

**SEATTLE CHILDREN'S HEALTHCARE SYSTEM**

Consolidated Financial Statements

September 30, 2013 and 2012

(With Independent Auditors' Report Thereon)

## **Independent Auditors' Report**

The Board of Trustees  
Seattle Children's Healthcare System:

### **Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of Seattle Children's Healthcare System (SCHS) (a Washington not-for-profit corporation) and affiliates, which comprise the consolidated balance sheets as of September 30, 2013 and 2012, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditors' Responsibility***

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

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

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

***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly in all material respects, the financial position of Seattle Children's Healthcare System and affiliates as of September 30, 2013 and 2012, and the results of their operations and their cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.

KPMG LLP

January 23, 2014

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Consolidated Balance Sheets

September 30, 2013 and 2012

(In thousands of dollars)

<b>Assets</b>	<b>2013</b>	<b>2012</b>
Current assets:		
Cash and cash equivalents	\$ 34,073	22,854
Accounts receivable, net of allowance for uncollectible accounts of \$1,319 in 2013 and \$1,528 in 2012	137,801	141,314
Other current assets	38,846	39,172
Current portion of assets whose use is limited	17,707	16,668
Total current assets	228,427	220,008
Assets whose use is limited:		
Investments	1,215,227	1,077,060
Investments under bond indenture and other agreements, noncurrent portion	58,720	55,839
	1,273,947	1,132,899
Land, buildings and equipment, at cost, less accumulated depreciation of \$500,251 in 2013 and \$449,169 in 2012	907,812	871,834
Other assets, net	139,960	134,225
Total assets	\$ 2,550,146	2,358,966
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Current portion of long-term debt	\$ 8,275	7,983
Accounts payable	44,281	52,353
Accrued salaries, wages, and benefits	61,678	56,049
Other payables	15,672	31,504
Interest payable	9,544	8,875
Total current liabilities	139,450	156,764
Other long-term liabilities	41,672	53,064
Long-term debt, net of current portion	532,536	542,497
Total liabilities	713,658	752,325
Commitments and contingencies (note 9)		
Net assets:		
Unrestricted	1,523,434	1,318,030
Temporarily restricted	109,116	89,679
Permanently restricted	203,938	198,932
Total net assets	1,836,488	1,606,641
Total liabilities and net assets	\$ 2,550,146	2,358,966

See accompanying notes to consolidated financial statements.

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Consolidated Statements of Operations and Changes in Net Assets

Years ended September 30, 2013 and 2012

(In thousands of dollars)

	<u>2013</u>	<u>2012</u>
Operating revenues:		
Net patient service revenues (net of contractual allowances and discounts)	\$ 883,610	815,531
Provision for uncollectible accounts	(2,464)	(2,287)
Net patient service revenues	881,146	813,244
Research revenues	63,167	60,194
Other operating revenues	39,335	55,939
Unrestricted contributions	9,090	13,592
Net assets released from restriction for operations:		
Uncompensated care	11,996	11,594
Other	28,278	27,170
Total operating revenues	<u>1,033,012</u>	<u>981,733</u>
Operating expenses:		
Salaries, wages, and benefits	462,622	425,763
Purchased services	186,004	160,605
Supplies and other expenses	176,164	174,619
Depreciation	61,007	58,010
Interest	19,191	17,054
Total operating expenses	<u>904,988</u>	<u>836,051</u>
Operating income	<u>128,024</u>	<u>145,682</u>
Nonoperating income (expenses):		
Investment income, net	21,054	23,717
Unrealized gains on trading securities, net	27,131	40,591
Change in valuation of interest rate swap agreements	11,353	(3,781)
Other nonoperating expenses, net	(856)	(427)
Loss on refinancing of debt	—	(4,054)
Net nonoperating income	<u>58,682</u>	<u>56,046</u>
Excess of revenues over expenses	<u>186,706</u>	<u>201,728</u>

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Consolidated Statements of Operations and Changes in Net Assets

Years ended September 30, 2013 and 2012

(In thousands of dollars)

	<b>2013</b>	<b>2012</b>
Excess of revenues over expenses, brought forward	\$ 186,706	201,728
Other changes in unrestricted net assets:		
Net assets released from restriction for capital	13,166	2,191
Net amounts repaid to replenish funds with deficiencies (note 4)	1,031	3,525
Other	4,501	(4,362)
Increase in unrestricted net assets	<u>205,404</u>	<u>203,082</u>
Changes in temporarily restricted net assets:		
Net investment income and unrealized gains on investments	27,515	28,941
Restricted donations	45,362	27,249
Net assets released from restriction	<u>(53,440)</u>	<u>(40,955)</u>
Increase in temporarily restricted net assets	<u>19,437</u>	<u>15,235</u>
Changes in permanently restricted net assets:		
Investment change, restricted by donors	1,453	3,043
Restricted donations	<u>3,553</u>	<u>4,104</u>
Increase in permanently restricted net assets	<u>5,006</u>	<u>7,147</u>
Increase in net assets	229,847	225,464
Net assets, beginning of year	<u>1,606,641</u>	<u>1,381,177</u>
Net assets, end of year	<u>\$ 1,836,488</u>	<u>1,606,641</u>

See accompanying notes to consolidated financial statements.

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Consolidated Statements of Cash Flows

Years ended September 30, 2013 and 2012

(In thousands of dollars)

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Increase in net assets	\$ 229,847	225,464
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	60,415	57,760
Provision for uncollectible accounts	2,464	2,287
Realized gains on investments, net	(14,850)	(19,983)
Restricted donations	(3,553)	(4,104)
Unrealized gains on investments, net	(47,859)	(64,264)
Equity earnings on investments in joint ventures, net of cash distributions	(7,487)	(5,668)
Loss on refinancing of debt	—	4,054
Change in valuation of interest rate swap agreements	(11,353)	3,781
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable, net	1,049	(35,905)
Decrease in other current assets	326	92
Decrease (increase) in other assets	1,413	(2,405)
(Decrease) increase in payables and other liabilities	(17,646)	19,824
Net cash provided by operating activities	<u>192,766</u>	<u>180,933</u>
Cash flows from investing activities:		
Capital expenditures	(97,069)	(144,245)
Proceeds from sale of investments	657,595	1,476,297
Purchases of investments	(736,974)	(1,556,825)
Net cash used in investing activities	<u>(176,448)</u>	<u>(224,773)</u>
Cash flows from financing activities:		
Restricted donations	3,553	4,104
Repayment of long-term debt	(8,652)	(7,480)
Proceeds from long-term debt	—	220,223
Advance repayment of long-term debt	—	(169,460)
Increase in deferred financing costs	—	(2,110)
Net cash (used in) provided by financing activities	<u>(5,099)</u>	<u>45,277</u>
Net increase in cash and cash equivalents	11,219	1,437
Cash and cash equivalents, beginning of year	<u>22,854</u>	<u>21,417</u>
Cash and cash equivalents, end of year	<u>\$ 34,073</u>	<u>22,854</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest (net of capitalized interest)	\$ 19,052	16,849

See accompanying notes to consolidated financial statements.

## SEATTLE CHILDREN'S HEALTHCARE SYSTEM

### Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(In thousands of dollars)

#### (1) Organization and Summary of Significant Accounting Policies

##### (a) Organization

Seattle Children's Healthcare System (SCHS), a Washington not-for-profit corporation, functions as the parent organization to the following controlled corporations. The consolidated financial statements include the financial position and results of operations of all controlled entities, each of which is a Washington not-for-profit corporation and a 501(c)(3) organization:

Seattle Children's Hospital (the Hospital) – A regional pediatric medical center and research institute.

Seattle Children's Hospital Foundation (the Foundation) – A corporation established to support SCHS and its affiliates, primarily the Hospital, through fundraising activities.

Seattle Children's Hospital Guild Association (the Guild Association) – A corporation established to support SCHS and its affiliates, primarily the Hospital, through fundraising events and memberships.

Seattle Children's Retail (Retail) – A corporation established to support SCHS, through the operation of thrift stores.

Seattle Children's Research Holdings LLC (SCRH) – A limited liability company (LLC) formed to develop, construct and lease portions of the Hospital's research facility.

Seattle Children's Research Investors LLC (SCRI) – A limited liability company (LLC) formed to facilitate the development of a portion of the Hospital's research facility by SCRH.

Contributions raised by the Foundation, the Guild Association and Retail are transferred to the Hospital or to SCHS consistent with the restriction specified by donors. During the years 2013 and 2012, the Foundation and the Guild Association transferred contributions of \$53,727 and \$40,044 to SCHS, respectively.

The consolidated financial statements of SCHS and its controlled affiliates are presented on a consolidated basis and all intercompany balances have been eliminated.

##### (b) Tax Exemption

The Commissioner of the Internal Revenue Service has granted SCHS exemption from federal income taxes under Section 501(a) of the Internal Revenue Code (IRC) as an organization described in Section 501(c)(3) of the IRC formed to operate for charitable, educational, scientific and medical purposes. The Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) Topic 740, *Accounting for Uncertainty in Income Taxes*, which prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. During the years ended September 30, 2013 and 2012, SCHS did not record any liability for unrecognized tax benefits.



## SEATTLE CHILDREN'S HEALTHCARE SYSTEM

### Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(In thousands of dollars)

**(c) Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The most significant estimates relate to contractual allowances, uncollectible accounts and self-insurance reserves.

**(d) Subsequent Events**

SCHS has performed an evaluation of subsequent events through January 23, 2014, which is the date these financial statements were issued.

**(e) Cash and Cash Equivalents**

Included in cash and cash equivalents are cash equivalents of \$2,770 and \$575 as of September 30, 2013 and 2012, respectively, invested in money market funds which are highly liquid investments that are readily convertible to known amounts of cash.

**(f) Assets Whose Use is Limited**

Assets whose use is limited includes designated unrestricted assets set aside by the Board of Trustees for future capital and various program purposes, over which the Board of Trustees retains control and may at its discretion subsequently use for other purposes. Assets whose use is limited also includes temporarily and permanently restricted assets, based on donor restriction, and assets held by trustees under indenture and other agreements. As of September 30, the fair value of assets whose use is limited is as follows:

	<b>2013</b>	<b>2012</b>
Board-designated	\$ 586,534	512,903
Board-designated endowments	419,544	373,861
Donor-restricted endowments	209,149	190,296
Trusts, annuities and other	58,720	55,839
Assets held by bond trustees	17,707	16,668
	<u>\$ 1,291,654</u>	<u>1,149,567</u>

Investment income, net, is comprised of interest, dividends and realized gains and losses. It is reported separately from unrealized gains or losses on trading securities in nonoperating income and expenses in the accompanying statements of operations and changes in net assets.

Investment securities, in general, are exposed to various risks, such as interest rate, credit and overall market volatility. Due to the level of risks associated with certain investment securities, it is reasonably possible that changes in the value of investments could occur in the near term and that

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such changes could materially affect the amounts reported in the accompanying consolidated balance sheets.

#### **Investments under Bond Indenture and Other Agreements**

Investments under bond indenture and other agreements primarily include assets held by trustees under the terms of the Revenue Bonds, trust agreements and certain deferred compensation arrangements. Amounts required to meet current liabilities of SCHS have been classified as current assets in the accompanying consolidated balance sheets at September 30, 2013 and 2012.

#### **(g) *Charitable Trusts and Annuities***

SCHS is a recipient of charitable gift annuities and charitable remainder trusts for which SCHS is the trustee. When a gift is received, the present value of future expected payments to the beneficiaries is recorded as a liability based upon life expectancy tables and current discount rate assumptions established by the Internal Revenue Service, which have ranged between 1% and 10%. The difference between the gift and the liability is recorded as a contribution and classified as an increase in temporarily restricted net assets based upon time restrictions placed by the donor. The assets held related to annuity and trust assets are reported at fair value. SCHS maintains separate reserve funds adequate to meet the future payments under its charitable gift annuity contracts as required by governing state laws. The total amount held in the separate reserve funds as of September 30, 2013 and 2012 were \$3,071 and \$2,581, respectively. The recorded liability amount for the gift annuity contracts as of September 30, 2013 and 2012 were \$2,377 and \$1,941, respectively. Any charitable gift annuities and charitable remainder trusts for which SCHS is the trustee are reflected in investments under bond indenture and other agreements, noncurrent portion, under assets whose use is limited in the accompanying consolidated balance sheets. These amounts as of September 30, 2013 and 2012 were \$4,669 and \$3,897, respectively.

SCHS is also the beneficiary of irrevocable perpetual trusts and charitable remainder trusts for which SCHS is not the trustee. These funds held in trust by others represent resources neither in the possession nor under the control of SCHS and are administered by outside trustees. When SCHS is notified of the existence of an irrevocable perpetual trust and has sufficient information about the trust to value its beneficial interest, SCHS recognizes its beneficial interest in the outside trust at fair value as a contribution. The contribution is classified as an increase in permanently restricted net assets based on restrictions placed by the donor. Irrevocable perpetual trusts are reflected in investments under bond indenture and other agreements, noncurrent portion, under assets whose use is limited in the accompanying consolidated balance sheets. The changes in the fair value of the irrevocable perpetual trusts are reflected as investment changes restricted by donors, in permanently restricted net assets on the statement of changes in net assets. These amounts as of September 30, 2013 and 2012 were \$33,941 and \$32,491, respectively.

When SCHS is notified of an irrevocable charitable remainder trust for which it is not the trustee and has sufficient information about the trust to value its beneficial interest, SCHS recognizes its beneficial interest in the outside trust as a contribution at fair value, which is measured as the present value of the estimated expected future benefits to be received. The contribution is classified as an

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(In thousands of dollars)

increase in temporarily restricted net assets based on restrictions placed by the donor upon SCHS's beneficial interest in the assets. Periodic adjustments recorded to the beneficial interest to reflect changes in the fair value and life expectancy are recognized based on information from outside trustees. Any charitable remainder trusts for which SCHS is not the trustee are reflected as a receivable from trusts and are included in investments under bond indenture and other agreements, noncurrent portion, under assets whose use is limited in the accompanying consolidated balance sheets. These amounts as of September 30, 2013 and 2012 were \$12,216 and \$11,090, respectively.

From time to time SCHS is notified that it is a beneficiary of a trust. Although SCHS is notified of the existence of a trust, SCHS will not recognize its interest in a trust until the fiscal year in which reliable and verifiable information about the trust becomes available.

SCHS has been notified of two estate gifts in which it has beneficial interests. As of September 30, 2013 SCHS did not have sufficient information to recognize these gifts.

### (h) *Land, Buildings and Equipment*

Land, buildings and equipment are stated at cost, less accumulated depreciation. Maintenance and repairs are expensed as incurred. Interest costs incurred during construction are capitalized under applicable accounting guidance. In addition, interest is capitalized on those assets that require a period of time to get them ready for their intended use. SCHS capitalized \$4,794 and \$5,530 of interest cost in 2013 and 2012, respectively. Land, buildings and equipment consist of the following at September 30:

	<b>2013</b>	<b>2012</b>
Land and improvements	\$ 224,345	211,743
Buildings and improvements	785,852	603,067
Furniture and equipment	385,170	336,294
Construction in progress	12,696	169,899
	<u>1,408,063</u>	<u>1,321,003</u>
Less accumulated depreciation	(500,251)	(449,169)
	<u>\$ 907,812</u>	<u>871,834</u>

Construction in progress primarily relates to certain facility renovations and information technology projects. In 2013, SCHS completed construction and occupied a 320,000 square foot building, named Building Hope. Building Hope includes 80 new inpatient beds, a new emergency department and expansion space for 112 additional inpatient beds. SCHS has various future commitments for future construction and development totaling \$5,221 and \$40,845 as of September 30, 2013 and 2012, respectively.

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### Notes to Consolidated Financial Statements

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(In thousands of dollars)

**(i) Depreciation**

Depreciation is computed using the straight-line method, which allocates the cost of the asset ratably over its estimated useful life. An estimated life of 40 years is used for buildings and 8 to 15 years for building and land improvements. Various lives ranging from 4 to 25 years are used for furniture and equipment. Leasehold improvements are depreciated over the shorter of the remaining life of the lease or the useful life of the asset.

**(j) Joint Ventures and Investments in Affiliated Companies**

The equity method of accounting is used for joint ventures and investments in affiliated companies in which SCHS has significant influence, but does not have control. Significant influence is deemed to exist when the ownership interest in the investee is at least 20% and not more than 50% of net assets, although other factors, such as representation on the investee's board of directors, are considered in determining whether the equity method of accounting is appropriate.

**(k) Deferred Financing Costs**

Deferred financing costs are included in other assets and are amortized using the effective interest method over the term of the related outstanding obligation.

**(l) Net Patient Service Revenues, Patient Accounts Receivable and Bad Debts**

The Hospital has agreements with third-party payors that provide payments at amounts different from its established charges. Payment arrangements may include prospectively determined rates per discharge, reimbursed costs, discounted charges, fee schedules and per-diem payments. Net patient service revenue and patient accounts receivable are reported at the estimated net realizable amounts from patients and third-party payors for services rendered.

The sources of the Hospital's revenue include commercial insurers (including managed care), Washington and other states' Medicaid programs (including state funded managed care programs), the federal Medicare and Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) programs and other. The following table summarizes gross patient revenue by payor for the years ended September 30:

	2013	2012
Commercial and commercial managed care	48%	49%
Medicaid managed care	28	18
Medicaid	17	26
Medicare	2	2
CHAMPUS	4	4
Other	1	1

## SEATTLE CHILDREN'S HEALTHCARE SYSTEM

### Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(In thousands of dollars)

The concentration of credit risk by payor as measured by patient accounts receivable was as follows at September 30:

	<u>2013</u>	<u>2012</u>
Commercial and commercial managed care	49%	51%
Medicaid managed care	26	20
Medicaid	13	20
Medicare	2	2
CHAMPUS	6	3
Other	4	4

For uninsured patients that do not qualify for charity care, the Hospital provides a discount from standard rates. This discount is recorded as an offset to net patient service revenues in the accompanying statements of operations and changes in net assets. This discount rate is equal to or greater than the contractual discount negotiated with all commercial and commercial managed care payors. The provision for uncollectible accounts is determined from an evaluation of potentially uncollectible portions of all patient accounts receivable and recognized in the period the services are provided. The provision valuation is based on analysis of current and past-due accounts, collection experience in relation to amounts billed and other relevant information. The provision, less any write-offs is recorded net with accounts receivable in the accompanying balance sheets. The Hospital's provision for doubtful accounts was 63% and 64% of self-pay accounts receivable as of September 30, 2013 and 2012. Activity in the allowance for uncollectible accounts as of September 30, was as follows:

	<u>2013</u>	<u>2012</u>
Beginning balance	\$ 1,528	1,309
Provision for uncollectible accounts	2,464	2,287
Write-offs	(2,673)	(2,068)
Ending balance	<u>\$ 1,319</u>	<u>1,528</u>

Management believes these allowances for uncollectible accounts are adequate at September 30, 2013 and 2012.

### Hospital Safety Net Assessment

In 2009, the State of Washington enacted legislation that provided for increased Medicaid payments to certain hospitals funded by assessments paid by these hospitals as well as matching federal funds (the safety net program). The safety net program covered the period from July 1, 2009 to June 30, 2013.

In 2013 and 2012, payments of \$17,100 and \$19,500, respectively, were recorded in net patient service revenues and assessments of \$9,500 and \$12,200, respectively, were recorded in expenses in the accompanying statements of operations and changes in net assets.

## SEATTLE CHILDREN'S HEALTHCARE SYSTEM

### Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(In thousands of dollars)

In connection with the safety net program, the Hospital entered into a separate agreement with the Washington State Hospital Association and certain other Washington hospitals. Under the terms of this agreement, certain of the benefits of the safety net program are distributed among participating hospitals. Reductions to the benefit of the Hospital's safety net program of \$3,300 and \$6,500 were recorded in 2013 and 2012, respectively.

In 2013, the State of Washington approved a new Hospital Safety Net Assessment program to replace the original program which covers the period from July 1, 2013 through June 30, 2017. There are no assurances when, or that the Centers for Medicare and Medicaid Services (CMS) will approve the new program. Supplemental payments and assessments under the new program will commence and be reflected in the period that CMS enacts the new program.

**(m) Other Operating Revenues**

Other operating revenues primarily include revenues from a federal graduate medical education grant, regional services, SCHS's equity earnings from its participation in joint ventures and amounts received from Children's University Medical Group (CUMG).

**(n) Net Assets and Endowments**

Contributions are reported at fair value at the date of donation. Such amounts are reported as either unrestricted, temporarily restricted or permanently restricted net assets, based on donor stipulations (if any) 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 accompanying consolidated statements of operations and changes in net assets as net assets released from restriction.

Endowment fund balances, including funds functioning as endowments, are classified and reported as permanently restricted, temporarily restricted or unrestricted net assets in accordance with donor or Board specifications. Funds functioning as endowments include board-designated named endowments and other board-designated funds. See note 4 for additional information on endowment net assets.

**(o) Recently Issued Accounting Standards**

In July 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, which provides financial statement users with greater transparency about a healthcare entity's net patient service revenue and the related allowance for doubtful accounts. The standard requires healthcare entities to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue (net of contractual allowances and discounts) on their statement of operations, as well as expanded disclosures. Although the standard is effective for the Hospital beginning October 1, 2012, Management elected to early adopt this ASU for the year ended September 30, 2012.

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## Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(In thousands of dollars)

### (2) Un and Undercompensated Care and Other Community Benefits

The mission of the Hospital is to provide excellent patient care for children, to engage in innovative research that will improve the health of children, to train the next generation of physicians, other healthcare workers and scientists who will advance the health of children, and to advocate for the healthcare needs of children. As part of the mission, the Hospital is committed to caring for children in its service area irrespective of ability to pay and to otherwise identify and help to meet the healthcare needs of children in the community and to advance science that will meet those needs. The estimated costs include, but are not limited to, the following for the years ended September 30:

	<b>2013</b>	<b>2012</b>
Medicaid payment shortfall	\$ 103,184	\$ 103,154
Charity care	14,060	10,572
Total un and undercompensated care	117,244	113,726
Other community benefits		
Research	91,743	85,023
Health and professional education	22,017	19,291
Other community benefits	15,613	16,284
Total other community benefits	129,373	120,598
Total un and undercompensated care and other community benefits	\$ <u>246,617</u>	\$ <u>234,324</u>

Medicaid payment shortfall represents the estimated cost of providing services to patients covered under Medicaid in excess of payments. The estimated cost of services provided to Medicaid patients is based on a ratio of Hospital total patient care costs as a percentage of Hospital total gross patient care charges. This cost ratio is applied to gross charges related to services provided to Medicaid patients, resulting in the estimated cost of providing care to these patients.

Charity care represents the estimated cost of care provided to children who are uninsured or underinsured and whose families cannot afford to pay for their own medical care. The Hospital provides charity care in accordance with its charity care policy based on family need and maintains records to identify the level of charity it provides. The determination of family need is evaluated during a patient's course of care and can be updated after care is complete. Because the Hospital does not pursue collection of these amounts determined to qualify as charity care, they are not reported as revenue. The estimated cost of charity care provided is based on a ratio of Hospital total patient care costs as a percentage of Hospital total gross patient care charges. This cost ratio is applied to gross charges related to charity care services, resulting in the estimated cost of providing charity care.

Other community benefits represent the cost of providing services for the benefit of the entire community. These benefits include research, education and various other community-based healthcare programs. The majority of these benefits are for pediatric research and graduate medical education.

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(In thousands of dollars)

#### (3) Investments, Fair Value Measurements and the Fair Value Option

ASC Topic 820, *Fair Value Measurements*, established a three-tier hierarchy to maximize the use of observable market data and minimize the use of unobservable inputs, and to establish classification of fair value measurements for disclosure purposes. Inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. Inputs may be observable or unobservable. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based upon market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available. The three-tier hierarchy of inputs is summarized in the three broad levels below:

Level 1 – Quoted prices in active markets for identical assets or liabilities. Investments include certain money market funds, investments in U.S. equity securities, and mutual funds;

Level 2 – Other significant observable inputs. Investments include certain money market funds, commercial paper, U.S. and international corporate debt securities, U.S. municipal debt securities, U.S. government and U.S. government agency notes, certain alternative investments, and interest rate swap agreements;

Level 3 – Significant unobservable inputs, including assets and liabilities that are traded infrequently. Investments include certain alternative investments and trust agreements.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The fair value hierarchy does not necessarily correspond to a financial instrument's relative liquidity in the market or to its level of risk.

Investments in equity and debt securities are based on quoted market prices, if available, or estimated using quoted market prices for similar securities. Cash and cash equivalents, accounts receivable, other current assets, accounts payable and accrued expenses are reported at cost, which approximates the fair value because of their short-term nature. Interest rate swaps are valued based on the net present value of the associated variable cash flows, adjusted for SCHS's and the respective counterparty's nonperformance risk.

The fair value of alternative investments is reported based on information provided by the fund managers. The alternative investments classified in Levels 2 and 3 consist of shares or units in investment funds as opposed to direct interests in the fund's underlying holdings, which may be marketable. Because the net asset value reported by each fund is used as a practical expedient to estimate the fair value of SCHS's interest therein, its classification in Level 2 or 3 is based on SCHS's ability to redeem its interest at or near the balance sheet date. If the interest can be redeemed in the near term, the investment is classified as Level 2. The classification in the fair value hierarchy is not necessarily an indication of the risks, liquidity, or degree of difficulty in estimating the fair value of each investment's underlying assets and liabilities.



# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

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The following tables present assets and liabilities that are measured at fair value on a recurring basis (including items that are required to be measured at fair value and items for which the fair value option has been elected) at September 30, 2013 and 2012:

	September 30, 2013	Fair value measurements at reporting date using		
		Level 1	Level 2	Level 3
Assets:				
Investments:				
Money market	\$ 56,378	45,095	11,283	—
Commercial paper	29,792	—	29,792	—
U.S. equity securities	5,189	5,189	—	—
U.S. corporate debt securities	47,294	—	47,294	—
International corporate debt securities	10,913	—	10,913	—
U.S. municipal debt securities	73,460	—	73,460	—
Notes issued by the U.S. and U.S. government agencies	41,520	—	41,520	—
Mutual funds:				
U.S. equities	109,992	109,992	—	—
International equities	24,136	24,136	—	—
U.S. corporate debt securities	385,788	385,788	—	—
Alternative investments:				
U.S. equity securities	96,160	—	65,437	30,723
International equity securities	108,019	—	108,019	—
Hedged equity	58,055	—	27,265	30,790
Absolute return	83,370	—	48,405	34,965
Private equity	40,511	—	—	40,511
Real assets	44,650	—	24,424	20,226
Trustee-held funds:				
Principal, interest and cost of issuance funds – money market	17,707	17,707	—	—
Charitable gift annuities	3,774	3,362	17	395
Deferred compensation – mutual funds	7,895	7,895	—	—
Perpetual and Charitable remainder trust agreements	47,051	2	893	46,156
Total assets	\$ 1,291,654	599,166	488,722	203,766
Liabilities:				
Interest rate swap agreements	\$ 20,400	—	20,400	—
Total liabilities	\$ 20,400	—	20,400	—

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	September 30, 2012	Fair value measurements at reporting date using		
		Level 1	Level 2	Level 3
Assets:				
Investments:				
Money market	\$ 82,171	46,063	36,108	—
Commercial paper	32,279	—	32,279	—
U.S. equity securities	5,494	5,494	—	—
U.S. corporate debt securities	35,430	—	35,430	—
International corporate debt securities	12,209	—	12,209	—
U.S. municipal debt securities	77,750	—	77,750	—
Notes issued by the U.S. and U.S. government agencies	40,228	—	40,228	—
Mutual funds:				
U.S. equities	98,245	98,245	—	—
International equities	20,407	20,407	—	—
U.S. corporate debt securities	325,397	325,397	—	—
Alternative investments:				
U.S. equity securities	52,139	—	52,139	—
International equity securities	89,308	—	89,308	—
Hedged equity	51,577	—	24,398	27,179
Absolute return	93,036	—	33,222	59,814
Private equity	16,089	—	—	16,089
Real assets	45,301	—	26,942	18,359
Trustee-held funds:				
Principal, interest and cost of issuance funds – money market	16,668	16,668	—	—
Swap collateral	280	280	—	—
Charitable gift annuities	3,005	2,527	116	362
Deferred compensation – mutual funds	8,081	8,081	—	—
Perpetual and Charitable remainder trust agreements	44,473	890	2	43,581
Total assets	\$ 1,149,567	524,052	460,131	165,384
Liabilities:				
Interest rate swap agreements	\$ 31,753	—	31,753	—
Total liabilities	\$ 31,753	—	31,753	—

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The fair value of long-term debt, estimated based on the quoted market prices for similar issues, considered a Level 2 measure, was \$572,886 and \$590,118 at September 30, 2013 and 2012, respectively. The carrying value was \$540,811 and \$550,480 at September 30, 2013 and 2012, respectively.

The following table presents SCHS's activity for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as defined in Topic 820 for the years ended September 30, 2013 and 2012:

	<u>Alternative investments</u>	<u>Gift annuities and trusts</u>	<u>Total</u>
Balance at September 30, 2012	\$ 121,441	43,943	165,384
Total realized and unrealized gains, net included in income	14,533	2,808	17,341
Purchases, sales and settlements:			
Purchases	31,495	—	31,495
Sales	(10,254)	(149)	(10,403)
Settlements	—	(51)	(51)
Balance at September 30, 2013	<u>\$ 157,215</u>	<u>46,551</u>	<u>203,766</u>

	<u>Alternative investments</u>	<u>Gift Annuities and Trusts</u>	<u>Other</u>	<u>Total</u>
Balance at September 30, 2011	\$ 107,702	42,669	3,600	153,971
Total realized and unrealized gains, net included in income	10,238	4,947	—	15,185
Purchases, sales and settlements:				
Purchases	19,472	6	—	19,478
Sales	(15,971)	(488)	(3,600)	(20,059)
Settlements	—	(3,191)	—	(3,191)
Balance at September 30, 2012	<u>\$ 121,441</u>	<u>43,943</u>	<u>—</u>	<u>165,384</u>

Net unrealized gains and (losses) included in income, relating to assets held at September 30, 2013 were \$13,335 and \$2,808 for alternative investments and trusts, respectively.

Unrestricted investment return comprises the following for the years ended September 30:

	<u>2013</u>	<u>2012</u>
Interest and dividend income	\$ 12,389	11,929
Realized gains on investments, net	8,665	11,788
Unrealized gains on trading securities, net	27,131	40,591
	<u>\$ 48,185</u>	<u>64,308</u>

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Notes to Consolidated Financial Statements

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Alternative investments include limited partnerships, limited liability corporations, investment trusts, institutional funds and off-shore investment funds. Included in these funds are certain types of financial instruments, including, among others, futures and forward contracts, options, swaps and securities sold not yet purchased, intended to hedge against changes in the market value of investments. These financial instruments involve varying degrees of risk. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for such investments existed. Such differences could be material.

Alternative investments are less liquid than SCHS's other investments. The fair value of alternative investments subject to certain liquidity limitations was \$232,897 and \$179,444 at September 30, 2013 and 2012, respectively. Liquidity limitations on these alternative investments include, but are not limited to, lock-up provisions whereby SCHS is unable to redeem shares of an investment for a period of time (usually one year after the initial investment), private equity commitments and funds which do not provide monthly liquidity and/or require greater than 30 days notice prior to the redemption date.

Included within assets are investments in certain entities that report fair value using a calculated net asset value (NAV) or its equivalent. The nature of such investments as of September 30, 2013 follows:

	<u>Fair value 2013</u>	<u>Fair value 2012</u>	<u>Unfunded commitments 2013</u>	<u>Redemption frequency</u>	<u>Redemption notice period</u>
Alternative investments:					
U.S. equity securities (1)	\$ 96,161	52,139	—	Monthly, quarterly,	15 – 30 days
International equity securities (2)	108,018	89,308	—	Daily, semi-monthly, monthly	5 – 30 days
Hedged equity (3)	58,055	51,577	—	Monthly, quarterly, annually, 3-year rolling lock	30 – 60 days
Real assets (4)	44,651	45,301	11,393	Monthly, none	10 days
Private equity (5)	40,511	16,089	15,223	NA	NA
Absolute return (6)	<u>83,370</u>	<u>93,036</u>	<u>—</u>	Quarterly, annually	45 – 120 days
Total alternative investments	\$ <u>430,766</u>	<u>347,450</u>	<u>26,616</u>		

- (1) Investments in this category include a long-only diversified strategy which invests in equities across all sectors and a fund which focuses on global fixed income arbitrage.
- (2) Investments in this category include funds which are diversified among international, small cap and Asian opportunities, including emerging markets.
- (3) Investments in this category include investments in hedge funds that pursue diversification of both domestic and foreign fixed income and equity securities through multiple investment strategies. One fund, valued at \$15,751 as of September 30, 2013, has a three-year rolling lock with the next available redemption date being October 1, 2016.
- (4) Investments in this category include strategies in oil and gas exploration and production, alternative energy, real estate, and global energy sector private equity funds. Five of these investments, valued

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collectively at \$20,238 as of September 30, 2013, do not allow SCHS to submit redemption requests. Distributions from these funds will be received as the underlying investments are liquidated. Based on the expiration dates of the funds, it is estimated that the underlying assets will be liquidated over the next 1 to 9 years. The sixth fund in this asset class, valued at \$24,412 as of September 30, 2013, has monthly liquidity.

- (5) Private equity investments include both U.S. and foreign investments (primarily Europe and Asia) with strategies which can include mezzanine debt, venture capital, buyout, and debt investment of financially distressed middle market businesses. These investments cannot be redeemed by SCHS; rather SCHS has committed an amount to invest in the private funds over the respective commitment periods. After the commitment period has ended, distributions from these funds will be received after the underlying assets are liquidated. Based on the expiration dates of the funds, it is estimated that the underlying assets will be liquidated over the next 3 to 9 years.
- (6) Investments in this category include absolute return multi-strategy funds and U.S. hedge funds. Multi-strategy managers can invest in merger and event arbitrage, credit and distressed securities, special situations, convertible arbitrage, and can employ hedged equities strategies. Approximately \$5,541 of total absolute return investments are allocated to special investments. Distributions will be received as the underlying investments are liquidated.

Accounting Standards Codification (ASC) Topic 825, *Financial Instruments* (Topic 825) provides entities with an option to measure many financial instruments and certain other items at fair value. Under Topic 825, unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each reporting period. SCHS has elected to record its equity method alternative investments at fair value in order to measure those investments on a basis consistent with the measurement of its other alternative investments. At September 30, 2013 and 2012, the value of these investments is \$192,982 and \$177,170, respectively. Net investment income of \$24,424 and \$18,579 related to these investments is recorded in "unrealized gains (losses) on trading securities, net" on the consolidated statements of operations and changes in net assets as of September 30, 2013 and 2012, respectively.

#### **(4) Endowment Fund and Temporarily and Permanently Restricted Net Assets**

The Endowment Fund consists of numerous funds established for a variety of purposes. It includes donor-restricted endowments and funds functioning as endowments, which include board-designated named endowments and other board-designated endowment funds. Net assets associated with these funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The Board of Trustees of SCHS has interpreted the Washington State Uniform Prudent Management of Institutional Funds Act (WA-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, SCHS classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment (b) the original value of subsequent gifts donated to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund.

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The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets represents net un-appropriated endowment investment income which is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by SCHS in a manner consistent with the standards of prudence prescribed by WA-UPMIFA.

In making a determination to appropriate or accumulate donor-restricted endowment funds, SCHS makes a good faith application of the approved SCHS spending policy, considering (a) the duration and preservation of the fund; (b) the purposes of SCHS and the donor-restricted endowment; (c) general economic conditions; (d) the appreciation of endowment investments; (e) other resources of SCHS; and (f) the investment policy of SCHS. The good faith application of the approved SCHS spending policy may result in the total fair value of endowment assets being below the amount determined to be permanently restricted net assets for financial statement presentation. Deficiencies of this nature are reflected as a reduction in unrestricted net assets. For 2013 and 2012, the cumulative reduction from unrestricted net assets totaled \$877 and \$1,908, respectively.

SCHS has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowments while seeking to maintain the purchasing power of the endowment assets. To satisfy its long-term rate-of-return objectives, SCHS relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). SCHS targets a diversified asset allocation intended to achieve its long-term return objectives within prudent risk constraints.

SCHS has a spending policy of appropriating 5% of its endowment funds' twelve quarter average market value of donor-restricted and board-designated named endowments. In establishing this policy, SCHS considered the long-term expected return on its endowment funds. Over the long term, SCHS expects the current appropriation policy to allow its endowments to grow at an average real rate of return (adjusted for inflation) of greater than 5% annually. This is consistent with SCHS's objective to maintain the purchasing power of the endowment assets as well as to provide additional real growth.

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

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### Composition of Endowment by Net Asset Classification

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
September 30, 2013:				
Donor-restricted	\$ (877)	41,008	169,018	209,149
Board-designated:				
Named endowment funds	19,751	—	—	19,751
Other endowment funds	399,793	—	—	399,793
Total funds	<u>\$ 418,667</u>	<u>41,008</u>	<u>169,018</u>	<u>628,693</u>
September 30, 2012:				
Donor-restricted	\$ (1,908)	28,451	163,753	190,296
Board-designated:				
Named endowment funds	18,390	—	—	18,390
Other endowment funds	355,471	—	—	355,471
Total funds	<u>\$ 371,953</u>	<u>28,451</u>	<u>163,753</u>	<u>564,157</u>

### Changes in Endowment Net Assets are as Follows

	<u>September 30, 2013</u>			
	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, September 30, 2012	\$ 371,953	28,451	163,753	564,157
Investment return:				
Net interest and dividends	10,660	5,356	—	16,016
Net appreciation (realized and unrealized)	37,500	15,591	—	53,091
Total investment return	48,160	20,947	—	69,107
Contributions	—	—	5,265	5,265
Appropriation of endowment assets for expenditure:				
Donor-restricted	(538)	(8,390)	—	(8,928)
Board-designated named	(908)	—	—	(908)
Total appropriations	(1,446)	(8,390)	—	(9,836)
Endowment net assets, September 30, 2013	<u>\$ 418,667</u>	<u>41,008</u>	<u>169,018</u>	<u>628,693</u>

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Notes to Consolidated Financial Statements

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	September 30, 2012			
	Unrestricted	Temporarily restricted	Permanently restricted	Total
Endowment net assets, September 30, 2011	\$ 318,798	14,316	160,398	493,512
Investment return:				
Net interest and dividends	4,151	2,341	—	6,492
Net appreciation (realized and unrealized)	50,715	19,035	—	69,750
Total investment return	54,866	21,376	—	76,242
Contributions	—	—	3,355	3,355
Appropriation of endowment assets for expenditure:				
Donor-restricted	(841)	(7,241)	—	(8,082)
Board-designated named	(870)	—	—	(870)
Total appropriations	(1,711)	(7,241)	—	(8,952)
Endowment net assets, September 30, 2012	\$ 371,953	28,451	163,753	564,157

Temporarily restricted net assets are available for the following purposes at September 30:

	2013	2012
Healthcare services:		
Purpose restrictions	\$ 21,555	18,995
Unappropriated endowment earnings	41,008	28,451
Trusts and annuities	14,109	12,443
Research	30,810	28,613
Purchase of equipment and other property	1,634	1,177
	\$ 109,116	89,679



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Permanently restricted net assets are restricted to investments in perpetuity, the income from which is expendable to support the following at September 30:

	<b>2013</b>	<b>2012</b>
Healthcare services	\$ 103,694	100,071
Research	66,303	66,372
Perpetual trusts	33,941	32,489
	<u>\$ 203,938</u>	<u>198,932</u>

### (5) Related-Party Transactions

#### (a) *Seattle Cancer Care Alliance*

The Seattle Cancer Care Alliance (SCCA), a not-for-profit corporation, was organized in 1998 by SCHS, the UWSOM and Fred Hutchinson Cancer Research Center for the purpose of offering a comprehensive program of integrated cancer care services. SCCA operates an ambulatory cancer care facility and a 20-bed licensed hospital inside the UWMC. Members of SCCA share equally in the results of its operations.

The investment of SCHS in SCCA is included in other assets in the accompanying consolidated balance sheets. SCHS accounts for its 33% ownership interest in SCCA using the equity method of accounting. As of September 30, 2013 and 2012, SCHS's investment balance in this venture totaled \$96,497 and \$89,218, respectively. Equity in earnings on SCHS's investment for 2013 and 2012, totaling \$7,279 and \$6,114, respectively, is included in other operating revenues in the accompanying consolidated statements of operations and changes in net assets.

The following is a summary of SCCA's financial results for its fiscal years ended June 30:

	<b>2013</b>	<b>2012</b>
Total assets	\$ 440,985	415,597
Total liabilities	\$ 157,923	153,585
Unrestricted net assets	280,810	260,154
Temporarily restricted net assets	1,366	972
Permanently restricted net assets	886	886
Total liabilities and net assets	<u>\$ 440,985</u>	<u>415,597</u>
Total revenues	\$ 393,731	346,578
Total expenses	(363,819)	(324,716)
Nonoperating (loss) income	(22,794)	9,426
Change in value of investment in Procure Seattle Holdings, Inc	13,538	(13,538)
Increase in unrestricted net assets	<u>\$ 20,656</u>	<u>17,750</u>

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The Hospital purchases services from SCCA and provides services to SCCA in connection with the SCCA's comprehensive program of integrated cancer care services. During 2013 and 2012, SCHS purchased services from SCCA incurring \$3,232 and \$4,097, respectively, which are included in purchased services in the accompanying consolidated statements of operations and changes in net assets. Additionally, SCHS provided services to SCCA and recorded other operating revenues of \$117 and \$97 in 2013 and 2012, respectively.

In 2011, SCCA entered into an arrangement with Procure Washington Holdings, LLC to form ProCure Seattle Holdings, LLC (Midco), a holding company with no operations. Midco is the sole member of Seattle ProCure Management, LLC, an operating company that intends to provide proton therapy treatments to cancer patients throughout the Northwest. As of June 30, 2013 and 2012, SCCA's investment in Midco was valued at \$5,000 and \$15,962, respectively. For the year ended June 30, 2013, SCCA recorded losses of \$24,500 for its share in Midco on the statement of operations and changes in unrestricted net assets, which comprised \$8,708 in Midco operating losses and \$15,792 in impairment charges to SCCA's equity ownership interest. As of June 30, 2012, SCCA reflected the impact of Midco's derivative investments as a reduction in the amount of \$13,538 in its statement of changes in net assets as the investments are designated and qualify as a cash flow hedge. Through the recording of the impairment in fiscal 2013, the cumulative amount of \$13,538 was reversed out of unrestricted net assets into nonoperating income. SCHS reflected its portion of SCCA's share of the reversal in the amount of \$4,513 out of unrestricted net assets into operating income. In fiscal 2013, SCHS also reflected its portion of SCCA's recorded losses of \$8,166 on the statement of operations and changes in unrestricted net assets.

#### **(b) Other Related Parties**

SCHS participates in other joint ventures with organizations that engage in the delivery of healthcare related services. SCHS and the University of Washington School of Medicine (UWSOM), jointly own Children's University Medical Group (CUMG); which is a pediatric practice plan that employs and manages the clinical practices of its members who are medical staff at both the Hospital and faculty at the UWSOM. The Hospital participates in a jointly owned venture with Providence Regional Medical Center of Everett, which operates as Providence-Children's Neonatal Services, LLC (PCNS). SCHS's ownership interests in these joint ventures are accounted for under the equity method of accounting.

During 2013 and 2012, SCHS provided healthcare services, at cost totaling \$7,698 and \$6,669 to these joint ventures, respectively. SCHS purchased healthcare services of \$71,664 and \$68,588 in 2013 and 2012, included in purchase services respectively. Earnings from these joint ventures in 2013 and 2012 of \$253 and \$2,030, respectively, are included in other operating revenues in the accompanying consolidated statements of operations and changes in net assets. As of September 30, 2013 and 2012, SCHS's investment in the CUMG and PCNS joint ventures totaled \$6,029 and \$5,777, respectively, which is included in other assets in the accompanying consolidated balance sheets.

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(In thousands of dollars)

### (6) Long-Term Debt

Long-term debt and capital lease obligation consist of the following at September 30:

	<u>2013</u>	<u>2012</u>
Revenue Bonds, Series 2001, final payment made October 1, 2012	\$ —	2,015
Revenue Bonds, Series 2008C, interest paid semi-annually at rates ranging from 5.375% to 5.5% with principal payments ranging from \$8,400 in 2030 to \$17,105 in 2035, net of unamortized premium of \$1,605 in 2013 and \$1,687 in 2012, secured by an interest in certain bond funds	90,360	90,442
Revenue Bonds, Series 2009, interest paid semi-annually at rates ranging from 3.00% to 5.625% with principal payments ranging from \$875 in 2015 to \$24,945 in 2039, net of unamortized discount of \$912 in 2013 and \$953 in 2012, secured by an interest in certain bond funds	84,383	85,207
Revenue Bonds, Series 2010A, interest paid semi-annually at a rate of 5% with principal payments ranging from \$1,670 in 2032 to \$30,255 in 2041, net of unamortized premium of \$2,137 in 2013 and \$2,220 in 2012, secured by an interest in certain bond funds	77,137	77,220
Revenue Bonds, Series 2010B, interest paid semi-annually at rates ranging from 4% to 5% with principal payments ranging from \$3,075 in 2013 to \$4,330 in 2023, net of unamortized premium of \$3,052 in 2013 and \$3,674 in 2012, secured by an interest in certain bond funds	38,836	42,479
Revenue Bonds, Series 2012A, interest paid semi-annually at a rate of 5% with principal payments ranging from \$22,600 in 2042 and \$23,735 in 2043, net of unamortized premium of \$3,511 in 2013 and \$3,634 in 2012, secured by an interest in certain bond funds.	49,845	49,969
Revenue Bonds, Series 2012B, interest paid semi-annually at rates ranging from 3% to 5% with principal payments ranging from \$40 in 2014 to \$2,890 in 2035, net of unamortized premium of \$2,179 in 2013 and \$2,324 in 2012, secured by an interest in certain bond funds	30,234	30,379

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	<u>2013</u>	<u>2012</u>
Revenue Bonds, Series 2012C, interest paid monthly at variable rates ranging from 1.07% to 1.09% for the fiscal year ended September 30, 2013 with principal payments ranging from \$1,500 in 2014 to \$8,935 in 2029, secured by an interest in certain bond funds	\$ 66,695	68,140
Revenue Bonds, Series 2012D, interest paid monthly at variable rates ranging from 0.73% to 0.75% for the fiscal year ended September 30, 2013 with principal payments ranging from \$2,715 in 2014 to \$5,255 in 2032, secured by an interest in certain bond funds	73,465	74,025
Notes payable with US Bank, interest paid quarterly at 1.5% through 2038 with principal due in 2038, secured by a leasehold deed of trust and assets of SCRH	29,856	29,856
Capital lease obligation, final payment made in 2013	—	748
	<u>540,811</u>	<u>550,480</u>
Less current portion	<u>(8,275)</u>	<u>(7,983)</u>
	<u>\$ 532,536</u>	<u>542,497</u>

Scheduled principal repayments as of September 30, 2013 on the long-term debt are due as follows:

2014	\$ 8,275
2015	8,575
2016	8,575
2017	8,920
2018	9,305
Thereafter	<u>485,592</u>
	529,242
Add unamortized net premiums	<u>11,569</u>
	<u>\$ 540,811</u>

The members of the Obligated Group established under the Master Indenture include the Hospital and SCHS. As of September 30, 2013, total assets, total liabilities, and total unrestricted net assets of the Obligated Group constituted approximately 99%, 96% and 100%, respectively, of the respective SCHS's totals. For 2013, the total operating revenues, operating income and excess of revenues over expenses, from all sources attributable to the Obligated Group were 99%, 99%, and 99%, respectively, of the respective SCHS's consolidated totals.

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September 30, 2013 and 2012

(In thousands of dollars)

Under the terms of the Revenue Bonds and related indenture agreements, the Obligated Group is required to comply with various covenants, including income available for debt service.

In June 2012, the Hospital issued the following Bonds; the Series 2012A Bonds were issued to reimburse the Hospital for expenses incurred related to Building Hope; the Series 2012B Bonds were issued to advance refund and defease a portion of the outstanding Series 2009 Bonds; the Series 2012C and 2012D Bonds were issued to refund all of the outstanding Series 2008A and Series 2008B Bonds, respectively. The refunding of the Series 2009 Bonds and the Series 2008A and Series 2008B Bonds resulted in a consolidated loss on refinancing of debt of \$4,054, which is reflected as a component of nonoperating income (expenses) in the accompanying consolidated statements of operations and changes in net assets. The Series 2012A and Series 2012B Bonds were issued as fixed rate debt.

The Series 2012C Bonds are expected to be subject to mandatory tender after 10 years and may be remarketed or retired at such time. The Series 2012D Bonds are expected to be subject to mandatory tender after 7 years and may be remarketed or retired at such time.

SCHS has a \$10 million working capital line of credit with Wells Fargo N.A. (Wells) to be used to finance operations if necessary. The line is secured by a supplemental obligation under the Master Trust Indenture that gives Wells a pari passu security interest in the Obligated Group's gross receivables. As of September 30, 2013 and 2012, no funds have been drawn on the line of credit.

#### ***Accounting for Derivative Instruments***

Interest rate swap contracts are used to manage the net exposure to interest rate changes in attempting to reduce the overall cost of borrowing over time. Interest rate swap contracts generally involve the exchange of fixed and floating interest rate payments without the exchange of underlying principal (the swap of fixed or floating rates are on a notional amount). SCHS accounts for its interest rate hedging transactions in accordance with ASC Topic 815, *Derivatives and Hedging*. Topic 815 requires that derivative instruments be recorded on the balance sheet as either an asset or liability measured at its individual fair market value. Changes in the derivative instrument's fair market value are recognized in earnings unless certain specific hedge accounting criteria are met. Management has not designated their interest rate swap agreements as cash flow hedges and therefore this specific criteria has not been met. As such, all changes in the valuation of the interest rate swaps are recognized in the statements of operations and changes in net assets as a component of nonoperating income (expenses).

SCHS entered into two interest rate swap agreements (Swap Agreements) with two separate counterparties. Under each Swap Agreement, SCHS is obligated to pay a fixed rate per annum (3.48% on the Series 2012C Bonds and 3.69% on the Series 2012D Bonds) on a notional amount equal to the outstanding principal amount of the applicable series of bonds and receives a variable payment computed as 68% of the one month LIBOR rate. The bonds' variable-rate coupons are based upon rates calculated as a percentage of one month LIBOR plus a credit spread as defined in the respective financing agreements.

# SEATTLE CHILDREN'S HEALTHCARE SYSTEM

## Notes to Consolidated Financial Statements

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(In thousands of dollars)

The following table presents the effect of interest rate swap contracts on the balance sheet:

	<b>Balance sheet location</b>	<b>September 30</b>	
		<b>2013</b>	<b>2012</b>
Interest rate swaps not designated as hedges	Other long-term liabilities	\$ 20,400	31,753

To comply with Topic 820, SCHS has incorporated its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements.

The two Credit Support Annexes for the interest rate swaps require either party to post collateral if the fair market value of the swap is negative to them and exceeds the minimum threshold as defined in each respective Credit Support Annex. The amount of collateral required to be posted is equal to the difference of the fair market value over the minimum threshold. As of September 30, 2013 the Hospital was not required to post collateral for either swap.

### (7) New Market Tax Credit Financing

In November 2008, SCRH entered into a New Market Tax Credit Financing (NMTC) arrangement to facilitate the development and construction of a portion of SCHS's research facility. The NMTC program provides for a credit against federal income tax under Internal Revenue Code Section 45D for taxpayers who hold a Qualified Equity Investment (QEI). A QEI is any equity investment in a qualified Community Development Entity (CDE) if such investment is used by the CDE to make a Qualified Low-Income Community Investment (QLICI Investment) in a Qualified Low-Income Community Business (QLICB Business). A QEI is made by an Investment Fund (IF). SCRH is considered to be a QLICB Business. The NMTC is claimed over a seven-year period.

A tiered ownership structure exists to combine the investor's loan and equity with other nonrecourse loans to make a QEI. This structure is sometimes referred to as the NMTC leveraged investment model. The leveraged investment model includes loans made from SCRI to IF's which collectively made QEI's totaling \$22,372 in CDE's, which are not due until the end of the NMTC program. These loans are classified as long-term and included within other assets, net in the accompanying consolidated balance sheet as of September 30, 2013 and 2012. The CDE's made QLICI loans totaling \$29,856 to SCRH. SCRH does not control or have an economic interest in the assets of either the CDE's or the QEI's.

SCRI entered into put/call options with certain CDE's to take place at the end of the seven-year period. Under the respective agreements, the CDE's can exercise a put option to sell their interests in the respective QEI's for \$1 each. If the parties do not exercise the put option within 90 days of the end of the seven-year period, SCRI can exercise a call option to purchase the interests at appraised fair market values.

### (8) Self-Insurance

SCHS has purchased professional and general liability insurance on a claims-made basis. SCHS is self-insured for the deductible portion of its insurance coverage and for unreported incidents and accrues an actuarial estimate for claims within its deductible portion and for unreported incidents. At

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(In thousands of dollars)

September 30, 2013 and 2012, the gross liability before insurance receivable for future costs of professional and general liability claims was \$9,029 and \$9,545, respectively. At September 30, 2013 and 2012, \$6,974 and \$7,261, respectively, of this liability was included as long-term within other long-term liabilities with the remainder within other payables in the accompanying consolidated balance sheets. At September 30, 2013 and 2012, the Hospital also recorded an insurance receivable of \$2,223 and \$2,252, respectively. At September 30, 2013 and 2012, \$1,476 and \$1,712, respectively, of this receivable was included as long term within other assets and with the remainder within other current assets in the accompanying consolidated balance sheets.

SCHS is self-insured for workers' compensation. SCHS also carries an excess coverage policy for its workers' compensation program. SCHS has accrued an actuarial estimate for claims and unreported incidents. At September 30, 2013 and 2012, the workers' compensation obligation included within accrued salaries, wages and benefits was \$2,968 and \$2,866, respectively, in the accompanying consolidated balance sheets.

SCHS is self-insured for medical, dental and vision insurance plans. At September 30, 2013 and 2012, the obligation for medical, dental and vision insurance included within accrued salaries, wages and benefits was \$2,861 and \$2,341, respectively, in the accompanying consolidated balance sheets.

#### (9) Commitments and Contingencies

##### (a) Operating Leases

SCHS leases various equipment and facilities under operating leases expiring at various dates. Total rental expense in 2013 and 2012 was \$9,578 and \$9,440, respectively.

Operating lease commitments for future years are as follows:

2014	\$	7,230
2015		5,578
2016		4,987
2017		4,742
2018		3,704
Thereafter		9,393
	\$	<u>35,634</u>

##### (b) Regulatory Environment and Litigation

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services and Medicare and Medicaid fraud and abuse. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result

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### Notes to Consolidated Financial Statements

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in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed.

Management believes that SCHS, in all material respects, is in compliance with the fraud and abuse regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. SCHS is subject to litigation arising in the normal course of business. After consultation with legal counsel, management believes that these matters will be resolved without material adverse effect on SCHS's future financial position or results of operations.

#### (10) Retirement Plan and Deferred Compensation

SCHS Employees' Retirement Plan (the Plan) is a defined contribution plan. The Plan allows participants to contribute up to 75% (4% for highly compensated employees) of eligible compensation as pretax employee deferrals subject to certain limitations under the Internal Revenue Code. Employee deferrals are matched by SCHS at 25% of the first 4% of eligible compensation contributed by the participant to the Plan.

Each year, SCHS contributes a discretionary amount to the Plan. Contributions for participants with less than five years of vested service were 4% of eligible compensation for 2013 and 2012, respectively. Contributions for participants with five or more years of vested service were 6% of eligible compensation 2013 and 2012, respectively. The Plan covers substantially all SCHS employees. Pension expense for SCHS's plans during 2013 and 2012 totaled \$18,898 and \$17,809, respectively.

Deferred compensation arrangements are maintained by SCHS for the benefit of eligible employees. Substantially all amounts deferred under these arrangements are held until such time as these funds become payable to the participants. Assets related to deferred compensation totaling \$5,411 and \$4,908 at September 30, 2013 and 2012, respectively, are available to general creditors of SCHS and are included within assets whose use is limited in the accompanying consolidated balance sheets. The deferred compensation liability is included within other liabilities in the accompanying consolidated balance sheets.

#### (11) Functional Expenses

Functional expenses were as follows for the years ended September 30:

	2013	2012
Healthcare services	\$ 734,661	675,647
General and administrative	56,499	55,531
Fundraising	10,149	10,105
Research	103,679	94,768
Other nonoperating expense, net	856	427
	<u>\$ 905,844</u>	<u>836,478</u>