the pension asset to the funded status of the plan, accruals recorded to the deferred compensation plan, and accounting for construction costs on a new medical office building partially offset by malpractice claims payments, net of accruals.

Total debt decreased \$32.1 million due payments made on the debt partially offset by amortization of bond discounts and bond issue costs.

Thank you for your ongoing interest in Norton Healthcare. We are continually evaluating alternatives to manage and optimize our outstanding debt portfolio. We may from time to time seek to retire or purchase outstanding bonds through cash purchases, through a public Tender Offer, privately negotiated transactions, or otherwise at our sole discretion. Such purchases or exchanges, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions, and other factors. The amount of bonds purchased or exchanged may be material. If you have any questions or concerns, please contact Helena Schulz at (502) 629-8263 or by e-mail at helena.schulz@nortonhealthcare.org.

Sincerely,



Adam D. Kempf
Senior Vice President and Chief Financial Officer

COMBINED FINANCIAL STATEMENTS

Norton Healthcare, Inc. and Affiliates
Years Ended December 31, 2017 and 2016
With Report of Independent Auditors

Ernst & Young LLP



Norton Healthcare, Inc. and Affiliates

Combined Financial Statements

Years Ended December 31, 2017 and 2016

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Report of Independent Auditors

The Board of Trustees
Norton Healthcare, Inc. and Affiliates

We have audited the accompanying combined financial statements of Norton Healthcare, Inc. and Affiliates, which comprise the combined balance sheets as of December 31, 2017 and 2016, and the related combined statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the combined financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We 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 combined financial position of Norton Healthcare, Inc. and Affiliates at December 31, 2017 and 2016, and the combined results of their operations and changes in net assets, and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

March 29, 2018

Norton Healthcare, Inc. and Affiliates

Combined Balance Sheets

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 122,746	\$ 161,959
Marketable securities and other investments	124,792	18,844
Patient accounts receivable, net, less allowance for doubtful accounts of \$106,890 and \$90,716 for 2017 and 2016, respectively	263,746	247,686
Inventory	50,418	49,755
Prepaid expenses and other	36,648	29,589
Miscellaneous receivables	20,527	18,751
Current portion of assets limited as to use	23,704	28,319
Total current assets	<u>642,581</u>	554,903
Assets limited as to use, net of current portion	1,454,294	1,439,081
Property and equipment, net	878,268	797,427
Other assets:		
Investments in joint ventures	63,705	54,559
Pledges receivable, net	21,735	28,659
Beneficial interest in trusts held by others	23,125	20,313
Goodwill and intangible assets, net of accumulated amortization of \$3,711 and \$3,602 for 2017 and 2016, respectively	20,626	20,735
Interest rate swap asset	711	245
Other assets	25,550	26,223
Total other assets	<u>155,452</u>	150,734
Total assets	<u>\$ 3,130,595</u>	<u>\$ 2,942,145</u>

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 78,284	\$ 66,577
Accrued expenses and other	75,517	85,009
Accrued payroll and related items	159,882	161,489
Due to third-party payors, net	32,107	33,470
Accrued interest	8,587	8,587
Current portion of long-term debt	37,266	36,288
Total current liabilities	<u>391,643</u>	<u>391,420</u>
Other non-current liabilities:		
Pension liability	66,702	56,416
Insurance liability	87,018	109,054
Other	80,374	65,653
Total other non-current liabilities	<u>234,094</u>	<u>231,123</u>
Long-term debt, net of current portion	1,099,213	1,132,251
Net assets:		
Unrestricted	1,286,182	1,073,028
Temporarily restricted	78,277	76,160
Permanently restricted	41,186	38,163
Total net assets	<u>1,405,645</u>	<u>1,187,351</u>
Total liabilities and net assets	<u>\$ 3,130,595</u>	<u>\$ 2,942,145</u>

See accompanying notes.

Norton Healthcare, Inc. and Affiliates

Combined Statements of Operations and Changes in Net Assets

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Unrestricted revenue:		
Net patient service revenue before provision for doubtful accounts	\$ 2,210,815	\$ 2,107,214
Provision for doubtful accounts	<u>(75,897)</u>	<u>(67,088)</u>
Net patient service revenue	2,134,918	2,040,126
Other revenue	38,811	41,482
Donations and contributions	12,610	10,624
Joint venture income (loss)	756	(1,433)
Total unrestricted revenue	<u>2,187,095</u>	<u>2,090,799</u>
Operating expenses:		
Labor and benefits	1,156,311	1,113,382
Professional fees	69,349	63,760
Drugs and supplies	474,054	419,176
Fees and special services	120,637	114,658
Repairs, maintenance, and utilities	75,210	70,715
Rent and leases	35,334	32,976
Insurance	11,517	19,070
Provider tax	20,130	20,130
Other	19,686	17,479
Total operating expenses	<u>1,982,228</u>	<u>1,871,346</u>
Earnings before fixed expenses and other gains (losses)	204,867	219,453
Fixed expenses:		
Depreciation and amortization	90,890	86,571
Interest expense	42,167	40,406
Interest rate swap benefit, net	<u>(2,162)</u>	<u>(2,344)</u>
	<u>130,895</u>	<u>124,633</u>
Patient service margin	73,972	94,820

Norton Healthcare, Inc. and Affiliates

Combined Statements of Operations and Changes in Net Assets (continued)

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Patient service margin	\$ 73,972	\$ 94,820
Investment gain	76,914	36,046
Operating gain	<u>150,886</u>	<u>130,866</u>
Non-operating gains (losses):		
Change in net unrealized gains on investments	60,015	23,373
Change in interest rate swaps value	466	(10,289)
Petersdorf Fund grants	(301)	(804)
Net periodic pension cost	(11,925)	(5,524)
Net gain on debt extinguishment	—	5,644
Other non-operating losses, net	(81)	(528)
Total non-operating gains	<u>48,174</u>	<u>11,872</u>
Excess of revenue over expenses	<u>199,060</u>	<u>142,738</u>
Unrestricted net assets:		
Change in pension plan asset and obligation	1,769	(3,625)
Net assets released from restriction for equipment	2,325	4,586
Capital project settlement proceeds	10,000	—
Increase in unrestricted net assets	<u>213,154</u>	<u>143,699</u>
Temporarily restricted net assets:		
Investment gain	4,030	2,249
Contributions, fees, grants, bequests, net	5,046	11,869
Change in beneficial interest in trusts held by others	(3)	120
Change in net unrealized gains on investments	2,469	920
Net assets released from restriction	(9,425)	(10,552)
Increase in temporarily restricted net assets	<u>2,117</u>	<u>4,606</u>
Permanently restricted net assets:		
Change in beneficial interest in trusts held by others	2,198	241
Investment gain	95	36
Contributions, fees, grants, bequests, net	645	(50)
Change in net unrealized gains on investments	85	32
Increase in permanently restricted net assets	<u>3,023</u>	<u>259</u>
Increase in net assets	218,294	148,564
Net assets at beginning of year	1,187,351	1,038,787
Net assets at end of year	<u>\$ 1,405,645</u>	<u>\$ 1,187,351</u>

See accompanying notes.

Norton Healthcare, Inc. and Affiliates

Combined Statements of Cash Flows

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Operating activities		
Increase in net assets	\$ 218,294	\$ 148,564
Adjustments to reconcile increase in net assets to net cash provided by (used in) operating activities:		
Depreciation and amortization	90,890	86,571
Discount accretion	3,277	6,412
Change in net unrealized gains on investments	(62,570)	(24,325)
Change in interest rate swap values	(466)	10,289
Change in pension plan asset and obligation	(1,769)	3,625
Net gain on debt extinguishment	—	(5,644)
Restricted contributions and investment gain	(12,014)	(14,466)
Capital project settlement proceeds	(10,000)	—
Cash (used in) provided by operating assets and liabilities:		
Change in patient accounts receivable, net of provision for doubtful accounts	(16,060)	(5,458)
Change in assets limited as to use, net	61,972	(540,010)
Change in amounts due to third-party payors	(1,363)	7,821
Change in marketable securities and other investments	(105,948)	(105)
Change in other current and non-current assets and liabilities	1,695	45,030
Net cash provided by (used in) operating activities	<u>165,938</u>	<u>(281,696)</u>
Investing activities		
Purchase of property and equipment	(171,731)	(119,891)
Incremental investment in Regional Health Network of Kentucky and Southern Indiana, LLC	(886)	—
Change in joint ventures and other	(8,260)	(5,515)
Net cash used in investing activities	<u>(180,877)</u>	<u>(125,406)</u>
Financing activities		
Proceeds from issuances of long-term debt	—	717,502
Principal payments on long-term debt	(36,288)	(30,281)
Refund of 2006 Bonds	—	(310,619)
Refund of 2011D Bonds	—	(31,345)
Refund of 2013B Bonds	—	(68,730)
Cost of long-term debt issuances	—	(4,566)
Restricted contributions and investment gain	12,014	14,466
Net cash (used in) provided by financing activities	<u>(24,274)</u>	<u>286,427</u>
Decrease in cash and cash equivalents	(39,213)	(120,675)
Cash and cash equivalents at beginning of year	161,959	282,634
Cash and cash equivalents at end of year	<u>\$ 122,746</u>	<u>\$ 161,959</u>

See accompanying notes.

Norton Healthcare, Inc. and Affiliates
Notes to Combined Financial Statements

December 31, 2017 and 2016

1. Description of Organization and Summary of Significant Accounting Policies

Organization

The accompanying combined financial statements of Norton Healthcare, Inc. include the transactions and accounts of Norton Healthcare, Inc. (the controlling company) and Affiliates, including the following: Norton Hospitals, Inc.; Norton Enterprises, Inc.; Norton Properties, Inc.; The Children's Hospital Foundation, Inc.; Norton Healthcare Foundation, Inc.; and Community Medical Associates, Inc. Norton Healthcare, Inc. and Affiliates are collectively hereafter referred to as the Corporation. The Corporation operates in the Louisville, Kentucky metropolitan area, and its operations include 1,837 licensed beds, 13 Norton Immediate Care Centers, and more than 200 primary care and specialty offices.

All significant intercompany transactions and accounts have been eliminated in combination.

Use of Estimates

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

Cash and Cash Equivalents

Cash and cash equivalents include all cash and highly liquid investments that are neither internally nor externally restricted. The Corporation considers highly liquid investments to be cash equivalents when they are both readily convertible to cash and so near to maturity (typically within three months) that their value is not subject to risk due to changes in interest rates. The amount of cash and cash equivalents carried on the combined balance sheets represents fair value.

Marketable Securities and Other Investments

Marketable securities and other investments consist primarily of marketable debt securities which are used by the Corporation to support short-term operational and capital needs.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Allowance for Doubtful Accounts

The provision for doubtful accounts is based upon management's assessment of historical and expected net collections considering historical business and economic conditions, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the allowance for doubtful accounts based upon historical write-off experience by payor category. The results of this review are then used to make modifications to the provision for doubtful accounts to establish an appropriate allowance for doubtful accounts.

Inventory

Inventories (predominately medical and surgical supplies and pharmaceuticals) are primarily carried at the lower of cost (first-in, first-out method) or net realizable value.

Assets Limited as to Use and Investment Results

Assets limited as to use include a portfolio of investments that are set aside by the Board of Trustees (the Board) for future services, indigent care, education, research, and community health initiatives over which the Board retains control and may, at its discretion, subsequently use for other purposes. This portfolio of investments also includes assets restricted by donors. The Corporation utilizes a pooled investment program (the Master Trust Fund) to manage this portfolio of investments. Income is allocated to each entity based on its investment balance to the total investment balance by type of investment. All entities that participate in the Master Trust Fund are included in these combined financial statements. Other investments within assets limited as to use include assets held by trustees under a self-insurance trust agreement and assets under bond indenture trust agreements. Amounts required to meet current liabilities of the Corporation have been classified as current in the combined balance sheets at December 31, 2017 and 2016.

Investment securities are exposed to various risks, such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term, and that such change could materially affect the amounts reported in the combined balance sheets.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

All investment securities are considered trading. Included in investment gain are interest, dividends, realized gains and losses on investments, and changes in the value of investments carried at net asset value (NAV). Investment gain and the change in net unrealized gains on investments are included in the excess of revenue over expenses unless a donor or law restricts the income or loss.

Alternative investments, including hedge funds, real estate funds, and private equity funds, are recorded under the equity method of accounting using NAV. The NAV of the alternative investments is based on valuations provided by the administrators of the specific financial instrument. The underlying investments in these financial instruments may include marketable debt and equity securities, commodities, foreign currencies, derivatives, and private equity investments. The underlying investments themselves are subject to various risks, including market, credit, liquidity, and foreign exchange risk. The Corporation believes the NAV is a reasonable estimate of its ownership interest in the respective alternative investments. The Corporation's risk of alternative investments is limited to its carrying value plus amounts committed to private equity funds as disclosed in Note 4. Alternative investments can be divested only at specified times in accordance with terms of the subscription agreements. The financial statements of all of the Corporation's alternative investments are audited annually. Because these financial instruments are not readily marketable, the estimated carrying value is subject to uncertainty, and, therefore, may differ from the value that would have been used had a market for such financial instruments existed. The change in the carrying value of the alternative investments is included in investment gain in the combined statements of operations and changes in net assets.

The Corporation has elected to account for common and collective trust funds at fair value as allowed under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 825, *Financial Instruments* (ASC 825). The Corporation believes that this election is appropriate given the nature of the investments and their similarity to mutual funds.

Fair Value of Financial Instruments

The Corporation follows the provisions of ASC 820, *Fair Value Measurements and Disclosures* (ASC 820), which defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establishes a framework for measuring fair value. ASC 820 defines a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

ASC 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability. As a basis for considering market participant assumptions in fair value measurements, and, as noted above, ASC 820 defines a three-level fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity and the reporting entity's own assumptions about market participants. The fair value hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – Inputs utilize quoted market prices in active markets for identical assets or liabilities.
- Level 2 – Inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset and liability (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.
- Level 3 – Inputs are unobservable inputs for the asset or liability, which is typically based on an entity's own assumptions, as there is little, if any, related market activity.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

In order to meet the requirements of ASC 820, the Corporation utilizes three basic valuation approaches to determine the fair value of its assets and liabilities required to be recorded at fair value. The first approach is the cost approach. The cost approach is generally the value a market participant would expect to replace the respective asset or liability. The second approach is the market approach. The market approach looks at what a market participant would consider an exact or similar asset or liability to that of the Corporation, including those traded on exchanges,

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

to determine value. The third approach is the income approach. The income approach uses estimation techniques to determine the estimated future cash flows of the Corporation's respective asset or liability expected by a market participant and discounts those cash flows back to present value (more typically referred to as a discounted cash flow approach).

Property and Equipment

Property and equipment are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable assets and is computed primarily using the straight-line method. Land improvements are depreciated over a range of 2 to 30 years. Buildings and equipment are depreciated over a range of 1 to 40 years. Costs incurred in the development and installation of internal-use software are expensed if they are incurred in the preliminary project stage or post-implementation stage, while certain costs are capitalized if incurred during the application development stage. Internal-use software is amortized over its expected useful life, generally between 1 and 10 years, with amortization beginning when the project is completed and the software is placed in service.

Useful lives of assets are determined through consultation of the American Hospital Association's *Life of Depreciable Hospital Assets* and in consideration of how the Corporation intends to use the asset or has used similar assets in the past. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization expense is included in depreciation and amortization in the combined statements of operations and changes in net assets.

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support and are excluded from the excess of revenue over expenses. Such gifts are recorded at fair value at the date of donation. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted support.

The Corporation evaluates long-lived assets used in operations for impairment as events and changes in circumstances indicate that the carrying amount of such assets might not be recoverable. Assets are grouped at the lowest level for which there is identifiable cash flows that are largely independent of the cash flows of other groups of assets. Impairment write-downs are recognized in the statements of operations and changes in net assets at the time the impairment is identified. There was no impairment of property and equipment recognized for the year ended December 31, 2017 or 2016.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Investments in Joint Ventures

The Corporation maintains an ownership percentage of 50% or less in various joint ventures and other companies that do not require combination. These investments are accounted for using the equity method or cost method of accounting, as appropriate.

The following is a summary of the investments in joint ventures as of December 31:

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Premier Healthcare Alliance, LP <i>(Note 16)</i>	\$ 47,343	\$ 37,192
The Regional Healthcare Network of Kentucky and Southern Indiana, LLC <i>(Note 17)</i>	13,468	15,497
Other	2,894	1,870
	<u>\$ 63,705</u>	<u>\$ 54,559</u>

The following is a summary of joint venture income (loss) for the years ended December 31:

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Premier Healthcare Alliance, LP <i>(Note 16)</i>	\$ 2,557	\$ 2,111
The Regional Healthcare Network of Kentucky and Southern Indiana, LLC <i>(Note 17)</i>	(2,915)	(4,057)
Other	1,114	513
	<u>\$ 756</u>	<u>\$ (1,433)</u>

Investments in joint ventures are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the investment might not be recoverable. No impairment was recognized for the year ended December 31, 2017 or 2016.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Goodwill and Intangible Assets

The Corporation follows the provisions of ASC 958, *Not-for-Profit Entities* (ASC 958), which provides guidance for a not-for-profit entity with respect to goodwill and other intangible assets subsequent to an acquisition. In accordance with ASC 958, the Corporation tests goodwill and indefinite-lived intangible assets for impairment on an annual basis (October 1) utilizing qualitative and quantitative factors and between annual tests in certain circumstances. Goodwill impairment testing is done at the reporting unit level by comparing the fair value of the reporting unit's net assets against the carrying value of the reporting unit's net assets, including goodwill. The Corporation is defined as the reporting unit for purposes of impairment testing. If a quantitative analysis is performed, the fair value of net assets is generally estimated based on a quantitative analysis of discounted cash flows. The Corporation has goodwill and indefinite-lived intangible assets recorded related to a pathology laboratory, several physician practices, diagnostic centers, and an ambulatory surgical center license totaling \$20.5 million at both December 31, 2017 and 2016.

The annual impairment test performed in 2017 and 2016 resulted in no adjustments to recorded goodwill and indefinite-lived intangible assets. Separate identifiable intangible assets, net of accumulated amortization, of \$0.1 million and \$0.2 million at December 31, 2017 and 2016, respectively, which are not deemed to have an indefinite life, continue to be amortized over their useful lives, which range from three to five years. Future amortization expense of these identifiable intangible assets is not material to the Corporation's combined financial statements.

Medical Malpractice and General Liability Self-Insurance

The Corporation is self-insured for medical malpractice and general liability claims. The provision for estimated self-insured medical malpractice and general liability claims includes estimates of the ultimate costs of settlement for both reported claims and claims incurred but not reported. The Corporation recorded total medical malpractice and general liability self-insurance liabilities of \$111.9 million and \$136.7 million as of December 31, 2017 and 2016, respectively. Medical malpractice and general liability self-insurance liabilities of \$26.6 million and \$29.5 million are included in accrued expenses and other current liabilities at December 31, 2017 and 2016, respectively, based on the expectation of the payout of claims in the subsequent year. Additionally, the Corporation has recorded total receivables of \$13.7 million and \$16.0 million as of December 31, 2017 and 2016, respectively, for anticipated reinsurance recoveries. Of total anticipated reinsurance recoveries, \$3.4 million and \$3.0 million are classified as current at

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

December 31, 2017 and 2016, respectively, and are recorded in miscellaneous receivables on the combined balance sheets. The non-current portions of \$10.4 million and \$13.0 million at December 31, 2017 and 2016, respectively, are recorded in other assets on the combined balance sheets. The Corporation recorded a decrease in medical malpractice and general liability self-insurance expense of approximately \$11.5 million and \$5.0 million in 2017 and 2016, respectively, related to changes in actuarial estimates reflecting lower claim activity, closed claims, improved claim resolution history, and other environmental factors. The Corporation has engaged independent actuaries to estimate the ultimate costs of the settlement of such claims. Recorded medical malpractice and general liability self-insurance liabilities, discounted at 2.25% at both December 31, 2017 and 2016, respectively, represent management's best estimate of ultimate costs.

The Corporation has excess loss insurance coverage for claims over the self-insured limits on a claims-made basis. Through the excess loss commercial policies, the Corporation is insured for losses up to established individual and aggregate claim limits.

The Corporation's management is of the opinion that the accompanying combined financial statements will not be materially affected by the ultimate cost related to asserted and unasserted claims, if any, at the combined balance sheet date.

Under the terms of the self-insurance trust agreements for the self-insurance funds, the Corporation makes annual deposits with its trustee based upon actuarial funding recommendations. Amounts deposited and interest thereon can only be used to pay self-insured losses and related expenses. Such trust fund assets are reported as assets limited as to use. Investment returns from trust assets are recorded as investment gain and change in net unrealized gains on investments, as applicable.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Corporation has been limited by donors to a specific time period or purpose. Permanently restricted assets have been restricted by donors to be maintained by the Corporation in perpetuity. Temporarily and permanently restricted net assets are primarily restricted for strategic capital projects or in support of the Corporation's mission.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Net Patient Service Revenue

The Corporation has agreements with third-party payors that provide for payment to the Corporation at amounts different than the Corporation's established charges. Payment arrangements include prospectively determined rates per discharge based on severity of illness, discounted charges, reimbursed costs, and flat fees.

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. The Corporation recognizes a significant amount of net patient service revenue at the time the services are rendered even though they do not assess the patient's ability to pay. As a result, the provision for doubtful accounts is presented as a deduction from net patient service revenue.

Other Revenue

Other revenue includes capitation revenue, rental income, parking revenue, research revenue, and revenue from other miscellaneous sources.

Excess of Revenue Over Expenses

The combined statements of operations and changes in net assets include subtotals for patient service margin, operating gain, and excess of revenue over expenses. The line excess of revenue over expenses represents the operating indicator for the Corporation as defined under U.S. GAAP. Changes in unrestricted net assets, which are excluded from excess of revenue over expenses, consistent with industry practice, include or may include contributions of long-lived assets, net assets released from restriction for equipment, investment returns on restricted assets, and changes in pension plan asset and obligation.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Charity Care

As a part of its not-for-profit mission, the Corporation provides care to patients who may be unable to pay. For those patients meeting certain criteria, the Corporation does not pursue collection of amounts determined to qualify as charity care. The Corporation follows FASB Accounting Standards Update (ASU) 2010-23, *Health Care Entities (Topic 954): Measuring Charity Care for Disclosure* (ASU 2010-23). ASU 2010-23 requires that cost be used as the measurement for charity care disclosure purposes and that cost be identified as the direct and indirect cost of providing charity care. ASU 2010-23 also requires entities to disclose any reimbursement received to offset the cost of providing charity care. The Corporation estimates charity care cost by calculating a ratio of cost to gross charges, and then multiplying the ratio by the gross charges attributable to patients that qualify for charity care, based on the Corporation's policy. The cost associated with charity care provided was \$10.0 million for both 2017 and 2016. To offset the cost of charity care provided, the Corporation received state means program reimbursement and other financial assistance related receipts of \$4.8 million and \$6.0 million in 2017 and 2016, respectively.

Donor Restricted Gifts

Unconditional promises to give cash and other assets to the Corporation are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the combined statements of operations and changes in net assets as donations and contributions if the purpose relates to operations, or as a change in unrestricted net assets if the purpose relates to purchase of property and equipment.

Beneficial Interest in Trusts Held by Others

The Corporation is an income beneficiary of irrevocable trust funds held by others. The Corporation has recorded the fair value of the ownership interest of the trusts in its combined balance sheet and the changes in the fair values of the ownership interests of the trusts as temporarily and permanently restricted net assets, as appropriate.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Contributions Received and Pledges Receivable

Pledges are recorded as donations and contribution revenue in the year pledged. Unconditional donor pledges to give cash, marketable securities, and other assets are reported at present value, through a discounted cash flow approach, at the date the pledge is made. Pledges receivable are discounted based on the nature of the individual pledge consistent with the Corporation's policy. Discount rates ranged from 0.03% to 1.37% at December 31, 2017, and December 31, 2016. Discount rates reflect the economic conditions of the year in which the pledge was made.

Conditional donor promises to give and indications of intentions to give are not recognized until the condition is satisfied. Pledges received with donor restriction on the use of the donated assets are reported as either temporary or permanently restricted support until the donor restriction expires. An allowance is recorded for amounts the Corporation has deemed uncollectible.

Outstanding pledges receivable from various corporations, foundations, and individuals at December 31 are as follows:

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Gross pledges due:		
In less than one year	\$ 10,792	\$ 9,152
In one to five years	4,533	13,330
In more than five years	29,725	27,186
	<u>45,050</u>	<u>49,668</u>
Allowance for uncollectible pledges	(1,455)	(1,663)
Discounting	(12,523)	(11,857)
Net pledges receivable	<u>31,072</u>	<u>36,148</u>
Less current portion	(9,337)	(7,489)
Net pledges receivable long-term	<u>\$ 21,735</u>	<u>\$ 28,659</u>

The current portion of pledges receivable, included in miscellaneous receivables on the combined balances sheets, was \$9.3 million and \$7.5 million at December 31, 2017 and 2016, respectively.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Income Taxes

Most of the income generated by the Corporation is exempt from taxation under Section 501(a) of the Internal Revenue Code. Certain of the Corporation's affiliates are taxable entities and some of the income generated by otherwise exempt entities is subject to taxation as unrelated business income. The Corporation files federal and Kentucky state income tax returns. The statute of limitations for tax years 2014 through 2016 remains open in the major U.S. taxing jurisdictions in which the Corporation is subject to taxation, and the 2017 tax year's statute of limitations will begin once returns for that year are filed. In addition, for all tax years prior to 2015 generating or utilizing a net operating loss (NOL), tax authorities can adjust the amount of NOL carryforward to subsequent years.

As of December 31, 2017, the Corporation has NOL carryforwards of approximately \$21.4 million (\$19.9 million at December 31, 2016). These NOL carryforwards expire in years 2018 to 2037. As a result of the NOL carryforwards, the Corporation recorded a deferred income tax asset of \$5.7 million and \$7.7 million at December 31, 2017 and 2016, respectively. The Corporation evaluates the realizability of the deferred tax assets annually. Based on the cumulative losses incurred by Norton Enterprises, Inc. over the previous five-year period and future projections, the Corporation determined it is not probable that future taxable income will be available to apply against the deferred tax assets. As a result, the Corporation recorded a full valuation allowance of \$5.7 million and \$7.7 million at December 31, 2017 and 2016, respectively.

The Tax Cuts and Jobs Act (the Act) was enacted on December 22, 2017. The primary impact in 2017 on the Corporation was the Act reduced the US federal corporate tax rate from 35% to 21% which required a remeasurement of the Corporation's deferred taxes. For tax-exempt entities, effective beginning the 2018 tax year, the Act also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on remuneration above certain thresholds that is paid to executives by the organization, and report income or loss from unrelated business activities on an activity-by-activity basis, among other provisions. At December 31, 2017, the Corporation has made a reasonable estimate of the tax effects of the enactment of the Act and remeasured its deferred tax balances, which did not have a material impact on the Corporation as all deferred tax balances are offset by a full valuation allowance. Certain regulatory guidance provides for a measurement period of up to one year during which the accounting for the tax effects of the Act may be completed. The Corporation may record further adjustments in future periods upon obtaining, preparing, or analyzing additional

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

information about facts and circumstances that existed as of the date of enactment. The Corporation will continue to revise and refine the calculations as additional Internal Revenue Service (IRS) guidance is issued, however, the Corporation does not anticipate any material impact to the combined financial statements.

Recent Accounting Pronouncements

Recently Adopted

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* (ASU 2017-07), which changes how employers that sponsor defined benefit pension present the net periodic benefit cost in the statement of operations. ASU 2017-07 requires employers to present the service cost component of net periodic benefit cost in the same statement of operations line items as other employee compensation costs arising from services rendered during the period. Employers are to present the other components of net periodic benefit cost separately from the line item that includes the service cost and outside of any subtotal of operating income, if one is presented. Employers will have to disclose the lines used to present the other components of net periodic benefit cost, if the components are not presented separately in the statement of operations.

The Corporation elected to adopt the provisions of ASU 2017-07 as of January 1, 2017. The non-contribution defined benefit pension plan (the Plan) was frozen effective January 1, 2010. As a result no service cost was incurred during the years ended December 31, 2017 and 2016. The other components of net periodic pension cost were \$11.9 million and \$5.5 million for the years ended December 31, 2017 and 2016, respectively, and are presented now in non-operating gains (losses) in the combined statement of operations and changes in net assets. The 2016 amount, which was previously reported in labor and benefits, has been reclassified to conform to the 2017 presentation in the combined statement of operations and changes in net assets, which resulted in an increase in operating gain and a decrease in total nonoperating gains of \$5.5 million, respectively, for the year ended December 31, 2016.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

Yet to be Adopted

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)* (ASU 2014-09), to clarify the principles for recognizing revenue and to improve financial reporting by creating common revenue recognition guidance for U.S. GAAP and International Financial Reporting Standards. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period by applying either the full retrospective method or the cumulative catch-up transition method. The full retrospective method requires application of the provisions of ASU 2014-09 for all periods presented while the cumulative catch-up transition method requires the application of the provisions of ASU 2014-09 as of the date of adoption with the cumulative effect of the retrospective application of the provisions as an adjustment through unrestricted net assets.

The Corporation adopted ASU 2014-09 on January 1, 2018 using the cumulative catch-up transition method. The Corporation's process for implementation began with a preliminary evaluation of ASU 2014-09 and considered subsequent interpretations by the FASB Transition Resource Group for Revenue Recognition and the AICPA. The Corporation has performed an analysis of revenue streams and transactions under ASU 2014-09. In particular, for net patient service revenue, the Corporation performed an analysis into the application of the portfolio approach as a practical expedient to group patient contracts with similar characteristics, such that net patient service revenue for a given portfolio would not be materially different than if it were evaluated on a contract-by-contract basis. The Corporation also assessed the impact of ASU 2014-09 on various reimbursement programs that represent variable consideration, including settlements with third-party payors, disproportionate share payments, supplemental state Medicaid programs, bundled payment of care programs and other reimbursement programs in which the Corporation participates. Industry guidance is continuing to develop around this issue, and any conclusions in the final industry guidance that is inconsistent with the Corporation's application could result in changes to the Corporation's expectations regarding the impact that ASU 2014-09 could have on the Corporation's combined financial statements. The Corporation does not believe such industry guidance will have an impact on its current accounting policies and procedures related to third-party settlements. Final drafts of industry guidance on these and other reimbursement programs unique to the healthcare industry are expected later in 2018. The Corporation is monitoring the development of such guidance.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

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

As currently determined, the impact to the combined financial statements upon adoption is not material. Upon adoption in 2018, the majority of what is currently classified as the provision for doubtful accounts (and presented as a reduction to net patient service revenue on the combined statements of operations and changes in net assets) will be treated as an implicit price concession that reduces the transaction price (net patient service revenue). ASU 2014-09 also requires enhanced disclosures related to the disaggregation of revenue and significant judgments made in measurement and recognition. The Corporation is still evaluating certain presentation and disclosure items under ASU 2014-09.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The guidance in ASU 2016-02 supersedes the lease recognition requirements in ASC 840, *Leases*. ASU 2016-02 requires an entity to recognize assets and liabilities arising from a lease for both financing and operating leases, along with additional qualitative and quantitative disclosures. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The Corporation is currently evaluating the effect that ASU 2016-02 will have on its combined financial statements.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities* (ASU 2016-14), which will change certain financial statement requirements for not-for-profit (NFP) entities. NFPs will no longer be required to distinguish between resources with temporary and permanent restrictions on the face of their financial statements, meaning they will present two classes of net assets (with donor restrictions and without donor restrictions) instead of three classes. The guidance also will change how NFPs report certain expenses and provide information about their available resources and liquidity. In addition, NFPs will be required to present expenses by their natural and functional classification and present investment returns net of external and direct investment expenses. ASU 2016-14 is effective for fiscal years beginning after December 15, 2017, and interim periods thereafter. The guidance will be applied retrospectively, but NFPs will have the option to omit certain information for comparative periods presented in the year of adoption. The Corporation is currently evaluating the impact that ASU 2016-14 will have on its combined financial statements.

Reclassification

Certain reclassifications were made to the 2016 combined financial statement presentation to conform to the 2017 combined financial statement presentation.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

2. Community Service (Unaudited)

The Corporation continues to build on a tradition of community service established over 100 years ago by its predecessor organizations, with a mission to provide quality health care to all those served. Through Norton Children's Hospital (formerly named Kosair Children's Hospital) and Norton Children's Medical Center (formerly named Kosair Children's Medical Center) tertiary, acute-level inpatient services, and emergency and outpatient specialty care, are provided to children who live throughout Kentucky and Southern Indiana, regardless of ability to pay. In addition, many patients treated at Norton Hospital, Norton Audubon Hospital, Norton Women's and Children's Hospital (formerly named Norton Women's and Kosair Children's Hospital), and Norton Brownsboro Hospital receive free or discounted care. The Corporation is a major participant in the residency and medical education programs of the University of Louisville School of Medicine.

The Corporation uses the 2015 edition of the Catholic Health Association's *Guide for Planning and Reporting Community Benefit* (CHA guidelines) to report the community benefit amounts.

In 1987, the Corporation established a fund designated for providing indigent care, education, research, and community health initiatives, now known as the James R. Petersdorf Fund (Petersdorf Fund) (see Note 4). Other programs that benefit the Corporation's community are listed below. The costs associated with providing community service for the years ended December 31 are as follows:

	2017	2016
	<i>(In Thousands)</i>	
Charity care ^(A)	\$ 5,159	\$ 4,003
Educational support	39,702	35,005
Unpaid cost of Medicaid services	97,433	97,172
Sponsorships	1,700	1,768
Community cancer initiatives	4,499	3,755
Community service activities	1,291	1,433
Other community benefits	7,411	12,325
	\$ 157,195	\$ 155,461

^(A) Consistent with Internal Revenue Service (IRS) Form 990 requirements and CHA guidelines, this amount is to be reported net of state means programs and amounts received specifically to provide financial assistance. The Corporation received state means program reimbursement and other financial assistance related receipts of \$4.8 million and \$6.0 million in 2017 and 2016, respectively.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

3. Property and Equipment

Property and equipment at December 31 consists of:

	2017	2016
	<i>(In Thousands)</i>	
Land and land improvements	\$ 44,919	\$ 44,556
Buildings	926,447	902,682
Equipment	1,051,433	1,008,930
	2,022,799	1,956,168
Accumulated depreciation and amortization	(1,349,530)	(1,260,361)
	673,269	695,807
Construction-in-process	204,999	101,620
	\$ 878,268	\$ 797,427

Equipment includes computer software costs of \$82.4 million and \$79.3 million at December 31, 2017 and 2016, respectively, which are primarily related to the Corporation's clinical and revenue cycle information systems. The accumulated depreciation related to computer software recorded in accumulated depreciation and amortization is \$59.1 million and \$53.5 million at December 31, 2017 and 2016, respectively. The expense related to computer software recorded in depreciation and amortization expense on the combined statements of operations and changes in net assets was \$5.6 million and \$5.2 million for the years ended December 31, 2017 and 2016, respectively.

4. Assets Limited as to Use and Investment Return

Asset Limited as to Use

The composition of assets limited as to use at December 31 is set forth in the following table by type of Board designation or restriction. Assets limited as to use are carried at fair value, except for alternative investments (consisting of hedge funds, real estate funds, and private equity funds), which are accounted for under the equity method of accounting.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

4. Assets Limited as to Use and Investment Return (continued)

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
By Board of Trustees for indigent care, education, research, and community health initiatives (Petersdorf Fund)	\$ 136,715	\$ 122,135
By Board of Trustees	1,004,070	890,172
By self-insurance trust agreements	114,600	135,657
Less current portion	(23,208)	(26,469)
By self-insurance trust agreements, net	<u>91,392</u>	109,188
By bond indenture trust agreements	135,601	258,179
Less current portion	(21)	(21)
By bond indenture trust agreements, net	<u>135,580</u>	258,158
By contractual agreement (<i>Note 12</i>)	32,369	14,056
Less current portion	(476)	(1,830)
By contractual agreement	<u>31,893</u>	12,226
By donors	54,644	47,202
	<u>\$ 1,454,294</u>	<u>\$ 1,439,081</u>

The Corporation's investment portfolio is structured in a manner that matches investment risk and return. Short-term volatility and uncertainty of investment results are recognized as real risks that are managed through specific asset allocation strategies and diversification.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

4. Assets Limited as to Use and Investment Return (continued)

The Corporation's actual weighted-average allocations for assets limited as to use at December 31, by asset category, are as follows:

	<u>2017</u>	<u>2016</u>
Cash and cash equivalents	3.4%	2.9%
Marketable debt securities	21.4	32.1
Marketable equity securities	4.0	7.0
Mutual funds	38.8	29.9
Hedge funds	20.7	18.8
Real estate funds	6.5	5.6
Common and collective trust funds	3.4	3.2
Private equity funds	1.8	0.5
	<u>100.0%</u>	<u>100.0%</u>

At December 31, 2017, the Corporation has committed capital yet to be called of approximately \$34.9 million to private equity funds over the next one to three years (\$48.0 million at December 31, 2016).

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

4. Assets Limited as to Use and Investment Return (continued)

Investment Return

Investment return is shown under unrestricted, temporarily restricted, and permanently restricted net assets in the line items titled investment gain (included in operating gain for the unrestricted net assets) and change in net unrealized gains on investments (included in non-operating gains (losses) for unrestricted net assets). The following is a summary of the key components of investment return for the years ended December 31:

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Investment gain by net asset class:		
Unrestricted	\$ 76,914	\$ 36,046
Temporarily restricted	4,030	2,249
Permanently restricted	95	36
Total investment gain	<u>\$ 81,039</u>	<u>\$ 38,331</u>
Components of investment gain:		
Interest and dividends	\$ 23,168	\$ 18,343
Income distributions from trusts	1,128	994
Investment fees	(3,865)	(3,225)
Net realized gains on investments recorded at fair value	24,805	9,477
Net realized (losses) gains on investments recorded at other than fair value	(1,350)	2,292
Change in net unrealized gains on investments recorded at other than fair value	37,153	10,450
Total investment gain	<u>\$ 81,039</u>	<u>\$ 38,331</u>

The unrestricted, temporarily restricted, and permanently restricted change in net unrealized gains on investments was \$62.6 million and \$24.3 million for the years ended December 31, 2017 and 2016, respectively, is solely composed of the change in net unrealized gains on investments recorded at fair value.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements

The following table summarizes the recorded amount of assets and liabilities by class of asset or liability recorded at fair value on a recurring basis. Certain assets are marked as not applicable (N/A), as they are not recorded at fair value, or elected to be recorded at fair value, on a recurring basis. The valuation level of the asset or liability as defined by ASC 820 is included for assets and liabilities carried at fair value.

	December 31		Level
	2017	2016	
	<i>(In Thousands)</i>		
Marketable securities and other investments, at fair value			
Total marketable debt securities ^(A)	\$ 124,792	\$ 18,844	2
Assets limited as to use, at fair value			
By Board of Trustees and donors:			
Cash	138	4,072	1
Mutual funds:			
Templeton Global Equity Fund ^(B)	95,802	75,537	1
PIMCO Real Return Fund ^(C)	46,170	52,152	1
Capital World Growth and Income Fund ^(D)	88,032	72,874	1
Dodge & Cox Global Stock Fund ^(E)	82,280	78,446	1
Dreyfus Global Equity Fund ^(F)	91,315	71,634	1
Wells Capital Management Core Fixed Income ^(G)	53,673	60,865	1
Vanguard Emerging Market Stock Fund ^(H)	22,913	—	1
MetWest Total Return Bond Fund ^(I)	51,951	—	1
Other publicly traded mutual funds ^(J)	41,560	34,751	1
Total mutual funds	573,696	446,259	1
Common and collective trust funds ^(K)	50,172	46,726	NAV
Separately-managed accounts:			
PNC (marketable debt securities) ^(L)	15	54,442	2
Sterling Capital ^(M)	64,211	61,681	2
EPOCH All Cap US Equity ^(N)	37,589	41,744	1
Baron (domestic equity growth) ^(O)	5	5	1
Disciplined Growth Investors ^(P)	37,892	38,722	1
Other ^(Q)	1,680	1,289	1
Total separately-managed accounts	141,392	197,883	
Total assets limited as to use by Board of Trustees and donors at fair value	765,398	694,940	

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements (continued)

	December 31		Level
	2017	2016	
	<i>(In Thousands)</i>		
By contractual agreements:			
Cash	\$ 32,369	\$ 14,056	1
Total assets limited as to use by contractual agreements, at fair value	32,369	14,056	
By self-insurance trust agreements:			
Mutual fund:			
Sterling Behavioral Small Cap Value ^(R)	5,717	6,232	1
Total mutual funds	5,717	6,232	
Separately-managed accounts:			
Cash	5,957	6,564	1
Marketable debt securities ^(S)	81,742	100,861	2
Sterling Special Opportunities Equity ^(T)	21,184	22,000	1
Total separately-managed accounts	108,883	129,425	
Total assets limited as to use by self-insurance trust agreements, at fair value	114,600	135,657	
By bond indenture trust agreements:			
Cash	21	59	1
Marketable debt securities ^(L)	135,580	258,120	2
Total assets limited as to use by bond indenture, at fair value	135,601	258,179	
Total assets limited as to use, at fair value	1,047,968	1,102,832	
Assets limited as to use at other than fair value:			
Hedge funds ^(V)	306,855	275,290	N/A
Real estate funds ^(W)	96,699	81,540	N/A
Private equity ^(X)	26,476	7,738	N/A
Total assets limited as to use at other than fair value	430,030	364,568	
Less current portion of self-insurance trust and bond indenture trust and assets limited as to use in escrow	(23,704)	(28,319)	
Total assets limited as to use	\$ 1,454,294	\$ 1,439,081	
Other assets at fair value:			
Beneficial interest in trusts held by others <i>(Note 1)</i>	\$ 23,125	\$ 20,313	2
Interest rate swap asset <i>(Note 7)</i>	711	245	2

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements (continued)

- (A) Investment-grade readily marketable corporate debt securities (95%), municipal fixed-income securities (3%) and money market funds invested in high-quality fixed-income securities (2%).
- (B) Mutual fund invests in domestic and international equities to achieve long-term capital growth. Fund strives to exceed the MSCI World Index.
- (C) Mutual fund seeks to maximize real returns by investing the majority of its assets in Treasury Inflation Protected Securities (TIPS) issued by the U.S. government. The fund may also invest in U.S. Treasury securities, corporate bonds, mortgage-backed securities and emerging market bonds to add value when opportunities arise.
- (D) Mutual fund invests in domestic and international equities with a focus on companies paying regular dividends and strives to exceed the MSCI World Index.
- (E) Mutual fund invests in equity securities issued by medium-to-large-sized well-established global companies, including those domiciled in emerging markets, and strives to exceed the MSCI World Index.
- (F) Mutual fund invests in domestic and international equities and strives to exceed the MSCI World Index.
- (G) Mutual fund seeks to deliver excess return relative to the taxable fixed-income universe as measured by the Barclays U.S. Aggregate Bond Index.
- (H) Mutual fund seeks to provide long-term capital appreciation. The fund invests mainly in equity securities of companies located in emerging markets including small, mid, and large capitalization companies.
- (I) Mutual fund seeks to maximize long-term total return. At least 80% of its net assets are invested in investment grade fixed income securities or unrated securities of similar quality. Up to 20% of its net assets may be invested in securities rated below investment grade.
- (J) Various other publicly traded mutual funds invested in a variety of money market, fixed-income, domestic equity, and international equity mutual funds. The equity mutual funds are diverse in investment strategies, including both value and growth and a variety of market capitalizations.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements (continued)

- (K) Common and collective trust fund whose objective is to maximize real return by investing in a variety of securities that offer strong relative performance in a rising inflation environment. This common and collective trust fund seeks to exceed the Dow Jones AIG Commodity Total Return Index.
- (L) Manager invests in marketable corporate debt securities (44%), U.S. government fixed-income securities (53%) and other fixed-income investments (3%) that strives to provide a return better than traditional cash or money market portfolios.
- (M) Manager invests primarily in marketable corporate debt securities (64%), U.S. government fixed-income securities (29%), and other fixed-income investments (7%) with the objective of maximizing total return while preserving capital. Manager strives to exceed the Barclays Capital Aggregate index.
- (N) Manager invests in domestic equities across various industries with a value orientation and high rates of free cash flow. Manager strives to exceed the Russell 3000 Value Index.
- (O) Manager invests in domestic equities across various industries with a variety of market capitalizations with a growth orientation and strives to exceed the Russell 3000 Growth Index.
- (P) Manager seeks to invest in mid-cap companies with market caps between \$1 billion and \$10 billion that are expected to yield high returns. The portfolio will generally hold between 40-50 securities with an average turnover ratio ranging from 15% to 30%.
- (Q) Conglomeration of smaller accounts whose components are not deemed material for individual breakout. Largest holding is a money market fund (67%).
- (R) Mutual fund that seeks to capitalize on behaviorally driven market anomalies by employing a disciplined investment process that ranks small capitalization companies in the fund's universe based on a number of factors including valuation, price momentum and earnings revisions.
- (S) Externally managed portfolio holding investment grade U.S. agency and U.S. Treasury fixed-income securities whose maximum maturity does not exceed five years.
- (T) Equity portfolio that primarily invests in companies with the best perceived combination of underlying growth potential and attractive valuation in a high conviction portfolio of 25-40 holdings.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements (continued)

- (U) Externally managed portfolio holding primarily U.S. agency and Treasury securities (approximately 73% of the portfolio) and highly rated municipal and commercial paper fixed-income securities (approximately 27% of the portfolio) structured to generate returns while protecting principal and providing liquidity to fund draws on the project fund.
- (V) The hedge funds are composed of both fund of funds and direct hedge funds that seek to provide equity-like returns over a full market cycle with reduced volatility and low correlation. The hedge fund total consists for twelve separate funds. The managers employ various strategies, including, but not limited to, long/short equity, long/short credit, distressed credit, merger/credit arbitrage, and macrotrading strategies.
- (W) The real estate funds include an actively managed private real estate investment trust (REIT) composed of participating mortgages and wholly owned real estate investments. The real estate fund total consists of two separate funds. A smaller portion of the holdings include a commingled real estate fund, which includes the purchase of REITs, real estate properties, private equity funds, public debt securities, and high-yield private debt.
- (X) The private equity funds are comprised of limited partnerships that invest in the equity and debt of privately held companies. The private equity fund total consists of eight separate funds. The objective of these strategies is to provide a return that exceeds that of public equity markets over a long-term time period. These investments will typically have a life of five to ten years depending on the strategy.

Valuation

Marketable Debt Securities and Other Investments and Assets Limited as to Use

Level 1 securities are stated at quoted market prices. The Corporation's various investment portfolios are held by a variety of managers and these managers use external pricing services in providing the valuation for all levels of securities. The Corporation does not adjust the quoted market prices for such financial instruments.

Level 2 securities include valuations based upon direct and indirect observable market inputs that may utilize the market, income, or cost approaches in determination of their fair value. The pricing services use a variety of pricing models and inputs based upon the type of security being valued.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements (continued)

These inputs may include, but are not limited to the following: reported trades; similar security trade data; bid/ask spreads; institutional bids; benchmark yields; broker/dealer quotes; issuer spreads; yield to maturity; and corporate, industry, and economic events.

As nearly all of the Corporation's marketable debt securities are actively traded, the recorded fair value reflects current market conditions. However, due to the inherent volatility in the investment market, there is at least a possibility that recorded investment values may change by a material amount in the near term.

The common and collective trust funds are valued at NAV provided by the respective fund administrators. Management has determined that the NAV is an appropriate estimate of the fair value of the common and collective trust funds at December 31, 2017 and 2016, based on the fact that the common and collective trust funds are audited and accounted for at fair value by the administrators of the respective common and collective trust funds. There are no restrictions on the ability of the Corporation to redeem any of the common and collective trust funds at December 31, 2017 or 2016.

Beneficial Interests in Trusts Held by Others

The Corporation is an income beneficiary of irrevocable trust funds held by others. The Corporation has recorded the fair value of the ownership interest of the irrevocable trust funds based on its pro rata share of the underlying assets or income. Based on the observable inputs, typically marketable debt or equity securities held in the irrevocable trust funds, the Corporation has determined its beneficial interests in outside trust funds held by others fall in Level 2 of the fair value hierarchy. This technique is consistent with the market approach.

Interest Rate Swap Asset

The fair value is calculated based on a discounted cash flow model, taking into consideration the terms of each interest rate swap and the credit rating of the Corporation or counterparty, as applicable. Based on the observable inputs, typically published interest rates and credit spreads, the Corporation has determined its interest rate swaps fall in Level 2 of the fair value hierarchy. The specific Corporation inputs are disclosed in Note 7. This technique is consistent with the income or discounted cash flow approach.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Fair Value Measurements (continued)

Other Fair Value Measurements

Certain financial instruments are not required to be marked to fair value on a recurring basis, and, therefore, the level of disclosure is noted as not applicable. The carrying value of pledges receivable is required to be disclosed at fair value under applicable accounting guidance. The fair value of the Corporation's pledges receivable, based on discounted cash flow analysis and adjusted for consideration of the donor's credit, is \$31.1 million and \$36.1 million at December 31, 2017 and 2016, respectively. These fair values are determined using a Level 2 methodology in the fair value hierarchy based on observable inputs through formal pledge agreements and other similar documents, as well as market interest rates.

6. Net Patient Service Revenue

Net patient service revenue is recorded during the period the health care services are provided, based on estimated amounts due from the patients and third-party payors. Third-party payors include federal and state agencies (under Medicare, Medicaid, and other government programs), managed care health plans, commercial insurance companies, and employers. Patient service revenue is reported at estimated net realizable amounts for services rendered. The Corporation recognizes patient service revenue associated with patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, patient service revenue is recognized on the basis of discounted rates in accordance with the Corporation's policy.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

6. Net Patient Service Revenue (continued)

Net patient service revenue (net of contractual allowances and discounts) before the provision for doubtful accounts from major payor sources for the years ended December 31 is as follows:

	2017	% of Total	2016	% of Total
	<i>(In Thousands)</i>			
Medicare	\$ 649,143	30%	\$ 575,244	27%
Medicaid	427,346	19	417,615	20
Commercial	1,112,968	50	1,033,790	49
Self-pay and other	21,358	1	80,565	4
Net patient service revenue before provision for doubtful accounts	<u>2,210,815</u>	<u>100%</u>	<u>2,107,214</u>	<u>100%</u>
Provision for doubtful accounts	75,897		67,088	
Net patient service revenue	<u>\$ 2,134,918</u>		<u>\$ 2,040,126</u>	

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Corporation believes that it is in compliance with all applicable laws and regulations, and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. The Corporation has established a corporate compliance program to assist in maintaining compliance with such laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action, including fines and penalties and exclusion from the Medicare and Medicaid programs. As a result, there is at least a reasonable possibility that current recorded estimates will change by material amounts in the near term.

Medicare

Inpatient acute care services are reimbursed based on the patient's diagnosis related group (DRG). Outpatient services are reimbursed based on the services provided using ambulatory payment classifications (APCs). Medicare payments include Disproportionate Share Hospital and Medical Education add-ons. These add-ons are subject to annual retrospective review by the Medicare program. In the opinion of management, adequate provision has been made in the combined financial statements for any adjustments that may result from such reviews.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

6. Net Patient Service Revenue (continued)

Medicaid

The Commonwealth of Kentucky has contracted with various managed care plans to provide coverage for Medicaid eligible residents. Under these plans, inpatient acute care services are reimbursed based on a prospective DRG system similar to the Medicare acute reimbursement methodology. Outpatient services rendered to beneficiaries are reimbursed under a mixed methodology consisting of prospectively set rates (similar to the Medicare APC methodology), fee schedules, and cost reimbursement. Components of Medicaid reimbursement are subject to annual retrospective review by the Medicaid program. In the opinion of management, adequate provision has been made in the combined financial statements for any adjustments that may result from such reviews.

The Commonwealth of Kentucky has established a provider tax program to provide funds for indigent care provided by Kentucky hospitals. Under the provider tax program, the Corporation's hospitals pay a fixed amount based on total historical receipts from all payors and are eligible for reimbursement for certain services based on historical indigent care utilization. These amounts are shown net on the combined statement of operations and changes in net assets.

Commercial

The Corporation has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Corporation under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

The Corporation recorded an increase in net patient service revenue before the provision for doubtful accounts of approximately \$6.0 million and \$0.2 million in 2017 and 2016, respectively, as a result of changes in estimated settlements with Medicare, Medicaid, and other commercial payors.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

6. Net Patient Service Revenue (continued)

Policy for Assessing the Timing and Amount of Uncollectible Net Patient Service Revenue and Patient Accounts Receivable

Net patient service revenue is reduced by the provision for doubtful accounts, and patient accounts receivable are reduced by an allowance for doubtful accounts. These amounts are based on management's assessment of historical and expected net collections for each major payor, considering business and economic conditions, trends in health care coverage, and other collection indicators. Management regularly reviews data about these major payor sources of net patient service revenue in evaluating the sufficiency of the allowance for doubtful accounts. On the basis of historical experience, a significant portion of the Corporation's uninsured patients will be unable to pay for the services provided. Thus, the Corporation records a significant provision for doubtful accounts in the period services are provided related to self-pay patients, including both uninsured patients and patients with deductible and copayment balances due for which third-party coverage exists for a portion of their balance. For patient account receivables associated with patients who have third-party coverage, the Corporation analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for doubtful accounts, if necessary. Patient accounts receivable are written off after collection efforts have been followed in accordance with the Corporation's policies.

The allowance for doubtful accounts was \$106.9 million and \$90.7 million at December 31, 2017 and 2016, respectively. These balances as a percentage of patient accounts receivable, net of contractual allowances, were approximately 29% and 27% at December 31, 2017 and 2016, respectively. The following is a summary of the Corporation's allowance for doubtful accounts activity for the years ended December 31:

	2017	2016
	<i>(In Thousands)</i>	
Balance at beginning of year	\$ 90,716	\$ 86,316
Additions charged to cost and expenses	75,897	67,088
Patient accounts written off, net of recoveries and other	(59,723)	(62,688)
Balance at end of year	\$ 106,890	\$ 90,716

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt

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

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Louisville/Jefferson County Metro Government Health System Revenue Bonds, Series 2016, dated August 11, 2016 (2016 Bonds)	\$ 592,675	\$ 610,205
Louisville/Jefferson County Metro Government Health System Revenue Bonds, Series 2013, dated September 26, 2013 (2013 Bonds)	204,580	204,580
Louisville/Jefferson County Metro Government Health System Fixed Rate Revenue Refunding Bonds, dated October 31, 2012 (2012A Bonds)	7,000	9,000
Louisville/Jefferson County Metro Government Health System Variable Rate Revenue Bonds, dated August 10, 2011 (2011 Bonds)	85,545	88,045
Kentucky Economic Development Finance Authority, Health System Revenue Bonds, Series 2000, dated October 1, 2000 (2000 Bonds)	200,560	211,700
	1,090,360	1,123,530
Unamortized premiums	15,263	11,986
Less unamortized deferred financing costs	(9,856)	(10,807)
	1,095,767	1,124,709
Capital leases	40,712	43,830
Total long-term debt	1,136,479	1,168,539
Less amounts due within one year	(37,266)	(36,288)
Total long-term debt, net of current portion	\$ 1,099,213	\$ 1,132,251

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

The 2000 Bonds are secured by a mortgage lien on the principal hospital facilities and parking garages of Norton Hospitals, Inc. built before 2006. The net book value of these properties is \$105.2 million and \$113.2 million at December 31, 2017 and 2016, respectively. At December 31, 2017 and 2016, all bonds outstanding are tax-exempt bond issues. All bonds are secured by a security interest in certain pledged collateral, including the operating revenue of the Obligated Group (defined as Norton Healthcare, Inc. and Norton Hospitals, Inc.). Principal and interest related to the bonds are payable solely by the Obligated Group.

Deferred financing costs are being amortized over the life of the respective bond issues using the effective interest method for fixed-rate bonds and the bonds outstanding method for variable-rate bonds.

The Corporation has agreed to certain covenants, which, among other things, limit additional indebtedness and guarantees and require the Corporation to maintain specific financial ratios. The Corporation is in compliance with these covenants at December 31, 2017 and 2016.

2016 Bonds

In 2016, the Corporation entered into loan agreements with Louisville/Jefferson County Metro Government to issue \$521.1 million of Series A uninsured fixed-rate revenue bonds (2016A Bonds), \$31.3 million of Series B uninsured variable-rate bonds (2016B Bonds), and \$68.7 million of Series C uninsured variable-rate revenue bonds (2016C Bonds). Proceeds from 2016A Bonds were used to refund all of the remaining 2006 Bonds outstanding at the time and to pay or reimburse the Corporation for the cost of acquiring, constructing, renovating, and equipping areas related to patient care and to pay certain expense in connection with the issuance of the 2016 Bonds. Proceeds from the 2016B Bonds and 2016C Bonds were used to refund all remaining 2013B Bonds and Series 2011D Bonds outstanding at the time. As a result of the refunding, the Corporation reported a gain on extinguishment of debt of \$5.6 million for the year ended December 31, 2016.

At December 31, 2017 and 2016, the 2016A Bonds consist of term bonds with interest rates ranging from 3.0% to 5.5% maturing through October 1, 2037. Interest is payable semiannually on April 1 and October 1. Beginning October 1, 2026, the 2016A Bonds maturing on or after October 1, 2026, are subject to optional redemption by the Corporation prior to maturity for 100% of par.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

The 2016B Bonds and 2016C Bonds are a direct placement issue and held entirely by Branch Banking and Trust Company, with final maturity in 2021 and 2023, respectively. The 2016B and 2016C Bonds are subject to optional redemption at any time prior to maturity by the Corporation for 100% of par. At both December 31, 2017 and 2016, the applicable cost of the debt for the 2016B and 2016C Bonds was approximately 1.5% and 1.0%, respectively.

2013 Bonds

In 2013, the Corporation entered into loan agreements with Louisville/Jefferson County Metro Government to issue \$154.6 million of Series A uninsured fixed-rate revenue bonds (2013A Bonds), \$75.0 million of Series 2013B uninsured taxable variable-rate bonds (2013B Bonds), and \$50.0 million of Series C uninsured variable-rate revenue bonds (2013C Bonds). Proceeds from 2013A Bonds and 2013C Bonds were used to pay or reimburse the Corporation for the cost of acquiring, constructing, renovating, and equipping areas related to patient care and to pay certain expense in connection with the issuance of the bonds. Proceeds from the 2013B Bonds were used to refund all remaining Series 2000C Bonds outstanding at the time.

At both December 31, 2017 and 2016, the 2013A Bonds consisted of fixed-rate term bonds with interest rates ranging from 4.50% to 5.75% maturing through October 1, 2042. The 2013A Bonds have annual sinking fund deposits of various amounts due annually on October 1 beginning in 2028. Interest is payable semiannually on April 1 and October 1. Beginning October 1, 2023, the 2013A Bonds maturing on or after October 1, 2023, are subject to optional redemption by the Corporation prior to maturity for 100% of par.

The 2013C Bonds are secured by an irrevocable direct-pay letter of credit issued by PNC Bank that has a stated maturity of September 26, 2018, however certain contractual provisions ensure that the 2013C Bonds could not be put back to the Corporation within 12 months of the combined balance sheet date. While bearing interest at a weekly interest rate, the 2013C Bonds are subject to optional redemption prior to maturity at the direction of the Corporation at a redemption price of 100% of the principal amount, plus accrued interest. The 2013C Bonds have one annual sinking fund deposit of \$17.6 million due on October 1, 2042, with final maturity in 2043. At December 31, 2017 and 2016, the applicable cost of the debt for the 2013C Bonds was approximately 2.4% and 1.4%, respectively.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

2012 Bonds

In 2012, the Corporation entered into a loan agreement with Louisville/Jefferson County Metro Government to issue \$21.1 million of Series A uninsured fixed-rate revenue bonds (2012A Bonds). Proceeds from the 2012A Bonds were used to refund the remainder of the 1997 Bonds. The 2012A Bonds are a direct placement issue, with a final maturity occurring in 2021. The approximate cost of debt at both December 31, 2017 and 2016, was 2.00%. The 2012A Bonds are subject to optional redemption by the Corporation at any time prior to maturity subject to “make whole” provisions.

2011 Bonds

In 2011, the Corporation entered into loan agreements with Louisville/Jefferson County Metro Government to issue \$35.0 million of Series A uninsured variable-rate revenue bonds (2011A Bonds), \$40.0 million of Series B uninsured variable-rate revenue bonds (2011B Bonds), \$23.8 million of Series C uninsured variable-rate bonds (2011C Bonds), and \$53.7 million of Series D uninsured taxable variable-rate bonds (2011D Bonds). Proceeds from the 2011A and 2011B Bonds were used to pay or reimburse the Corporation for the cost of acquiring, constructing, renovating, and equipping areas related to patient care and to pay certain expense in connection with the issuance of the bonds. Proceeds from the 2011C Bonds were used to refund a portion of the 1997 Bonds, and proceeds from the 2011D Bonds were used to refund all of the 2000A Bonds.

The 2011A and 2011B Bonds are secured by an irrevocable direct-pay letters of credit issued by PNC Bank that expire on July 26, 2021. The final maturities for the 2011A and 2011B Bonds occur in 2039. While bearing interest at weekly or daily interest rates, the 2011A and 2011B Bonds are subject to optional redemption prior to maturity at the direction of the Corporation at a redemption price of 100% of the principal amount, plus accrued interest. The 2011A and 2011B Bonds have annual sinking fund deposits of various amounts annually, beginning October 1, 2022, through their maturity.

At December 31, 2017 and 2016, the applicable cost of the debt for the 2011A Bonds and 2011B Bonds was approximately 2.50% and 1.40%, respectively.

The 2011C Bonds are direct placement issuances and are held entirely by PNC Bank, and their final maturity occurs in 2021. At December 31, 2017 and 2016, the applicable cost of debt for the 2011C Bonds was approximately 2.30% and 1.80%, respectively. The 2011C Bonds are subject to optional redemption at any time prior to maturity subject to make whole provisions.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

2000 Bonds

In 2000, the Corporation entered into loan agreements with Kentucky Economic Development Finance Authority to issue \$148.3 million of Series A uninsured revenue bonds (2000A Bonds), \$119.2 million of Series B (2000B Bonds), and \$180.5 million of Series C insured revenue bonds (2000C Bonds), for a total of \$448.0 million (collectively, the 2000 Bonds). Proceeds from the 2000 Bonds and certain other available monies were used to legally defease the 1998 Bonds and a portion of certain outstanding 1997 and 1992 Bonds issued on behalf of the Corporation through deposits to irrevocable trusts pursuant to escrow agreements, and to pay certain expenses incurred in connection with the issuance of the 2000 Bonds, as well as fund a debt service reserve account.

At December 31, 2017 and 2016, the remaining 2000 Bonds consist of the 2000B Bonds with interest rates ranging from 6.01% to 6.23%, respectively, maturing through October 1, 2028. Payment of principal and interest on the 2000B Bonds is guaranteed by National Public Finance Guarantee Corporation (formerly MBIA Insurance Corporation).

Interest on the 2000B Bonds will be compounded from the dates of delivery to their respective maturities, and will be payable only at maturity, or upon redemption prior to maturity or acceleration. 2000B Bonds mature in various amounts on October 1 through 2028. 2000B Bonds are not subject to optional redemption prior to maturity.

Required debt service on all outstanding bonds is as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
	<i>(In Thousands)</i>		
2018	\$ 26,497	\$ 45,713	\$ 72,210
2019	26,915	45,192	72,107
2020	27,338	44,658	71,996
2021	26,506	45,898	72,404
2022	26,674	45,777	72,451
Thereafter	803,386	504,837	1,308,223
	<u>\$ 937,316</u>	<u>\$ 732,075</u>	<u>\$ 1,669,391</u>

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

Included as part of the interest payments above is \$7.3 million of the 2000B Bonds interest payable in 2017, which is paid at the maturity of the 2000B Bonds. For 2017 through final maturity of 2000B Bonds, \$153.0 million is included in interest payments, which is paid at the various maturities of the 2000B Bonds.

For the variable-rate bond series, which includes all of the Series 2011 Bonds, 2013C Bonds, 2016B Bonds, and 2016C Bonds, the future periods interest estimate was based on terms of the Master Trust Indenture and is calculated using an average of Securities Industry and Financial Markets Association (SIFMA), for tax-exempt issues over approximately the last 20 years plus 1.00% to estimate liquidity, credit support, and remarketing fees. Thus, for purposes of this presentation, the Corporation has utilized 2.79%.

The Corporation paid interest of \$46.1 million and \$38.4 million during 2017 and 2016, respectively. The Corporation capitalized interest costs of \$1.1 million and \$0.5 million during 2017 and 2016, respectively.

The remaining long-term debt consists of capital leases. Future payments on capital leases are as follows:

	Principal	Interest	Total
	<i>(In Thousands)</i>		
2018	\$ 3,431	\$ 2,781	\$ 6,212
2019	3,787	2,528	6,315
2020	4,173	2,249	6,422
2021	4,688	1,940	6,628
2022	5,125	1,601	6,726
Thereafter	19,508	2,654	22,162
	<u>\$ 40,712</u>	<u>\$ 13,753</u>	<u>\$ 54,465</u>

Assets recorded under capital lease were \$52.6 million at both December 31, 2017 and 2016. Accumulated amortization on these capital lease assets was \$17.3 million and \$13.7 million at December 31, 2017 and 2016, respectively.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

In December 2013, the Corporation entered into a revolving credit agreement with Commerce Bank. The revolving credit agreement consists of a \$30 million credit line with a termination date of November 22, 2016, and was not renewed. No amounts were drawn under the revolving credit line during the year ended December 31, 2016.

Interest Rate Swaps

The Corporation uses derivative instruments to manage its cost of capital through interest rate swaps, which generate cash flow meant to reduce interest expense. The Corporation pays a rate based upon the SIFMA Municipal Swap Index, an index of seven-day, high-grade, tax-exempt variable-rate demand obligations. In return, the Corporation receives a rate based upon London Interbank Offered Rates (LIBOR).

At December 31, the Corporation holds the following interest rate swaps:

Effective Date	Notional Amount	Maturity Date	Receive	Pay	2017	2016
					<i>(In Thousands)</i>	
2/21/2001	\$ 100,000	10/1/2028	1.4925% of one-month LIBOR	2 times SIFMA	\$ 1,346	\$ 870
10/1/2004	100,000	10/1/2028	62.6% of one-month LIBOR plus 0.57%	SIFMA	(627)	(2,417)
11/3/2006	140,000	11/3/2031	61.7% of one-month LIBOR plus 0.577%	SIFMA	1,896	(115)
11/3/2008	200,000	11/3/2026	61.7% of ten-year LIBOR minus 0.016%	SIFMA	(1,904)	1,907
					<u>\$ 711</u>	<u>\$ 245</u>

Citigroup serves as counterparty for all of the Corporation's interest rate swaps. Consistent with industry practice, the interest rate swaps require posting of collateral should either party's cumulative mark-to-market liability exceed certain thresholds based upon the credit rating of the counterparty. At December 31, 2017 and 2016, based upon the agreements with Citigroup, the Corporation's cumulative mark-to-market at contract value was an asset of \$0.1 million and a liability of \$2.5 million, respectively. Based upon the Corporation's lowest credit rating (A-), collateral must be posted for liabilities in excess of \$25 million. At December 31, 2017 and 2016 the Corporation had no collateral posted and was not required to post any collateral. Should the Corporation's credit rating fall below BBB, Citigroup would have the option of terminating some or all of the interest rate swaps at the market value.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Long-Term Debt (continued)

All of the Corporation's interest rate swaps outstanding at December 31, 2017 and 2016, were issued pursuant to a single International Swaps and Derivatives Association, Inc. agreement with a single counterparty. Therefore, all interest rate swaps are viewed under a master netting arrangement to determine the aggregate amount of collateral to be posted or received by the Corporation. Should the Corporation hold all interest rate swaps to maturity, as it intends, no cash settlement will be necessary, and at maturity, any posted interest rate swap collateral will be returned.

None of the Corporation's interest rate swaps has been designated as a hedge for accounting purposes; therefore, the change in fair value for these interest rate swaps is included in the combined statements of operations and changes in net assets as change in interest rate swap values within non-operating gains (losses). The cash flow impact of the interest rate swaps is included in the line change in interest rate swap benefit, net in the combined statements of operations and changes in net assets. The fair value is calculated based on a discounted cash flow model taking into consideration the terms of each interest rate swap and the credit rating of the Corporation or counterparty, as applicable.

The cash flow for these interest rate swaps is settled semi-annually on April 1 and October 1. During the interim periods, a receivable or payable is recorded. As of December 31, 2017 and 2016, the cash flows were in a receivable position. The receivable is included within miscellaneous receivables in the combined balance sheets.

	Miscellaneous Receivable	Interest Rate Swap Asset	Combined Balance Sheet, net
	<i>(In Thousands)</i>		
December 31, 2015	\$ 1,139	\$ 10,534	\$ 11,673
Interest rate swap benefit, net	2,344	-	2,344
Swap cash settlement received	(3,169)	-	(3,169)
Change in interest rate swaps value	-	(10,289)	(10,289)
December 31, 2016	314	245	559
Interest rate swap benefit, net	2,162	-	2,162
Swap cash settlement received	(2,035)	-	(2,035)
Change in interest rate swaps value	-	466	466
December 31, 2017	\$ 441	\$ 711	\$ 1,152

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

8. Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets at December 31, are available for the following purposes:

	2017	2016
	<i>(In Thousands)</i>	
Temporarily restricted:		
Health care services	\$ 78,277	\$ 76,160
Permanently restricted:		
Investments to be held in perpetuity, the income from which is expendable to support health care services	\$ 18,288	\$ 18,077
Beneficial interest in trusts held by others, the income from which is expendable to support health care services	22,898	20,086
Total permanently restricted	\$ 41,186	\$ 38,163

9. Endowment Funds

The Corporation's endowment consists of 11 individual donor-restricted endowment funds (nine at The Children's Hospital Foundation, Inc. and two at Norton Healthcare Foundation, Inc.) (The Children's Hospital Foundation, Inc. and Norton Healthcare Foundation, Inc., are collectively referred to as the Foundations) established for a variety of purposes. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

Interpretation of Relevant Law

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) was enacted in the Commonwealth of Kentucky on March 25, 2010. The Foundations have interpreted the UPMIFA 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, the Foundations classify as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) market appreciation and/or investment income that is permanently restricted by the donor in the gift agreement. The remaining portion of the

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

9. Endowment Funds (continued)

donor-restricted endowment fund that is not classified as permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the Foundations.

Investment Objectives and Policy

The Foundations follow the investment policy objectives of the Corporation. The long-term objective of the policy is to generate a return, which is sufficient to meet its current and expected future financial requirements, as defined by the Corporation's long-range financial plan. To accomplish this objective, the Corporation seeks to earn the greatest total return possible consistent with its general risk tolerance, the securities noted as eligible for purchase, and the asset allocation strategies included in the investment policy. The asset allocation includes investments in cash, fixed income, equities, and alternative investments.

Spending Policy and How the Investment Objectives Relate to Spending Policy

The Foundations have adopted a 5% spending policy, which is based upon a three-year rolling average of the fair market value of the endowment fund. The current year spending policy is calculated using year-end December 31 market values.

In addition to the 5% spending policy, the Foundations consider the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

1. The duration and preservation of the fund
2. The purposes of the Foundations and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the Foundations
7. The investment policies of the Corporation

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

9. Endowment Funds (continued)

Funds With Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the original fair market value of the gift. In accordance with applicable accounting guidance, deficiencies of this nature are reported in unrestricted net assets. The Foundations will not appropriate funds from the endowment for spending until the current value of the fund exceeds the fair value of the original gift, unless an appropriation is deemed prudent based upon the factors listed above. There were deficiencies of approximately \$0.1 million and \$0.3 million as of December 31, 2017 and 2016, respectively, due to investment market losses.

In 2017, the Corporation had the following endowment-related activities:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
	<i>(In Thousands)</i>			
Endowment net assets, beginning of year	\$ (280)	\$ 1,046	\$ 18,077	\$ 18,843
Investment return:				
Investment gain	132	266	95	398
Net unrealized gains on investments	90	1,949	85	2,219
Total investment returns	222	2,215	180	2,617
Contributions, less uncollectible pledges	—	—	31	31
Appropriation of endowment assets for expenditure	—	(800)	—	(800)
Endowment net assets, end of year	<u>\$ (58)</u>	<u>\$ 2,461</u>	<u>\$ 18,288</u>	<u>\$ 20,691</u>

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

9. Endowment Funds (continued)

In 2016, the Corporation had the following endowment-related activities:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
	<i>(In Thousands)</i>			
Endowment net assets, beginning of year	\$ (244)	\$ 908	\$ 18,059	\$ 18,723
Investment return:				
Investment gain	—	59	36	59
Net unrealized gains on investments	—	861	32	929
Total investment return	—	920	68	988
Contributions, less uncollectible pledges	—	—	31	31
Appropriation of endowment assets for expenditure	(36)	(782)	—	(818)
Reclassification of net assets	—	—	(81)	(81)
Endowment net assets, end of year	<u>\$ (280)</u>	<u>\$ 1,046</u>	<u>\$ 18,077</u>	<u>\$ 18,843</u>

10. Employee Benefit Plans

Defined Benefit Plan

Certain employees of the Corporation are covered by the Plan. Benefits are generally based upon years of service and an employee's annual compensation during his or her years of service. The Corporation annually funds an amount not less than the minimum required under the Employee Retirement Income Security Act of 1974. The Plan was frozen effective January 1, 2010, and, as a result, no service cost was incurred in 2017 or 2016 and none is expected in future periods.

The Plan has been named as a defendant in a class action suit brought on behalf of certain former employees who elected to take early retirement (the Plaintiff Class), alleging that lump-sum payments made by the Plan upon their retirement were incorrectly calculated. Although the Corporation is not directly a party to the class action suit, and a judgment entered in favor of the

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Employee Benefit Plans (continued)

plaintiffs would be paid from assets of the Plan, in the event that such a judgment causes the Plan to be underfunded, the Corporation would be required to make quarterly minimum contributions over a period of 10 to 17 years to restore the funding of the Plan. In early 2016, the Court issued its final, appealable order, indicating that the Plan owes additional lump-sum benefits to the Plaintiff Class. The Court ordered the Plan to recalculate benefits using a court determined formula, which is different than the formula as interpreted by the Plan, and provide additional data to allow for the recalculation of the benefits. As of December 31, 2017 and 2016, management has estimated potential exposures to the Plan of \$60.2 million, which has been recorded by the Plan as part of the Plan's projected benefit obligation. As of the issuance of these combined financial statements, both the Plaintiff Class and the Plan have appealed the court order; as such, the final outcome of the litigation is still uncertain and the final outcome to the Corporation may differ than the amount recorded at December 31, 2017, and may be material to the Plan and Corporation. The Corporation will continue to evaluate the status of the litigation and potential outcome. At this time, the Corporation is not currently required to fund the Plan as result of this litigation.

A summary of the components of net periodic benefit cost, which is included in non-operating gains (losses) in the combined statements of operations and changes in net assets, for the Plan for the years ended December 31, is as follows:

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Interest cost	\$ 8,831	\$ 9,425
Expected return on plan assets	(4,417)	(5,209)
Amortization of net loss	4,372	5,308
Settlement cost	3,139	3,140
Loss contingency adjustment	—	(7,140)
Net periodic benefit cost	<u>\$ 11,925</u>	<u>\$ 5,524</u>

Included as a component of net periodic benefit cost in both 2017 and 2016 is a settlement cost of \$3.1 million. A settlement cost is required under applicable pension accounting guidance when the amount of the lump-sum benefit payments made during the fiscal year exceeds the service cost plus interest cost components of net periodic pension cost. During 2017 and 2016, the Plan paid \$12.4 million and \$12.1 million, respectively, in lump-sum benefit payments.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Employee Benefit Plans (continued)

This exceeded the threshold of \$8.8 million and \$9.4 million in 2017 and 2016, respectively. The settlement cost is determined by taking the ratio of the lump-sum benefit payments made to the projected benefit obligation before settlement, multiplied by the unrecognized loss in the Plan. Due to the risk and uncertainty associated with the Plan litigation, the Corporation accelerated \$7.1 million in net periodic benefit cost, in addition to the amount determined by the Plan actuary for fiscal year 2015. For the years ended December 31, 2016, net period benefit cost recorded was reduced by the \$7.1 million accelerated in 2015.

Included in unrestricted net assets are \$67.1 million and \$68.7 million of unrecognized actuarial losses at December 31, 2017 and 2016, respectively, which have not been recognized as an increase (decrease) in net periodic benefit cost. Changes in pension plan assets and obligations recognized in unrestricted net assets for the years ended December 31, 2017 and 2016, were \$1.8 million and \$(3.6) million, respectively.

A summary of the components of the changes in projected benefit obligation and fair value of plan assets for the Plan at and for the year ended December 31 is as follows:

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Change in projected benefit obligation:		
Benefit obligation at beginning of year	\$ 264,398	\$ 264,303
Additional liability for Plan litigation	—	5,431
Benefit obligation at beginning of year, adjusted	<u>264,398</u>	269,734
Interest cost	8,831	9,425
Actuarial loss (gain)	7,964	(370)
Benefit payments:		
Lump sum	(12,445)	(12,089)
Annuity	(2,636)	(2,302)
Projected benefit obligation at the end of year	<u>266,112</u>	<u>264,398</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	207,982	217,144
Actual return on plan assets	6,509	5,229
Benefit payments:		
Lump sum	(12,445)	(12,089)
Annuity	(2,636)	(2,302)
Fair value of plan assets at end of year	<u>199,410</u>	<u>207,982</u>
Funded status and net pension liability	<u>\$ (66,702)</u>	<u>\$ (56,416)</u>

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Employee Benefit Plans (continued)

Since the Plan is frozen, there is no difference between the projected benefit obligation and the accumulated benefit obligation at December 31, 2017 or 2016.

Assumptions

Weighted-average assumptions used to determine the projected benefit obligation at December 31, are as follows:

	<u>2017</u>	<u>2016</u>
Discount rate	3.26%	3.60%

Weighted-average assumptions used to determine net periodic benefit cost at December 31, are as follows:

	<u>2017</u>	<u>2016</u>
Discount rate	3.60%	3.75%
Expected long-term rate of return on assets	3.00%	3.25%

The rate of return assumption was developed by applying an expected long-term rate of return, based primarily on long-term historical returns by asset type and applying the weighted-average percent of total plan assets.

Plan Assets

At December 31, 2017 and 2016, the Plan's asset allocation was invested entirely in fixed-income strategies through marketable debt securities and pooled separate accounts. This is consistent with the Plan's target asset allocation.

Fair Value Measurements

The Plan's assets impacting the funded status of the Plan are accounted for under ASC 715, *Compensation – Retirement Benefits*.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Employee Benefit Plans (continued)

The following table presents the plan assets carried at fair value as of December 31, by type of investments and the fair value levels defined in Note 1:

	2017	2016	Level
	<i>(In Thousands)</i>		
Separately-managed accounts:			
Standish fixed income ^(A)			
Marketable debt securities:			
U.S. government	\$ 42,460	\$ 36,293	2
Corporate	43,852	55,134	2
Other	3,317	1,924	2
Total standish fixed income	<u>89,629</u>	<u>93,351</u>	
Principal fixed income ^(B)			
Marketable debt securities:			
U.S. government	9,233	17,873	2
Corporate	90,088	90,525	2
Other	4,309	3,114	2
Total Principal fixed income	<u>103,630</u>	<u>111,512</u>	
Total separately-managed accounts	<u>193,259</u>	<u>204,863</u>	
Pooled separate accounts:			
Edge asset management ^(C)	5,919	2,918	2
Cash	232	201	1
Total pooled separate accounts	<u>6,151</u>	<u>3,119</u>	
Total assets at fair value	<u>\$ 199,410</u>	<u>\$ 207,982</u>	

^(A) Separately-managed account invested in fixed income securities, including U.S. government securities, corporate bonds, and other fixed-income strategy investments. The account seeks to perform at the three-year U.S. Treasury yield plus 50 basis points to match the estimated duration of the cash balance obligations.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Employee Benefit Plans (continued)

- ^(B) Separately-managed account invested in fixed-income securities, including U.S. government securities, corporate bonds, and other fixed-income strategy investments. The account seeks to perform at a custom benchmark, which is a blend of Barclays indices (including U.S. Long Credit, U.S. Treasury Strips, U.S. Intermediate Term Corporate, and U.S. Aggregate Long Government/Credit) optimized to match the estimated duration of the traditional pension benefit obligations.
- ^(C) Actively managed fund of corporate and municipal fixed-income securities whose return is meant to mirror the Barclays U.S. 1 – 3 Year Credit Bond Index.

Level 2 securities include valuations based upon direct and indirect observable market inputs that may utilize the market, income, or cost approaches in determination of their fair value. The pricing service uses a variety of pricing models and inputs based upon the type of security being valued. These inputs may include, but are not limited to, reported trades, similar security trade data, bid/ask spreads, institutional bids, benchmark yields, broker/dealer quotes, issuer spreads, yield to maturity, and corporate, industry, and economic events.

Cash Flows

The Corporation does not expect to contribute to the Plan in 2018. The following table sets forth the benefit payout projections for the next ten years (in thousands):

Plan year ending December 31:	
2018	\$ 38,840
2019	17,790
2020	18,960
2021	16,180
2022	16,780
2023 – 2027	59,920

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Employee Benefit Plans (continued)

Defined Contribution Plans

403(b)/401(k) Plan

In addition to the Plan, the Corporation also has defined contribution 403(b)/401(k) retirement plans (collectively referred to as Defined Contribution Plans). The Defined Contribution Plans are available to all employees that work more than 1,000 hours in a plan year. The Corporation matches contributions to participants employed on the last day of the plan year. Under the terms of these Defined Contribution Plans, the Corporation provides for a 100% matching contribution of the participant's first 4% of plan deferrals for those participants employed on December 31.

While the Plan was frozen effective January 1, 2010, additional discretionary employer contributions to the Defined Contribution Plans went into effect on the same date. For both 2017 and 2016, these additional discretionary employer contributions were based on years of services according to the following grid:

<u>Years of Service</u>	<u>Employer Contribution</u>
0-4	1%
5-9	2
10-14	3
15-19	4
20-24	5
25+	6

Total expense related to the Defined Contribution Plans was \$46.5 million and \$44.6 million for the years ended December 31, 2017 and 2016, respectively, and is included in labor and benefits on the combined statements of operations and changes in net assets.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

11. Functional Expenses

The Corporation, through certain affiliates (principally Norton Hospitals, Inc.), provides general health care services to residents within its geographic location. Approximately 87% of the Corporation's expenses relate to health care services for both the years ended December 31, 2017 and 2016, and 13% of the Corporation's expenses relate to general and administrative expenses for both the years ended December 31, 2017 and 2016.

12. Affiliation Agreement

In accordance with the Second Restated Agreement of Affiliation (the Affiliation Agreement) between the Corporation and Kosair Charities Committee, Inc. (Kosair), Kosair agreed to contribute a total of \$117.0 million to Kosair Children's Hospital (renamed to Norton Children's Hospital (NCH) in November 2016) from 2007 through 2026. Based on the terms of the Affiliation Agreement, this did not meet the accounting definition of a pledge receivable and was to be recorded in the year cash was received. The Corporation and Kosair also entered into a Special Projects Funding Agreement and an Additional Projects Funding Agreement where Kosair agreed to contribute \$1.0 million annually to NCH, beginning in 2010 and continuing through 2026, when, in the final year of these agreements, Kosair was to contribute \$1.5 million. Based on the terms of the agreements, this also did not meet the accounting definition of a pledge receivable and was to be recorded in the year cash is received. In August 2013, Kosair sent notice to the Corporation asserting that the Corporation was in breach of all of these agreements and ceased making contributions according to the Affiliation Agreement and certain other agreements. Management believes that the Corporation was not in breach of these agreements. In 2014, Kosair filed suit against the Corporation, and the Corporation counterclaimed against Kosair.

As part of the ongoing claim between the Corporation and Kosair, Kosair deposited the amounts to be contributed to the Corporation for 2013 through 2015 under the previous Affiliation Agreement and certain other agreements with Jefferson Circuit Court in an interest-bearing court fund (the Court Fund). In June 2016, the Corporation and Kosair entered into a Settlement Agreement, which terminated the Affiliation Agreement, the Special Projects Funding Agreement, and the Additional Projects Funding Agreement. The Settlement Agreement directed the transfer of the monies held in the Court Fund (\$19.1 million) to a separate escrow account for the sole and exclusive benefit of the Corporation (the Escrow). This Escrow is managed by a mutually agreed upon third-party administrator (the TPA). The TPA shall pay endowment funds to the Corporation on an annual basis upon presentation by the Corporation of the Corporation's unreimbursed cost of charity care that is specifically attributable to NCH. The Settlement Agreement allowed

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

12. Affiliation Agreement (continued)

the Corporation to apply to the TPA and entitled the Corporation to receive from the TPA a payment of \$5.0 million representing the Corporation's unreimbursed costs of charity care at NCH from January 1, 2013, through December 31, 2016. The Corporation received these funds in December 2016 and recorded this amount in other revenue in the combined statement of operations during the year ended December 31, 2016. At the conclusion of each year commencing with the year ended December 31, 2016, the Corporation shall provide the TPA documentation of its unreimbursed costs of charity care at NCH for the preceding year. The TPA shall disburse to the Corporation an amount equal to the unreimbursed costs of charity care. This is to continue until the amount remaining in the Escrow is less than the unreimbursed costs of charity care for the applicable year, then the balance in the Escrow shall be paid to the Corporation and the Escrow shall be closed. As of December 31, 2017 and 2016, the remaining amounts in the Escrow are recorded in the combined financial statements in accordance with applicable accounting guidance. The Corporation has recorded \$0.5 million in current portion of assets limited as to use and as an increase to net patient service revenue before provision for doubtful accounts for amounts estimated to be applied for and received by the Corporation from the TPA in 2018 for the unreimbursed cost of charity care at NCH for the year ended December 31, 2017. The remainder (\$11.8 million) of the Escrow represents those amounts to be earned in future fiscal years and is reflected in assets limited as to use and other non-current liabilities. The Settlement Agreement also called for Kosair to pay \$10.0 million toward capital projects and/or new equipment at NCH. At December 31, 2017, this payment (\$10.0 million) has been made by Kosair and is reflected as an increase to unrestricted net assets ("Capital project settlement proceeds") in the combined statement of operations and changes in net assets. In accordance with the Settlement Agreement, the Corporation also segregated \$10.0 million of matching funds to be used towards these capital projects. The combination of the funds in the Escrow, \$10.0 million received from Kosair for capital projects and the \$10.0 million of matching funds from the Corporation, is included in assets whose use is limited by contractual agreements disclosed in Note 4 and 5.

13. Commitments and Contingencies

The Corporation is in the process of improving and expanding its facilities. Future commitments related to the renovation of existing facilities or construction of new facilities totaled \$55.4 million and \$51.7 million at December 31, 2017 and 2016, respectively. This will be funded through bond proceeds and cash flows generated from operations.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

13. Commitments and Contingencies (continued)

In connection with a contractual agreement with the University of Louisville (UofL) made in 2015, the Corporation has committed to the following obligations:

- The Corporation commits to expending at least \$35.0 million in facility improvements and other capital expenditures at NCH over the eight-year period beginning January 1, 2016. Based on the nature of this commitment, no amounts are recorded in the combined financial statements at December 31, 2017 or 2016. There is a facility improvement plan which began in 2017 that will fulfill this commitment.
- Continuing the Corporation's financial support of UofL, annual payments of at least \$30 million for eight years beginning January 1, 2016, which will all be paid pursuant to individual agreements and the commitment is such that should qualifying expenditures not be made during the fiscal year an accrual would be made to bring expenses to the \$30 million support level. Qualifying expenditures in 2016 totaled \$29.5 million, resulting in a \$0.5 million accrual recorded in accrued expenses and other in the combined balance sheet at December 31, 2016. Qualifying expenditures in 2017 totaled \$30.4 million, resulting in a \$0.1 million accrual recorded in accrued expenses and other in the combined balance set at December 31, 2017.
- At least \$24.0 million in additional support to be paid out over the eight-year period beginning January 1, 2016, spent as recommended by a committee made up of management of the Corporation and UofL. As this commitment can be incurred at any time during the eight-year period and there are no contingencies placed upon the committee's determination, it was fully accrued for at December 31, 2016, in accrued expenses and other in the combined balance sheets. Payments of \$3.0 million were made in 2017, and therefore \$21.0 million remains accrued at December 31, 2017, in accrued expenses and other in the combined balance sheets.

While there are terms within the contract which could negate these obligations, their occurrence is considered remote at this time.

The Corporation is subject to claims and suits arising in the ordinary course of business. Management assesses the probable outcome of unresolved litigation and records estimated settlements, if applicable. In the opinion of management, the ultimate resolution of pending legal proceedings will not have a material effect on the Corporation's combined financial position.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

14. Lease Commitments

Future minimum lease payments for office space and equipment, by year, under non-cancelable, operating leases with initial or remaining terms in excess of one year at December 31, 2017, are as follows (*in thousands*):

Year ending December 31:	
2018	\$ 29,911
2019	27,349
2020	26,526
2021	25,338
2022	24,324
Thereafter	122,828
Total	<u>\$ 256,276</u>

Rental expense, which includes amounts applicable to cancelable leases, for the years ended December 31, 2017 and 2016, was \$35.3 million and \$33.0 million, respectively.

15. Concentration of Credit Risk

The Corporation grants credit without collateral to its patients, most of whom are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 is as follows:

	<u>2017</u>	<u>2016</u>
Medicare	9%	9%
Medicaid	22	22
Blue Cross	23	20
Other third-party payors	28	28
Self-pay	18	21
	<u>100%</u>	<u>100%</u>

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

16. Premier Healthcare Alliance, LP

The Corporation is a partner in Premier Healthcare Alliance, LP (Premier), which is a group purchasing organization (GPO). The Corporation's participation in the GPO provides purchasing contract rates and rebates the Corporation would not be able to obtain on its own. The Corporation holds membership units in Premier which have vesting rights over a seven-year period and upon vesting become eligible for exchange into the Class A publicly traded common stock of Premier, Inc. The Corporation currently accounts for its membership units in Premier using the cost method of accounting. The increase in the estimated value of the Corporation's membership units as they vest is considered a vendor incentive under applicable accounting literature, which increases the Corporation's investment in Premier, Inc. and reduces supplies expense over the seven-year vesting period ending in 2020. The Corporation recognized a vendor incentive as a reduction in supplies expense for the common stock vesting of \$10.2 million and \$9.7 million for the years ended December 31, 2017 and 2016, respectively.

17. The Regional Health Network of Kentucky and Southern Indiana, LLC

In May 2012, the Corporation entered into a partnership agreement with Lifepoint Hospitals, Inc. to form The Regional Health Network of Kentucky and Southern Indiana, LLC (Regional) for the purpose of acquiring and operating hospitals in southern Indiana and Kentucky, currently Scott County Memorial Hospital and Clark Memorial Hospital.

The Corporation has an ownership interest in Regional of 25% at December 31, 2017 and 2016, respectively, and does not manage or control the operations. The investment is accounted for under the equity method of accounting wherein the Corporation's investment (recorded on a one-month lag) is recorded in investments in joint ventures in the Corporation's combined balance sheets and its share of the losses, which is disclosed in Note 1, is reflected in joint venture income (loss) in the Corporation's combined statements of operations and changes in net assets.

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

17. The Regional Health Network of Kentucky and Southern Indiana, LLC (continued)

The following is a summary of Regional's assets, liabilities, and equity as of December 31 (from its unaudited financial statements):

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Assets		
Cash and cash equivalents	\$ 1,155	\$ 2,716
Patient accounts receivable, net	25,086	28,556
Property and equipment, net	69,519	77,040
Other assets	10,966	11,331
Total assets	<u>\$ 106,726</u>	<u>\$ 119,643</u>
Liabilities and equity		
Accounts payable	\$ 7,590	\$ 8,736
Accrued payroll	6,692	6,586
Intercompany	36,530	29,909
Other liabilities	2,766	9,113
Total liabilities	<u>53,578</u>	<u>54,344</u>
Total equity	<u>53,148</u>	<u>65,299</u>
Total liabilities and equity	<u>\$ 106,726</u>	<u>\$ 119,643</u>

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

17. The Regional Health Network of Kentucky and Southern Indiana, LLC (continued)

The following is a summary of Regional's results of operations for the years ended December 31 (from its unaudited financial statements):

	<u>2017</u>	<u>2016</u>
	<i>(In Thousands)</i>	
Unrestricted revenue:		
Net patient service revenue before provision for doubtful accounts	\$ 206,781	\$ 204,035
Provision for doubtful accounts	<u>(22,313)</u>	<u>(21,663)</u>
Total unrestricted revenue	<u>184,468</u>	182,372
Operating expenses:		
Labor and benefits	97,486	97,673
Professional fees	4,310	3,566
Supplies	29,374	30,455
Fees and special services	12,205	11,687
Repairs, maintenance, and utilities	14,296	15,100
Rents and leases	1,469	2,838
Insurance	1,146	1,329
Non-income taxes	14,438	14,277
Other	3,366	2,454
Total operating expenses	<u>178,090</u>	<u>179,379</u>
Earnings before fixed expenses	6,378	2,993
Fixed expenses:		
Depreciation	11,633	11,116
Interest expense	1,363	966
Management fees	5,533	5,466
	<u>18,529</u>	<u>17,548</u>
Loss from operations	<u>\$ (12,151)</u>	<u>\$ (14,555)</u>

Norton Healthcare, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

18. Subsequent Events

Companies that are considered public (e.g., have publicly traded debt) are required to disclose significant changes occurring in the fourth quarter that may impact previously reported quarterly financial statements. Management has determined there are no transactions that require disclosure for the quarter ended December 31, 2017.

The Corporation has evaluated and disclosed any subsequent events through March 29, 2018, which is the date the accompanying combined financial statements were issued. No recognized or non-recognized subsequent events were identified for recognition or disclosure in the combined financial statements.

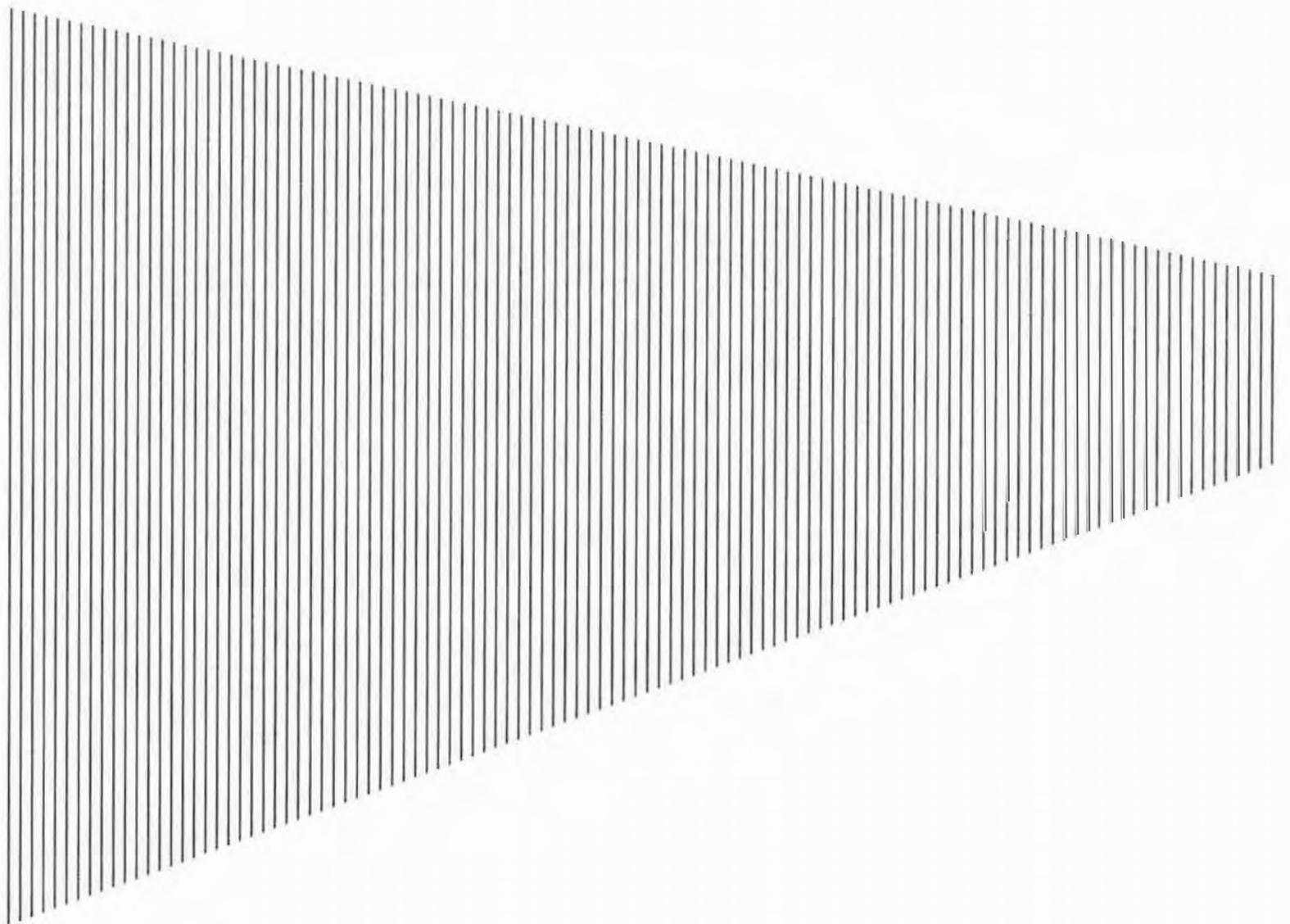
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Report of Independent Auditors

The Board of Trustees
Norton Healthcare, Inc. and Affiliates

We have audited the accompanying schedule of the debt service coverage ratio calculation of Norton Healthcare, Inc. and its Restricted Affiliate, Norton Hospitals, Inc. as of December 31, 2017 and for the year then ended and the related notes.

Management's Responsibility for the Schedule

Management is responsible for the preparation and fair presentation of the schedule of the debt service coverage ratio calculation on the basis of the financial reporting provisions of Section 5.7 of Article V of the Amended and Restated Master Trust Indenture dated as of September 15, 1997, as supplemented by Supplemental Indentures Nos. 1 and 2, dated as of September 15, 1997; as supplemented by Supplemental Indenture No. 3, dated as of October 1, 1998, by and between Norton Healthcare, Inc. and Bank One, Kentucky, NA; as supplemented by Supplemental Indenture No. 4 dated as of September 1, 2000; as supplemented by Supplemental Indenture No. 5, dated as of January 4, 2001; as supplemented by Supplemental Indenture No. 6, dated as of July 1, 2003, by and between Norton Healthcare, Inc., Norton Hospitals, Inc. and Bank One, Kentucky, NA; as supplemented by Supplemental Indenture No. 7, dated as of March 17, 2004; as supplemented by Supplemental Indenture No. 8, dated as of September 1, 2004; as supplemented by Supplemental Indenture No. 9, dated as of October 1, 2006; as supplemented by Supplemental Indenture No. 10, dated as of November 1, 2006; as supplemented by Supplemental Indenture Nos. 11 and 12, dated as of August 1, 2011, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA; and as supplemented by Supplemental Indentures No. 13, dated as of October 1, 2012, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA; and as supplemented by Supplemental Indenture No. 14, dated as of September 1, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA; and as supplemented by Supplemental Indenture No. 15, dated as of September 1, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 16, dated as of December 1, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 17, dated as of July 1, 2016, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 18, dated as of August 1, 2016, between Norton Healthcare, Inc. and The Bank of New York Mellon Trust



Company NA; and as supplemented by Supplemental Indenture No. 19, dated as of August 1, 2016, between Norton Healthcare, Inc. and The Bank of New York Mellon Trust Company NA. The calculation includes the accounts of Norton Healthcare, Inc. and its restricted affiliate, Norton Hospitals, Inc. Management also is responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedule of the debt service coverage ratio calculation that is free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the schedule of the debt service coverage ratio calculation based on our audit. We conducted our audit 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 schedule of the debt service coverage ratio calculation is free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule of the debt service coverage ratio calculation. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule of the debt service coverage ratio calculation, 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 schedule of the debt service coverage ratio calculation 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 schedule of the debt service coverage ratio calculation.

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 schedule referred to above presents fairly, in all material respects, the debt service coverage ratio calculation of Norton Healthcare, Inc. and its Restricted Affiliate, Norton Hospitals, Inc. as of December 31, 2017 and for the year then ended on the basis of the requirement referred to in the preceding paragraph.



Building a better
working world

Contractual Basis of Accounting

As described in Note 1 to the schedule, the schedule was prepared by Norton Healthcare, Inc. and Affiliates on the basis of the financial reporting provisions of Section 5.7 of Article V of the Amended and Restated Master Trust Indenture dated as of September 15, 1997, as supplemented by Supplemental Indentures Nos. 1 and 2, dated as of September 15, 1997; as supplemented by Supplemental Indenture No. 3, dated as of October 1, 1998, by and between Norton Healthcare, Inc. and Bank One, Kentucky, NA; as supplemented by Supplemental Indenture No. 4 dated as of September 1, 2000; as supplemented by Supplemental Indenture No. 5, dated as of January 4, 2001; as supplemented by Supplemental Indenture No. 6, dated as of July 1, 2003, by and between Norton Healthcare, Inc., Norton Hospitals, Inc. and Bank One, Kentucky, NA; as supplemented by Supplemental Indenture No. 7, dated as of March 17, 2004; as supplemented by Supplemental Indenture No. 8, dated as of September 1, 2004; as supplemented by Supplemental Indenture No. 9, dated as of October 1, 2006; as supplemented by Supplemental Indenture No. 10, dated as of November 1, 2006; as supplemented by Supplemental Indenture Nos. 11 and 12, dated as of August 1, 2011, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA; and as supplemented by Supplemental Indentures No. 13, dated as of October 1, 2012, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA.; and as supplemented by Supplemental Indenture No. 14, dated as of September 1, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA; and as supplemented by Supplemental Indenture No. 15, dated as of September 1, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 16, dated as of December 1, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 17, dated as of July 1, 2016, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 18, dated as of August 1, 2016, between Norton Healthcare, Inc. and The Bank of New York Mellon Trust Company NA; and as supplemented by Supplemental Indenture No. 19, dated as of August 1, 2016, between Norton Healthcare, Inc. and The Bank of New York Mellon Trust Company NA, which is a basis of accounting other than U.S. generally accepted accounting principles. Our opinion is not modified with respect to this matter.

Restriction on Use

This report is intended solely for the information and use of management, the Board of Trustees of Norton Healthcare, Inc. and Affiliates, Bank One, Kentucky, NA, and The Bank of New York Mellon Trust Company, NA and is not intended to be and should not be used by anyone other than the specified parties.

Ernst + Young LLP

March 29, 2018

Norton Healthcare, Inc. and its Restricted Affiliate, Norton Hospitals, Inc.

Debt Service Coverage Ratio

For the Year Ended December 31, 2017
(In Thousands)

Excess of revenue over expenses		\$	282,504
Depreciation and amortization			79,570
Interest expense			37,798
Gain on disposition of assets			(14)
Net gain on extinguishment of debt			—
Unrealized gain on investments			(92,289)
Unrealized gain on swap mark-to-market			(466)
Income available for debt service	(A)	\$	<u>307,103</u>
Principal and interest payments	(B)	\$	<u>71,863</u>
Debt service coverage ratio	(A)/(B)		<u>4.27</u>
Required debt service coverage ratio			<u>1.10</u>

Note 1 – The method of calculating the income available for debt service is prescribed by Section 5.7 of Article V of the Amended and Restated Master Trust Indenture dated as of September 15, 1997, as supplemented by Supplemental Indentures Nos. 1 and 2, dated as of September 15, 1997; as supplemented by Supplemental Indenture No. 3, dated as of October 1, 1998, by and between Norton Healthcare, Inc. and Bank One, Kentucky, NA; as supplemented by Supplemental Indenture No. 4 dated as of September 1, 2000; as supplemented by Supplemental Indenture No. 5, dated as of January 4, 2001; as supplemented by Supplemental Indenture No. 6, dated as of July 1, 2003, by and between Norton Healthcare, Inc., Norton Hospitals, Inc. and Bank One, Kentucky, NA; as supplemented by Supplemental Indenture No. 7, dated as of March 17, 2004; as supplemented by Supplemental Indenture No. 8, dated as of September 1, 2004; as supplemented by Supplemental Indenture No. 9, dated as of October 1, 2006; as supplemented by Supplemental Indenture No. 10, dated as of November 1, 2006; and as supplemented by Supplemental Indenture Nos. 11 and 12, dated as of August 1, 201; as supplemented by Supplemental Indenture No. 13, dated as of October 1, 2012; as supplemented by Supplemental Indenture Nos. 14 and 15, dated as of September 1, 2013, and as supplemented by Supplemental Indenture No. 16, dated as of December 31, 2013, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company, NA; as supplemented by Supplemental Indenture No. 17, dated as of July 1, 2016, between Norton Healthcare, Inc., Norton Hospitals, Inc., and The Bank of New York Mellon Trust Company NA; as supplemented by Supplemental Indenture No. 18, dated as of August 1, 2016, between Norton Healthcare, Inc. and The Bank of New York Mellon Trust Company NA; as supplemented by Supplemental Indenture No. 19, dated as of August 1, 2016, between Norton Healthcare, Inc. and The Bank of New York Mellon Trust Company NA. The calculation includes the accounts of Norton Healthcare, Inc. and its restricted affiliate, Norton Hospitals, Inc., which have been defined as the Obligated Group by the Amended and Restated Master Trust Indenture.

Norton Healthcare, Inc. and Affiliates
Liquidity
(dollars in thousands)

	<u>December 31,</u> <u>2017</u>
Cash & Cash Equivalents ⁽¹⁾	\$ 122,747
Marketable Securities & Other Investments ⁽²⁾	124,792
Assets Limited to use by Board	1,140,784
Subtotal ⁽³⁾	1,388,323
Debt Service Reserve Funds	21,577
	\$ 1,409,899
 Obligated Group	
Daily Expenses ⁽⁴⁾	\$ 4,356
 Days cash on hand ratio ⁽⁵⁾ :	
Excluding DSRF	319
Including DSRF	324
 Consolidated	
Daily Expenses ⁽⁶⁾	\$ 5,540
 Days cash on hand ratio ⁽⁵⁾ :	
Excluding DSRF	251
Including DSRF	254

(1) Cash and Cash Equivalents are composed of assets that are or may be immediately converted to cash.

(2) Marketable Securities are assets that are convertible into cash in one week or less.

(3) Assets limited to use by the Board are liquid assets (other than private equity) whose use has been restricted by the Board.

(4) Consistent with the Master Indenture definition of "Minimum Days Cash on Hand" the Daily Expenses include only those expenses of the Obligated Group.

(5) Total liquid assets (Cash and Cash Equivalents, Marketable Securities and Other Investments and Assets Limited to use by Board) divided by daily expenses (total operating expenses less depreciation and amortization divided by 366).

(6) Consolidated Daily Expenses include those of the Corporation and Affiliates.

Norton Healthcare, Inc. and Affiliates
Combined Capitalization

(dollars in thousands)

12/31/2017

	2016A	515,605,000
	2016B	21,420,000
	2016C	55,650,000
	Total 2016 Bonds	592,675,000
	2013A	154,580,000
	2013C	50,000,000
	Total 2013 Bonds	204,580,000
	2012	7,000,000
	Total 2012 Bonds	7,000,000
	2011A	35,000,000
	2011B	40,000,000
	2011C	10,545,000
	Total 2011 Bonds	85,545,000
	2000B	200,560,000
	Total 2000B Bonds	200,560,000
	Other Debt & Capital Leases	64,840,140
	Total Other Debt & Capital Leases	64,840,140
		1,155,200,140
Less:		
Unamortized (discount)/premium		15,263,488
Unamortized bond issue costs		(9,856,513)
Current installments of long-term debt		(37,266,300)
	Total Long Term Debt	1,123,340,815
Unrestricted net assets		1,287,206,011
	Total Capitalization	2,410,546,826
Total long-term debt as a percentage of total capitalization		46.60%

Norton Healthcare, Inc.
For the year ended December 31, 2017

Utilization Statistics

Certain utilization statistics for the Corporation and its Affiliates are set forth below. The statistics for "Adult Hospitals" include the operations of Norton Hospital, Norton Audubon Hospital, Norton Brownsboro Hospital and Norton Women's Hospital St Matthews. "Pediatric Hospital" includes Norton Children's Hospital, Norton Children's Medical Center and Norton Children's Hospital St. Matthews.

	Year Ended
	December 31, 2017
Admissions:	
Adult Hospitals (A)	60,751
Pediatric Hospital	11,375
	72,126
Patient Days:	
Adult Hospitals (A)	277,039
Pediatric Hospital	90,423
	367,462
Average LOS (in Days):	
Adult Hospitals (A)	4.6
Pediatric Hospital	7.9
	5.1
Outpatient Occasions (B):	
Adult Hospitals (A)	474,772
Pediatric Hospital	62,011
	536,783
Emergency Visits:	
Adult Hospitals (A)	150,811
Pediatric Hospital	94,841
	245,652
Deliveries:	
Norton Hospital	2,456
Norton Women's/Children's Hospital St. Matthews	5,256
	7,712
Ambulatory Surgeries:	
Adult Hospitals (A)	43,429
Pediatric Hospital	12,447
	55,876
Physician Practice Visits:	
	2,114,569
Total Licensed Beds:	
Adult Hospitals (A)	1,479
Pediatric Hospital	358
	1,837
Beds in Use:	
Adult Hospitals (A)	1,100
Pediatric Hospital	325
	1,425

(A) - Includes acute care services only.

(B) - An outpatient occasion is a visit of a hospital outpatient to a unit/department of a hospital regardless of the number of tests or services provided to the patient. Included within this statistic are the services provided by certain stand alone outpatient centers, providing a variety of services, operated as an outpatient department of the hospitals.

Norton Healthcare, Inc.
For the year ended December 31, 2017

The Obligated Group

Norton Healthcare, Inc. (the "Corporation") and Norton Hospitals, Inc. ("Norton") are the only members of the Obligated Group as it relates to outstanding debt obligations at December 31, 2017.

The Affiliates

The term "Affiliates" refers to entities which are directly or indirectly controlled by the Corporation, by another Affiliate of the Corporation or by any person which controls the Corporation or any other Affiliate.

At December 31, 2017 the Affiliates are:

Norton Hospitals, Inc.
Community Medical Associates, Inc.
Norton Properties, Inc.
Children's Hospital Foundation, Inc.
Norton Healthcare Foundation, Inc.
Norton Enterprises, Inc.
Clinical Associates, Inc.
Norton Louisville Primary Care Center, Inc.
Norton Occupational Medicine Associates

At December 31, 2017, the Obligated Group accounted for 83.8% of the total operating revenues, 79.0% of the total operating expenses and 89.5% of the total assets of the Corporation and its Affiliates which has been adjusted for Other Receivables (Payables) from Affiliates.