**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Consolidated Financial Statements

June 30, 2013 and 2012

(With Independent Auditors' Report Thereon)

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

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KPMG LLP
Suite 1900
440 Monticello Avenue
Norfolk, VA 23510

# Independent Auditors' Report

Board of Directors
Duke University Health System, Inc.:

We have audited the accompanying consolidated financial statements of Duke University Health System, Inc. and Affiliates (the Health System), which comprise the consolidated balance sheets as of June 30, 2013 and 2012, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### *Management's Responsibility for the 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 auditor considers internal control relevant to the Health System'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 Health System'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 Duke University Health System, Inc. and Affiliates as of June 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.

***Supplementary Information***

Our audits were performed for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information in schedules 1 and 2 is presented for the purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

KPMG LLP

October 3, 2013

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Consolidated Balance Sheets

June 30, 2013 and 2012

(In thousands)

| **Assets** | | **2013** | **2012** |
|---|---|---|---|
| Current assets: | | | |
| Cash and cash equivalents | $ | 177,195 | 243,215 |
| Patient accounts receivable, net | | 305,367 | 287,120 |
| Estimated third-party payor settlements, net | | 30,360 | — |
| Other receivables | | 30,491 | 40,275 |
| Due from parent, net | | — | 5,967 |
| Inventories of drugs and supplies | | 69,473 | 67,527 |
| Other assets | | 16,107 | 14,836 |
| Short-term investments | | 151,490 | 253,281 |
| Assets limited as to use | | 19,587 | 45,933 |
| Total current assets | | 800,070 | 958,154 |
| Assets limited as to use | | 159,161 | 316,898 |
| Investments | | 2,040,684 | 1,581,459 |
| Property and equipment, net | | 1,515,233 | 1,285,258 |
| Due from parent | | 1,093 | 1,242 |
| Other noncurrent assets | | 19,190 | 17,955 |
| Total assets | $ | 4,535,431 | 4,160,966 |
| **Liabilities and Net Assets** | | | |
| Current liabilities: | | | |
| Accounts payable | $ | 194,534 | 155,261 |
| Due to parent, net | | 2,145 | — |
| Other current liabilities | | 54,370 | 44,730 |
| Accrued salaries, wages and vacation payable | | 138,369 | 129,821 |
| Estimated third-party payor settlements, net | | — | 9,507 |
| Current portion of postretirement and postemployment benefit obligations | | 6,133 | 4,727 |
| Current portion of indebtedness | | 20,740 | 21,170 |
| Current portion of capital lease obligations | | 893 | 677 |
| Current portion of estimated professional liability costs | | 16,083 | 18,531 |
| Total current liabilities | | 433,267 | 384,424 |
| Other noncurrent liabilities | | 59,956 | 62,161 |
| Postretirement and postemployment benefit obligations, net of current portion | | 96,969 | 208,973 |
| Indebtedness, net of current portion | | 1,087,088 | 1,114,974 |
| Capital lease obligations, net of current portion | | 125,996 | 126,900 |
| Derivative instruments | | 93,448 | 139,026 |
| Estimated professional liability costs, net of current portion | | 52,537 | 55,125 |
| Total liabilities | | 1,949,261 | 2,091,583 |
| Net assets: | | | |
| Unrestricted | | 2,539,223 | 2,019,346 |
| Temporarily restricted | | 36,083 | 40,758 |
| Permanently restricted | | 10,864 | 9,279 |
| Total net assets | | 2,586,170 | 2,069,383 |
| Total liabilities and net assets | $ | 4,535,431 | 4,160,966 |

See accompanying notes to consolidated financial statements.

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Consolidated Statements of Operations

Years ended June 30, 2013 and 2012

(In thousands)

| | 2013 | 2012 |
|---|---|---|
| Unrestricted revenues, gains and other support: | | |
| Net patient service revenue (net of contractual allowances and discounts) | $ 2,460,175 | 2,412,672 |
| Provision for bad debts | (74,569) | (82,976) |
| Net patient service revenue less provision for bad debts | 2,385,606 | 2,329,696 |
| Other revenue | 153,416 | 148,394 |
| Total unrestricted revenues, gains and other support | 2,539,022 | 2,478,090 |
| Expenses: | | |
| Salaries, wages and benefits | 1,211,924 | 1,129,932 |
| Medical supplies | 519,853 | 510,168 |
| Interest | 22,727 | 17,997 |
| Depreciation and amortization | 105,040 | 94,800 |
| Other operating expenses | 495,370 | 469,583 |
| Total expenses | 2,354,914 | 2,222,480 |
| Operating income | 184,108 | 255,610 |
| Nonoperating income: | | |
| Investment income (loss) | 255,729 | (82,968) |
| Other | 104 | 205 |
| Total nonoperating income (loss) | 255,833 | (82,763) |
| Excess of revenues over expenses | 439,941 | 172,847 |
| Cumulative effect of change in accounting principle | — | (1,302) |
| Change in funded status of defined benefit plans | 137,847 | (219,268) |
| Net assets released from restrictions for purchase of property and equipment | (1,371) | 9,151 |
| Transfers to parent, net | (56,540) | (43,878) |
| Increase (decrease) in unrestricted net assets | $ 519,877 | (82,450) |

See accompanying notes to consolidated financial statements.

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2013 and 2012

(In thousands)

| | 2013 | 2012 |
|---|---|---|
| Unrestricted net assets: | | |
| Excess of revenues over expenses | $ 439,941 | 172,847 |
| Cumulative effect of change in accounting principle | — | (1,302) |
| Change in funded status of defined benefit plans | 137,847 | (219,268) |
| Net assets released from restrictions for purchase of property and equipment | (1,371) | 9,151 |
| Transfers to parent, net | (56,540) | (43,878) |
| Increase (decrease) in unrestricted net assets | 519,877 | (82,450) |
| Temporarily restricted net assets: | | |
| Contributions for restricted purposes | 6,651 | 11,076 |
| Transfers to parent, net | (11,051) | (64) |
| Net assets released from restrictions used for operations | (3,009) | (4,493) |
| Net assets released from restrictions for purchase of property and equipment | 1,371 | (9,151) |
| Net realized and unrealized gains (losses) | 1,363 | (659) |
| Decrease in temporarily restricted net assets | (4,675) | (3,291) |
| Permanently restricted net assets: | | |
| Contributions for endowment funds | 1,539 | 50 |
| Transfers to parent, net | — | (323) |
| Net realized and unrealized gains (losses) | 46 | (99) |
| Increase (decrease) in permanently restricted net assets | 1,585 | (372) |
| Increase (decrease) in net assets | 516,787 | (86,113) |
| Net assets, beginning of year | 2,069,383 | 2,155,496 |
| Net assets, end of year | $ 2,586,170 | 2,069,383 |

See accompanying notes to consolidated financial statements.

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Consolidated Statements of Cash Flows

Years ended June 30, 2013 and 2012

(In thousands)

| | | 2013 | 2012 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Increase (decrease) in net assets | $ | 516,787 | (86,113) |
| Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities: | | | |
| Depreciation and amortization | | 105,040 | 94,800 |
| Investment (income) losses | | (257,092) | 83,627 |
| Cumulative effect of change in accounting principle | | — | 1,302 |
| Net losses on other investments and disposals of property and equipment | | 577 | 99 |
| Transfers to parent, net | | 67,591 | 44,265 |
| Provision for bad debts | | 74,569 | 82,976 |
| Restricted contributions received for long-term capital projects | | (4,846) | (7,162) |
| Permanently restricted contributions and associated realized and unrealized gains | | (1,585) | 49 |
| (Increase) decrease in: | | | |
| Patient accounts receivable | | (92,816) | (90,540) |
| Other receivables | | 2,245 | (12,814) |
| Inventories of drugs and supplies | | (1,946) | (4,042) |
| Prepaid pension asset | | — | 88,645 |
| Other assets | | (2,734) | (5,708) |
| Increase (decrease) in: | | | |
| Accounts payable | | 9,157 | (9,208) |
| Due to parent, net | | 4,188 | (2,359) |
| Other current liabilities | | 8,702 | 6,602 |
| Accrued salaries, wages and vacation payable | | 8,548 | (2,432) |
| Estimated third-party payor settlements, net | | (39,867) | 6,262 |
| Postretirement and postemployment benefit obligations | | (110,598) | 134,967 |
| Other noncurrent liabilities | | 972 | 11,035 |
| Estimated professional liability costs | | (5,036) | (13,755) |
| Net cash provided by operating activities | | 281,856 | 320,496 |
| Cash flows from investing activities: | | | |
| Capital expenditures | | (311,628) | (338,458) |
| Decrease (increase) in assets limited as to use | | 153,674 | (140,068) |
| Sales of investments | | 1,025,545 | 1,195,824 |
| Purchases of investments | | (1,131,387) | (1,284,708) |
| Investment and endowment loss | | (7,011) | (4,931) |
| Proceeds from sale of fixed assets | | 224 | 593 |
| Decrease in other assets | | 206 | 149 |
| Net cash used in investing activities | | (270,377) | (571,599) |



(Continued)

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Consolidated Statements of Cash Flows

Years ended June 30, 2013 and 2012

(In thousands)

| | | 2013 | 2012 |
|---|---|---|---|
| Cash flows from financing activities: | | | |
| Payments on indebtedness and bank borrowings | $ | (75,920) | (481,755) |
| Proceeds from issuance of indebtedness and bank borrowings | | 48,225 | 794,709 |
| Bond issuance costs | | (520) | (2,870) |
| Rate lock payment | | — | (7,601) |
| Proceeds from restricted contributions and associated realized gains | | 11,612 | 9,565 |
| Payments on capital lease obligations | | (688) | (539) |
| Transfers to parent, net | | (60,208) | (42,649) |
| Net cash (used in) provided by financing activities | | (77,499) | 268,860 |
| Net (decrease) increase in cash and cash equivalents | | (66,020) | 17,757 |
| Cash and cash equivalents, beginning of year | | 243,215 | 225,458 |
| Cash and cash equivalents, end of year | $ | 177,195 | 243,215 |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid for interest, net of amount capitalized | $ | 22,287 | 13,552 |
| Supplemental disclosures of noncash investing/financing activities: | | | |
| Fixed asset payables as of June 30 | $ | 30,508 | 34,280 |
| Net transfers to the Parent of property and equipment | | 3,460 | 3,581 |
| Net transfers payable between the Health System and University | | 5,854 | 1,931 |

See accompanying notes to consolidated financial statements.

## (1) Description of Organization, Related Parties, and the Private Diagnostic Clinic

### *(a) Duke University Health System, Inc. (the Health System)*

The Health System is a North Carolina nonprofit corporation organized and controlled by Duke University (the University or the Parent). The Health System includes three hospitals operated as divisions and several subsidiaries and controlled affiliates, the most significant of which follow:

- ***Duke University Hospital (DUH)*** – a quaternary care teaching hospital located on the campus of Duke University in Durham, North Carolina, licensed for 957 acute care and specialty beds, leased from the University, operated by the Health System and providing patient care and serving as a site for medical education provided by the Duke University School of Medicine (School of Medicine or SOM) and clinical research conducted by the School of Medicine.
- ***Duke Regional Hospital (DRH)*** – formerly known as Durham Regional Hospital, DRH is a full service community hospital located in Durham, North Carolina, licensed for 369 acute care beds, leased from Durham County and operated by the Health System under agreements with concurrent terms of forty years.
- ***Duke Raleigh Hospital (DRaH)*** – a community hospital located in Raleigh, North Carolina, licensed for 186 acute care beds, leased from the University, operated by the Health System and providing patient care.
- ***Duke University Affiliated Physicians, Inc. (DUAP)*** – a North Carolina nonprofit corporation, doing business as Duke Primary Care, consisting of twenty primary care physician practices located in Alamance, Chatham, Durham, Granville, Orange, Vance, and Wake Counties, North Carolina, five urgent care centers located in Durham and Wake Counties, and a pediatric practice with two locations in Durham County.
- ***Durham Casualty Company, Ltd. (DCC)*** – a wholly owned subsidiary of the Health System, domiciled in Bermuda, insuring a portion of the medical malpractice risks and patient general liability risks of Health System clinical providers and the Private Diagnostic Clinic (PDC).

The Health System also includes other separately incorporated affiliates and subsidiaries and unincorporated divisions not listed above whose accounts are included in the accompanying consolidated financial statements. All significant intercompany accounts and transactions are eliminated in consolidation. The Health System's accounts are included in the consolidated financial statements of the University.

### *(b) The University*

Pursuant to a lease and operating agreement between the University and the Health System, the Health System acquired, or has acquired the right to operate, all of the operating assets of the University's health system and has assumed all of the University's liabilities and obligations related to the transferred assets. Under the Health System's current Master Trust Indenture, the owners of Health System bonds look solely to the Health System for repayment of those obligations. The operating agreement between the University and the Health System provides for certain common administrative services, human resources policy and practice, fiduciary responsibility, investment policies, and support for the School of Medicine.

(In thousands)

Certain shared administrative and general service expenses are incurred by the University for the benefit of the Health System. These are included within operating expenses and amounted to approximately $30,300 and $29,500 in 2013 and 2012, respectively.

### *(c) School of Medicine*

The SOM is one of the top-ranked medical schools and one of the largest biomedical research enterprises in the United States. The SOM is organized and operated as part of the University and is included in the University's consolidated financial statements (not in the Health System's consolidated financial statements).

The Health System provides support to the SOM in the form of cash (and some noncash) equity transfers. Examples of transfers to the SOM include but are not limited to support of specific initiatives, specific departments, or general support for the Chancellor or a departmental chair. For the years ended June 30, 2013 and 2012, unrestricted transfers to Parent and other changes are as follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Transfers to the School of Medicine | $ | 49,245 | 36,510 |
| Transfers to the University | | 4,914 | 4,248 |
| Transfers from the University/School of Medicine | | (1,079) | (461) |
| Total funded transfers, net | | 53,080 | 40,297 |
| Fixed assets and other unfunded transfers, net | | 3,460 | 3,581 |
| Unrestricted transfers to Parent, net | $ | 56,540 | 43,878 |

### *(d) Private Diagnostic Clinic (PDC)*

The PDC is a professional limited liability company consisting of physicians practicing primarily within Health System facilities and PDC clinics. The purpose of the PDC is to provide a structure separate from the University and the Health System in which the members of the physician faculty of the School of Medicine may engage in the private practice of medicine and still serve as members of the faculty of the University conducting clinical teaching and medical research. The PDC, under an agreement with the University, occupies and utilizes certain of the Health System's facilities. PDC physicians are not employed by the Health System, and the PDC is not included in the Health System's or the University's consolidated financial statements.

The Health System has numerous agreements with the PDC. Many are for services related to clinical operations such as professional service agreements (PSA) for physician staffing of certain Health

(In thousands)

System facilities, medical directors, and lab services. The Health System, through its Patient Revenue Management Organization (PRMO), has contracted responsibility for the billing and accounts receivable operations of the PDC. DCC provides the malpractice insurance coverage for the PDC. The PDC subleases, at market rates, clinical and administrative space owned by the University and leased to the Health System. The Health System also subleases to the PDC, at full cost, leased space from nonaffiliated third parties. The following table summarizes the PDC-related revenue reported in other revenue in the Health System's consolidated statements of operations:

| | | 2013 | 2012 |
|---|---|---|---|
| Billing and collection services | $ | 37,163 | 36,483 |
| Revenue under service agreements | | 38,461 | 36,980 |
| DCC malpractice insurance premiums | | 8,604 | 11,075 |
| Rental income | | 13,608 | 13,399 |
| Total | $ | 97,836 | 97,937 |

Other operating expenses in the Health System's consolidated statements of operations include PDC-related expenses under service agreements of $83,394 and $77,452, respectively. The Health System has net receivables from the PDC of $2,726 and $3,086, respectively, as of June 30, 2013 and 2012 related to various transactions.

### *(e) DUMAC, Inc. (DUMAC)*

DUMAC, a separate nonprofit support corporation organized and controlled by the University, manages multiple investment pools on behalf of the Health System and the University including the Health System Pool (HSP) and the Long Term Pool (LTP). DUMAC also manages the investment assets of the Employee's Retirement Plan of the University (ERP).

## (2) Summary of Significant Accounting Policies

Significant accounting policies of the Health System are as follows:

### *(a) Cash and Cash Equivalents*

Cash and cash equivalents include certain assets invested in the Duke University Short Term Account (STA), which the Health System utilizes to fund daily cash needs. The STA currently invests in short-term, highly liquid investments which can be liquidated within thirty days.

Cash and cash equivalents that are invested in the HSP and LTP are reported within short-term and noncurrent investments as these funds are not typically used for current operating needs.

### *(b) Short-Term Investments*

Short-term investments include debt securities and other instruments with maturities of one year or less from the balance sheet date and are not included in cash and cash equivalents.

***(c) Investments***

**Reporting**

Investments are classified as trading securities. As such, investment income or loss (including realized and unrealized gains and losses on investments, interest, and dividends) is included in excess of revenues over expenses unless the income or loss is restricted by donor or law.

**Valuation**

Investments are recorded in the consolidated financial statements at estimated fair value. For investments made directly by the Health System whose values are based on quoted market prices in active markets, the market price of the investment is used to report fair value. For shares in mutual funds, fair values are based on share prices reported by the funds as of the last business day of the fiscal year. The Health System's interests in alternative investment funds such as fixed income, equities, hedged strategies, private capital, and real assets are generally reported at the net asset value (NAV) reported by the fund managers. Unless it is probable that all or a portion of the investment will be sold for an amount other than NAV, the Health System has concluded, as a practical expedient, that the NAV approximates fair value.

**Derivatives**

Derivatives are used by the Health System and external investment managers to manage market risks. The most common derivative strategies entered into are total return swaps, futures contracts, and short sales. These derivative instruments are recorded at their respective fair values (note 8).

***(d) Assets Limited as to Use***

Assets limited as to use include funds on deposit with bond trustees, funds pledged as collateral under derivative swap agreements, and externally restricted funds. In addition, amounts required to settle estimated professional liability costs recorded in DCC have been classified as assets limited as to use.

### *(e) Property and Equipment*

Property and equipment acquisitions are recorded at original cost or, where original cost data is not available, at estimates of original cost. Property and equipment under capital leases are initially valued and recorded based on the present value of minimum lease payments. Costs associated with the development and installation of internal-use software may be capitalized or expensed. These costs are expensed if they are incurred in the preliminary project or post-implementation/operation stages and capitalized if they are incurred in the application development stage and meet certain capitalization requirements. Depreciation and amortization is calculated on the straight line basis over the estimated useful lives of the respective assets, except for leasehold improvements and property and equipment held under capital leases, which are amortized over the shorter of the expected useful life of the asset or related lease term. The estimated useful lives by asset type are as follows:

| Asset type | Useful life |
|---|---|
| Buildings and utilities | 10 – 50 years |
| Furnishings and equipment | 3 – 20 years |
| Internal-use software | 5 – 10 years |

Gains and losses from the disposal of property and equipment are included in operating income. Interest on borrowings to finance facilities is capitalized during construction, net of any investment income earned through the temporary investment of project borrowings.

### *(f) Asset Impairment*

The Health System assesses the recoverability of long lived assets by determining whether the carrying value of these assets can be recovered through undiscounted future operating cash flows generated by these assets. The amount of impairment, if any, is measured by comparison of the fair value of the assets to their carrying value. Fair value is determined using market data, if available, or projected discounted future operating cash flows using a discount rate reflecting the Health System's weighted average cost of capital.

### *(g) Net Assets*

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

*Unrestricted net assets* – Net assets that are not subject to externally imposed stipulations.

*Temporarily restricted net assets* – Net assets subject to externally imposed stipulations that may or will be met either by actions of the Health System and/or the passage of time.

(In thousands)

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

| | 2013 | 2012 |
|---|---|---|
| Healthcare services: | | |
| Health education | $ 3,239 | 2,974 |
| Capital expenditures | 18,026 | 24,943 |
| Other | 14,818 | 12,841 |
| | $ 36,083 | 40,758 |

*Permanently restricted net assets* – Net assets subject to externally imposed stipulations that they be maintained by the Health System in perpetuity.

Revenues are reported as increases in unrestricted net assets unless use of the related asset is limited by externally imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses are reported as increases or decreases in unrestricted net assets unless use of the related asset is limited by externally imposed restrictions or law. Expirations of temporary restrictions of net assets (i.e., the externally stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications between the applicable classes of net assets if used to acquire capital assets; otherwise, they are recorded as unrestricted operating revenue. Unrealized gains on permanently restricted net assets are included in the increase in temporarily restricted net assets.

### *(h) Excess of Revenues over Expenses*

Changes in unrestricted net assets that are excluded from excess of revenues over expenses include the cumulative effect of changes in accounting principles, certain nonperiodic defined benefit accounting adjustments, permanent transfers of assets to and from affiliates for other than goods and services, and assets acquired using contributions, which by externally imposed restriction, were used for the purposes of acquiring long lived assets.

### *(i) Net Patient Service Revenue (Net of Contractual Allowances and Discounts)*

The Health System recognizes revenues in the period in which services are rendered. The Health System has agreements with third-party payors that provide for payments to the Health System at amounts that are generally less than its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Accordingly, net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others, 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 changes to estimates become known and tentative and final settlement adjustments are identified.

***(j) Charity Care***

The Health System provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Health System does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue or included in patient accounts receivable.

***(k) Derivative Financial Instruments***

The Health System has elected not to use hedge accounting with respect to any of its debt derivative financial instruments. Derivative financial instruments are recognized as assets or liabilities in the consolidated balance sheets at fair value. Realized and unrealized gains and losses on derivatives are included in investment income (loss) in the consolidated statements of operations.

***(l) Income Taxes***

The Health System and substantially all of its affiliates are organizations described under Section 501(c)(3) of the Internal Revenue Code. Such organizations are not subject to federal and state income tax on income related to their exempt purpose. Accordingly, no provision for income taxes is made in the consolidated financial statements for these entities.

***(m) 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 as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include valuation allowances for receivables, third-party reimbursement settlements, self-insurance liabilities, retirement obligations, and the carrying amounts of property, equipment, investments, and derivative instruments. Actual results could differ from those estimates.

***(n) Reclassifications***

Certain 2012 amounts have been reclassified to conform to the 2013 presentation. The reclassifications had no effect on excess of revenue over expenses or net assets as of and for the year ended June 30, 2012.

During 2013, the Health System adopted an accounting policy change which resulted in the reclassification of the net current settlement differential (net realized gains and losses) on its debt derivatives from interest expense to investment income (loss). The 2012 net realized losses on debt derivatives of $18,101 were reclassified from interest expense to investment income (loss) in the consolidated statements of operations to conform to the 2013 presentation. The reclassification of net realized gains and losses on debt derivatives increased net cash provided by operating activities by $18,375 and increased net cash used in investing activities by the same amount for the year ended June 30, 2012.



(Continued)

(In thousands)

### (o) *Recently Adopted Accounting Standards*

The Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, in May 2011. This ASU requires the reason for the fair value measurement to be disclosed, a description of the valuation techniques, and descriptions of the inputs used for all Level 2 and Level 3 fair value measurements. It also requires all transfers between levels of the fair value hierarchy to be separately reported and described. The Health System adopted ASU 2011-04 in 2013.

## (3) Net Patient Service Revenue and Estimated Third-Party Payor Settlements

Patient service revenue, net of contractual allowances and discounts, but before the provision for bad debts, recognized in 2013 and 2012 from major payor sources is as follows:

| | 2013 | | 2012 | |
|---|---|---|---|---|
| | Amount | Percentage | Amount | Percentage |
| Commercial payors | $ 1,343,956 | 54.6% | $ 1,305,189 | 54.1% |
| Medicare | 708,635 | 28.8 | 681,788 | 28.3 |
| Medicaid | 287,936 | 11.7 | 306,548 | 12.7 |
| Self-pay patients | 34,402 | 1.4 | 37,834 | 1.6 |
| Other third-party payors | 85,246 | 3.5 | 81,313 | 3.3 |
| Total | $ 2,460,175 | 100.0% | $ 2,412,672 | 100.0% |

The Health System has entered into payment agreements with third-party payors including certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Health System under these agreements includes prospectively determined rates per discharge, prospectively determined daily rates, and discounts from established charges. The Health System recognizes patient service revenue associated with services provided to patients who have third-party coverage on the basis of contractual rates for the services rendered.

Net patient service revenue includes estimated retroactive adjustments under reimbursement agreements with governmental programs. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as changes to estimates become known and tentative and final settlement adjustments are identified. The effects of these adjustments are to increase net patient service revenue by $3,360 and $3,576 in 2013 and 2012, respectively. The amounts due to and from governmental programs (Medicare and Medicaid) for final settlement of reimbursements are determined based upon cost reports filed annually with the respective programs. The reports for all years through June 30, 2006 for Medicare and June 30, 2003 for Medicaid have been substantially resolved with the respective fiscal intermediary. In the opinion of management, adequate provisions have been made in the consolidated financial statements for adjustments that may result from final settlements of reimbursable amounts.

(In thousands)

The Health System receives supplemental Medicaid payments from the State of North Carolina through a federally approved disproportionate share program (Medicaid DSH). Medicaid DSH payments are part of the Medicaid Program and are designed to offset a portion of the Medicaid losses incurred. Amounts recognized in the Health System's financial statements related to supplemental Medicaid follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Supplemental Medicaid amounts included in net patient service revenue | $ | 126,535 | 159,811 |
| Medicaid assessments included in other operating expenses | | 47,797 | 64,047 |
| Net supplemental Medicaid revenue in operating income | | 78,738 | 95,764 |
| Net receivable from supplemental Medicaid included in estimated third-party payor settlements, net | | 39,723 | 95 |

There can be no assurance that the Health System will continue to qualify for future participation in this program or that the program will not be discontinued or materially modified.

For uninsured patients who do not qualify for charity care, the Health System recognizes revenue on the basis of its discounted rates. Uninsured patients receive a discount from billed charges (excluding cosmetic services). On the basis of historical experience, a significant portion of the Health System's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Health System records a significant provision for bad debts related to uninsured patients in the period the services are provided.

Patient accounts receivable, net at June 30 consists of the following:

| | | 2013 | 2012 |
|---|---|---|---|
| Patient accounts receivable | $ | 855,116 | 772,478 |
| Less allowance for bad debts | | (35,951) | (37,088) |
| Less allowance for contractual adjustments | | (513,798) | (448,270) |
| Patient accounts receivable, net | $ | 305,367 | 287,120 |

The Health System analyzes historical collections and write-offs and identifies trends for each of its major payor sources of revenue to estimate the appropriate balance sheet allowance for bad debts and statement of operations provision for bad debts. For receivables associated with services provided to patients who have third-party coverage, the Health System analyzes contractually due amounts and provides an allowance for bad debts, allowance for contractual adjustments, provision for bad debts, and contractual adjustments on accounts for which the third-party payor has not yet paid or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely. For receivables associated with self-pay patients or with balances remaining after the third-party coverage has already paid, the Health System records a significant provision for bad debts in the period of service on the basis of its historical collections. The difference between the discounted rates and the amounts collected after all reasonable collection efforts have been exhausted is charged off against the allowance for bad debts.

(In thousands)

The activity in the allowance for bad debts by major payor sources is as follows:

| Allowance for bad debts | | Commercial | Medicare | Medicaid | Self-pay | Other third-party | Total |
|---|---|---|---|---|---|---|---|
| Balance as of June 30, 2011 | $ | 9,694 | 4,814 | 1,610 | 11,505 | 9,020 | 36,643 |
| Provision for bad debts | | 37,386 | 8,738 | 3,908 | 29,687 | 3,257 | 82,976 |
| Less net write-offs | | (33,873) | (7,959) | (2,231) | (27,541) | (10,927) | (82,531) |
| Balance as of June 30, 2012 | | 13,207 | 5,593 | 3,287 | 13,651 | 1,350 | 37,088 |
| Provision for bad debts | | 32,065 | 10,201 | 5,205 | 25,459 | 1,639 | 74,569 |
| Less net write-offs | | (33,333) | (6,721) | (6,630) | (26,949) | (2,073) | (75,706) |
| Balance as of June 30, 2013 | $ | 11,939 | 9,073 | 1,862 | 12,161 | 916 | 35,951 |

The Health System's net write-offs decreased $6,825 from 2012 to 2013 and increased $19,200 from 2011 to 2012. Approximately 50% of the increase from 2011 to 2012 was attributed to a specific account write-off related to a contract dispute and the remaining increase was the result of negative trends experienced in the collection of amounts from self-pay patients in 2012. The Health System has not changed its charity care or uninsured discount policies during 2013 or 2012.

The Health System grants credit without collateral to its patients, most of whom are insured under third-party payor agreements. The mix of gross receivables from patients and third-party payors at June 30 is as follows:

| | 2013 | 2012 |
|---|---|---|
| Commercial payors | 40.2% | 42.5% |
| Medicare | 35.2 | 32.9 |
| Medicaid | 12.8 | 13.3 |
| Self-pay patients | 5.5 | 6.1 |
| Other third-party payors | 6.3 | 5.2 |
| | 100.0% | 100.0% |

## (4) Charity Care and Other Community Benefits

The Health System provides services at a free or substantially discounted rate to patients who are approved under the guidelines of its charity care policy. The Health System does not pursue collection of amounts determined to qualify as charity care. Services qualifying for charity care consideration include emergent and medically necessary services as determined by a Health System physician. Patient household income in relation to the federal poverty guidelines and the equity value of real property assets is included in the determination for charity care qualification.

(In thousands)

While charity care is excluded from net patient revenue and receivables, the Health System maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone and estimated costs incurred for services and supplies furnished under its charity care policy and other equivalent service statistics. Costs incurred are estimated based on the ratio of total operating expenses to gross charges applied to charity care charges. The Health System received gifts and grants of $156 and $155 in 2013 and 2012, respectively, to subsidize charity care.

In addition to charity care, the Health System provides services under the Medicare and Medicaid programs and medical education and research activities for which payments received from Medicare and Medicaid are less than the full cost of providing these activities. The Health System also provides both in-kind service contributions and direct support payments to Lincoln Community Health Center (LCHC) and the Durham Emergency Medical Services (EMS). LCHC is an outpatient clinic serving the Durham County, North Carolina community, supported in part by a U.S. Public Service Grant. EMS serves as the primary provider of emergency ambulance service in Durham County and is a unit of the Durham County government.

The Health System estimates charity care and other community benefits in accordance with Internal Revenue Code Section 501(r). Estimates of the cost of charity care and other community benefits provided during the years ended June 30 are as follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Charity care at cost | $ | 78,117 | 69,093 |
| Unreimbursed Medicaid | | 63,824 | 33,876 |
| Total charity care and means-tested programs | | 141,941 | 102,969 |
| Health professionals education | | 53,812 | 55,805 |
| Cash and in-kind contributions to community groups | | 10,211 | 11,283 |
| Total other benefits | | 64,023 | 67,088 |
| Total charity care and other community benefits at cost | $ | 205,964 | 170,057 |

In addition to the above total charity care and other community benefits reported on Internal Revenue Service (IRS) Form 990, Schedule H, the Health System also provided services under the Medicare program for which payments received were less than the full cost of providing the services. The estimated unreimbursed costs attributable to providing services under Medicare are $153,207 and $96,038 for the years ended June 30, 2013 and 2012, respectively. The Health System provides additional uncompensated care in the form of bad debts. Estimated uncompensated costs associated with bad debt accounts were $21,634 and $24,540 for June 30, 2013 and 2012, respectively.

(In thousands)

## (5) Cash and Investments

The following is a summary of cash and investments included in consolidated balance sheets at June 30:

| | | 2013 | 2012 |
|---|---|---|---|
| Cash and cash equivalents | $ | 177,195 | 243,215 |
| Short-term investments | | 151,490 | 253,281 |
| Investments | | 2,040,684 | 1,581,459 |
| Cash and investments available for operations | | 2,369,369 | 2,077,955 |
| Assets limited as to use, current | | 19,587 | 45,933 |
| Assets limited as to use, noncurrent | | 159,161 | 316,898 |
| Less receivables included in assets limited as to use | | (29,574) | (26,896) |
| Total cash and investments | $ | 2,518,543 | 2,413,890 |

The Health System invests through separate accounts and commingled vehicles (including limited partnerships). The fair value of cash and investments consists of the following at June 30, 2013 and 2012:

| | | 2013 | 2012 | | Unfunded commitments[2] |
|---|---|---|---|---|---|
| Cash and cash equivalents | $ | 191,700 | 258,912 | | — |
| Deposits with bond trustees | | 67,929 | 220,753 | | — |
| Short-term investments (a) | | 154,994 | 280,683 | | — |
| Fixed income (b) | | 350,857 | 226,864 | | — |
| Equities (c) | | 659,636 | 482,762 | | — |
| Hedged strategies (d) | | 502,097 | 381,612 | | 554 |
| Private capital (e) | | 259,476 | 249,840 | | 85,996 |
| Real assets (f) | | 302,468 | 287,209 | | 120,553 |
| Other | | 29,386 | 25,255 | | — |
| Total cash and investments [1] | | 2,518,543 | 2,413,890 | $ | 207,103 |
| Less cash and investments included in assets limited as to use | | (149,174) | (335,935) | | |
| Cash and investments available for operations | $ | 2,369,369 | 2,077,955 | | |

[1] Includes the Health System's participation in University-owned assets of $546,435 and $550,171 at June 30, 2013 and 2012, respectively, which are all managed by DUMAC.

[2] Future commitments likely to be called at various dates through 2018.

(In thousands)

a) Short-term investments include U.S. Treasury and other highly liquid debt securities with maturities of less than one year. Short term investments of $14,007 and $34,197 at June 30, 2013 and 2012, respectively, were posted as collateral under derivative agreements (including both debt and investment derivatives) and thus are not readily available for use.

b) Fixed income includes nongovernmental U.S. and non-U.S. debt securities.

c) Equities includes U.S. and non-U.S. stocks and funds that invest predominately long but also short stocks.

d) Hedged strategies includes both long and short investments in U.S. and non-U.S. stocks, credit-oriented securities, private equity, real estate, and arbitrage investments.

e) Private capital includes illiquid investments in venture capital, buyouts and credit. Distributions are received through liquidation of the underlying assets of the funds, and it is estimated that the underlying assets of the funds will be liquidated over the next 4 to 10 years.

f) Real assets includes illiquid investments in residential and commercial real estate, oil and gas production, energy, other commodities, and related services businesses. Distributions are received through liquidations of the underlying assets of the funds, and it is estimated that the underlying assets of the funds will be liquidated over the next 5 to 12 years.

As of June 30, 2013, investment liquidity and the corresponding redemption notice period in days are shown below:

| | | Daily | Monthly | Annually | Greater than 1 year | Total | Redemption notice period |
|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | $ | 191,700 | — | — | — | 191,700 | 1 |
| Deposits with bond trustees | | 67,929 | — | — | — | 67,929 | N/A |
| Short-term investments | | 154,994 | — | — | — | 154,994 | 1 |
| Fixed income | | 219,970 | 130,887 | — | — | 350,857 | 1 to 30 |
| Equities | | 55,405 | 276,915 | 302,854 | 24,462 | 659,636 | 1 to 90 |
| Hedged strategies | | — | 80,788 | 374,167 | 47,142 | 502,097 | 2 to 95 |
| Private capital | | — | — | — | 259,476 | 259,476 | N/A |
| Real assets | | — | — | — | 302,468 | 302,468 | N/A |
| Other | | — | 2,815 | 2,811 | 23,760 | 29,386 | N/A |
| Total | $ | 689,998 | 491,405 | 679,832 | 657,308 | 2,518,543 | |

The Health System's investments are exposed to several risks, including liquidity, currency, interest rate, credit and market risks. The Health System attempts to manage these risks through diversification, ongoing due diligence of fund managers, and monitoring of economic conditions. 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 changes could materially affect the amounts reported in the Health System's consolidated financial statements.

(In thousands)

The Health System's investment return for the years ended June 30 is detailed below:

| | | 2013 | 2012 |
|---|---|---|---|
| Net realized gains from sales of investments | $ | 112,364 | 7,239 |
| Net unrealized gains (losses) | | 113,510 | (20,560) |
| Total net gains (losses) | | 225,874 | (13,321) |
| Investment income | | 8,567 | 8,738 |
| Investment gains (losses) | | 234,441 | (4,583) |
| Net realized losses on debt derivatives | | (17,740) | (18,101) |
| Net unrealized gains (losses) on debt derivatives | | 45,578 | (56,328) |
| Total investment return | $ | 262,279 | (79,012) |

Investment return is classified in the consolidated statements of operations as follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Other revenue | $ | 5,141 | 4,714 |
| Nonoperating income (loss) | | 255,729 | (82,968) |
| Increase (decrease) in temporarily restricted net assets | | 1,363 | (659) |
| Increase (decrease ) in permanently restricted net assets | | 46 | (99) |
| Total investment return | $ | 262,279 | (79,012) |

Investment expenses charged directly to the Health System and netted in investment income are $2,844 and $3,215 for 2013 and 2012, respectively.

(In thousands)

A summary of assets limited as to use and externally restricted funds at June 30 is as follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Assets limited as to use: | | | |
| Deposits with bond trustees | $ | 67,929 | 220,753 |
| Investment securities posted as collateral for debt derivative marks-to-market | | 3,504 | 27,402 |
| Cash, receivables and investments designated to settle estimated professional liability costs | | 60,368 | 64,639 |
| Externally restricted assets | | 46,947 | 50,037 |
| Total assets limited as to use | | 178,748 | 362,831 |
| Less current portion of assets limited as to use | | (19,587) | (45,933) |
| Assets limited as to use, excluding current portion | $ | 159,161 | 316,898 |

## (6) Property and Equipment

A summary of property and equipment at June 30 is as follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Buildings and utilities | $ | 1,089,047 | 1,059,287 |
| Furnishings and equipment | | 651,526 | 596,255 |
| Buildings and equipment under capital lease obligations | | 115,817 | 115,817 |
| Internal-use software | | 279,972 | 195,497 |
| Depreciable property and equipment | | 2,136,362 | 1,966,856 |
| Less: accumulated depreciation and amortization | | (1,164,948) | (1,070,723) |
| Depreciable property and equipment, net | | 971,414 | 896,133 |
| Land and land improvements | | 73,337 | 74,805 |
| Construction in progress | | 470,482 | 314,320 |
| Property and equipment, net | $ | 1,515,233 | 1,285,258 |



(Continued)

(In thousands)

The following table summarizes other property and equipment information for 2013 and 2012:

| | | 2013 | 2012 |
|---|---|---|---|
| Depreciation expense | $ | 101,857 | 90,590 |
| Net capitalized interest expense | | 19,516 | 11,438 |
| Amortization of capital leases | | 2,866 | 2,880 |
| Capital leases' accumulated amortization | | 12,944 | 10,078 |

## (7) Indebtedness

A summary of indebtedness at June 30 is as follows:

| | | 2013 | 2012 |
|---|---|---|---|
| Duke University Health System, Inc. Revenue Bonds: | | | |
| Variable rate: | | | |
| Series 2005 – A, B, and C, payable in installments from 2016 through 2028 | $ | 322,140 | 322,140 |
| Series 2006 – A, B, and C, payable in installments from 2014 through 2039 | | 134,685 | 140,515 |
| Series 2012B, payable in installments from 2019 through 2023 | | 28,650 | 28,650 |
| Series 2012C, payable in installments from 2014 through 2015 | | 10,875 | 26,100 |
| Total variable rate | | 496,350 | 517,405 |
| Fixed rate: | | | |
| Series 2009A, payable in installments from 2029 to 2042 | | 180,000 | 180,000 |
| Series 2010A, payable in installments from 2029 to 2042 | | 120,000 | 120,000 |
| Series 2012A, payable in installments from 2014 to 2042 | | 293,360 | 300,000 |
| Total fixed rate | | 593,360 | 600,000 |
| Total indebtedness | | 1,089,710 | 1,117,405 |
| Unamortized premium – net | | 18,118 | 18,739 |
| Indebtedness, including premium – net | | 1,107,828 | 1,136,144 |
| Less current portion | | (20,740) | (21,170) |
| Indebtedness, net of current portion | $ | 1,087,088 | 1,114,974 |

The Health System's variable rate indebtedness is structured as direct bank-bought bonds with various banks at floating rates indexed to one-month LIBOR. The average interest cost for the variable rate bonds was 0.9% during 2013 and 2012. The fixed rate bonds bear interest at fixed coupon rates over the life of each bond issue with rates ranging from 3.0% to 5.0% in 2013 and from 2.0% to 5.0% in 2012. The average interest cost for the fixed rate bonds was 4.8% during 2013 and 2012.

(In thousands)

The Health System had $6,497 at June 30, 2012, in a debt service reserve fund designated to meet scheduled principal and interest payments on the Series 2012C Health System revenue bonds. During 2013, the Health System reduced the outstanding principal on the 2012C bonds by making an early payment utilizing this debt service reserve fund. The Health System also has $67,929 and $214,256 of trusteed assets at June 30, 2013 and 2012, respectively, related to tax-exempt financings to fund construction and other issuance costs. These amounts are included in assets limited as to use in the accompanying consolidated balance sheets.

Proceeds from the 2012B and 2012C bonds refunded the 1993A and 1985B bonds, respectively, and, were issued in a bank-bought index floating rate mode and purchased by a commercial bank. The 2012B bonds retained the original amortization schedule of the 1993A bonds and the 2012C bonds retained the original amortization schedule of the 1985B bonds, as adjusted to reflect the reduced principal due in 2015. On June 28, 2012, the Health System issued through the North Carolina Medical Care Commission (NCMCC) fixed-rate tax-exempt bonds in the par amount of $300,000 (2012A Series). Proceeds from the issuance are being used to finance the cost of additional Health System facilities and pay certain expenses of issuing the bonds.

All Duke University Health System Revenue Bonds were issued by the NCMCC. The Health System is obligated to make payments of principal and interest that correspond to the obligations of the NCMCC under the bond agreements. The aggregate annual maturities of indebtedness issued through the NCMCC for each of the five fiscal years subsequent to June 30, 2013 and thereafter are as follows:

| | | |
|---|---|---|
| 2014 | $ | 20,740 |
| 2015 | | 14,945 |
| 2016 | | 22,250 |
| 2017 | | 23,145 |
| 2018 | | 23,950 |
| Thereafter | | 984,680 |
| Total | $ | 1,089,710 |

The Health System must remain compliant with certain covenants and restrictions required by the trust indentures underlying its revenue bonds. These covenants include maintaining a required debt service coverage ratio and a specific liquidity target, as well as other nonfinancial restrictions.

## (8) Derivatives and Other Financial Instruments

### *(a) Debt Derivatives*

The Health System has executed derivative financial instruments in the normal course of managing its debt portfolio. The Health System has three interest rate swap agreements that are designed to synthetically decrease the variable rate exposure associated with its portfolio of indebtedness. In addition, the Health System has one basis swap designed to reduce the interest rate risk on variable rate indebtedness by utilizing the spread between the yield curves for taxable debt securities and tax-exempt municipal debt securities.

(In thousands)

The following summarizes the general terms for each of the Health System's swap agreements:

| Effective date | Associated debt series | Original term | Current notional amount | Health System pays | Health System receives |
|---|---|---|---|---|---|
| Interest rate: | | | | | |
| August 12, 1993 | 2012B | 30 years | $ 28,650 | 5.09% | SIFMA |
| May 19, 2005 | 2005 A/B/C | 23 years | 322,140 | 3.601% | 61.52% of one-month LIBOR plus 0.28% |
| April 1, 2009 | Portfolio[1] | 30 years | 157,870 | 3.717% | 67.00% of one-month LIBOR |
| Basis: | | | | | |
| July 6, 2001 | N/A | 20 years | 400,000 | SIFMA | 72.125% of one-month LIBOR |

[1] The notional amount of the April 2009 Interest Rate Swap declines coincident with the principal payment schedules for the Series 2012C and Series 2006 A/B/C bonds. The residual portion is $12,310.

The fair value of each swap is the estimated amount the Health System would receive or pay to terminate the swap agreement at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties. The fair value is included in derivative instruments on the consolidated balance sheets, while the change in fair value and the net settlement amount incurred on the swaps are included as a gain or loss in investment income (loss) on the consolidated statements of operations. The debt derivative instruments contain cross-collateralization provisions that require each counterparty to post collateral if the fair value meets certain thresholds.

(In thousands)

The related financial information on each of these instruments at June 30 is as follows:

| | Financial information related to debt derivative instruments | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2013 | | | 2012 | | | |
| | | Fair value[1] | Unrealized gain or (loss) recognized in income[2] | Realized gain or (loss) recognized in income[2] | Fair value[1] | Unrealized gain or (loss) recognized in income[2] | Realized gain or (loss) recognized in income[2] |
| Derivatives not designated as hedging instruments under ASC Topic 815: | | | | | | | |
| August 1993 Interest rate swap | $ | (6,974) | 2,355 | (1,428) | (9,329) | (2,921) | (1,415) |
| May 2005 Interest rate swap | | (47,514) | 21,841 | (10,255) | (69,355) | (30,005) | (10,201) |
| April 2009 Interest rate swap | | (32,974) | 18,407 | (6,114) | (51,381) | (25,442) | (6,587) |
| July 2001 Basis swap | | (5,986) | 2,975 | 57 | (8,961) | 2,040 | 102 |
| Total derivatives not designated as hedging instruments under ASC Topic 815 | $ | (93,448) | 45,578 | (17,740) | (139,026) | (56,328) | (18,101) |

[1] Balance sheet classifications is noncurrent derivative instruments.

[2] The unrealized and realized gain (loss) on derivative instruments recognized in income is included in nonoperating investment income (loss).

Health System debt derivative instruments contain provisions requiring long term, unsecured debt to be maintained at specified credit ratings from Moody's Investor Service and Standard and Poor's Rating Service, major rating agencies. If the ratings of the Health System's debt were to fall below certain benchmarks, the counterparty could request immediate payment on derivatives in net liability positions. At June 30, 2013 and 2012, the Health System's long term debt ratings exceeded these requirements. The aggregate fair value of all derivative instruments with credit risk related contingent features that are in a liability position on June 30, 2013 and 2012 is $93,448 and $139,026, respectively, for which the Health System has posted collateral of $3,504 and $27,402, respectively, in the normal course of business. If the credit risk related features underlying these agreements were triggered on June 30, 2013 and 2012, the Health System would be required to post an additional $89,944 and $111,624, respectively, of collateral to its counterparties.

The counterparty on the 2009 Interest Rate Swap may exercise an early termination right on April 1, 2016, and every seven years thereafter until 2037. In the event this right is exercised, the Health System may revoke it, at which time the Health System collateral threshold reduces to $0 for the remainder of the swap agreement.

The Health System is exposed to financial loss in the event of nonperformance by a counterparty to any of the financial instruments described above. General market conditions could impact the credit standing of the counterparties and, therefore, potentially impact the value of the instruments on the

(In thousands)

Health System's consolidated balance sheet. The Health System controls this counterparty risk by considering the credit rating, business risk, and reputation of any counterparty before entering into a transaction, monitoring for any change in credit standing of its counterparty during the life of the transaction, and requiring collateral be posted when predetermined thresholds are crossed. The Health System is also exposed to interest rate risk driven by factors influencing the spread between the taxable and tax-exempt market interest rates on its basis swap.

***(b) Investment Derivatives***

Investment strategies employed by DUMAC and investment managers retained by DUMAC incorporate the use of various derivative financial instruments with off balance sheet risk. DUMAC uses these instruments for a number of investment purposes, including hedging or altering exposure to certain asset classes and cost-effectively adding exposures to portions of the portfolio. Positions are expected to create gains or losses that, when combined with the applicable portion of the total investment portfolio, provide an expected result.

The following table provides the net notional amounts and fair value of the Health System's investment derivative activities at June 30, 2013 and 2012. It also provides the net gain (loss) amounts included in investment income (loss) during 2013 and 2012.

| | 2013 | 2012 | Location in financial statements |
|---|---|---|---|
| Net notional amounts | $ 1,055,949 | 212,446 | N/A |
| Derivative assets | 7,427 | 8,739 | Investments |
| Derivative liabilities | (8,693) | (1,695) | Investments |
| Net gain (loss) | 30,711 | (9,259) | Investment income (loss) |
| Posted collateral | 10,503 | 6,795 | Short-term investments |

## (9) Fair Value Measurements

The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer or settle a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820, *Fair Value Measurements and Disclosures*, establishes a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The classification of an investment within the hierarchy is based upon the pricing transparency or ability to redeem the investment and does not necessarily correspond to the perceived risk of that investment. Inputs are used in applying various valuation techniques that are assumptions, which market participants use to make valuation decisions, including assumptions about risk. Inputs may include price information, volatility statistics, operating statistics, specific and broad credit data, liquidity statistics, recent transactions, earnings forecasts, future cash flows, market multiples, discount rates and other factors.

(In thousands)

Assets and liabilities measured and reported at fair value are classified within the fair value hierarchy as follows:

*Level 1* – Valuations based on quoted market prices in active markets.

*Level 2* – Investments that trade in markets that are considered to be active, but are based on dealer quotations or alternative pricing sources supported by observable inputs or investments that trade in markets that are not considered to be active, but are valued based on quoted market prices, dealer quotations or alternative pricing sources supported by observable inputs.

*Level 3* – Investments classified within Level 3 have significant unobservable inputs, as they trade infrequently or not at all.

The following is a summary of the levels within the fair value hierarchy for the Health System's assets and liabilities measured at fair value at June 30:

| | June 30, 2013 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Cash and cash equivalents | $ 191,700 | 191,700 | — | — |
| Deposits with bond trustees | 67,929 | 67,929 | — | — |
| Short-term investments | 154,994 | 34,470 | 120,524 | — |
| Fixed income | 350,857 | 17,549 | 333,308 | — |
| Equities | 659,636 | 189,304 | 420,646 | 49,686 |
| Hedged strategies | 502,097 | 3,756 | 372,345 | 125,996 |
| Private capital | 259,476 | 603 | — | 258,873 |
| Real assets | 302,468 | 609 | — | 301,859 |
| Other | 29,386 | 5,160 | 466 | 23,760 |
| Total assets | $ 2,518,543 | 511,080 | 1,247,289 | 760,174 |
| Liabilities: | | | | |
| Interest rate derivatives | $ 87,462 | — | 87,462 | — |
| Basis swap derivative | 5,986 | — | 5,986 | — |
| Total liabilities | $ 93,448 | — | 93,448 | — |

(In thousands)

| | June 30, 2012 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets: | | | | |
| Cash and cash equivalents | $ 258,912 | 258,912 | — | — |
| Deposits with bond trustees | 220,753 | 220,753 | — | — |
| Short-term investments | 280,683 | 118,787 | 161,896 | — |
| Fixed income | 226,864 | 6,946 | 219,918 | — |
| Equities | 482,762 | 101,175 | 335,444 | 46,143 |
| Hedged strategies | 381,612 | 1,619 | 264,162 | 115,831 |
| Private capital | 249,840 | 352 | — | 249,488 |
| Real assets | 287,209 | 1,077 | — | 286,132 |
| Other | 25,255 | 2,778 | 1,942 | 20,535 |
| Total assets | $ 2,413,890 | 712,399 | 983,362 | 718,129 |
| Liabilities: | | | | |
| Interest rate derivatives | $ 130,065 | — | 130,065 | — |
| Basis swap derivative | 8,961 | — | 8,961 | — |
| Total liabilities | $ 139,026 | — | 139,026 | — |

The following methods and assumptions are used by the Health System in estimating the fair value of each class of financial instruments:

Cash and cash equivalents, patient accounts receivable, other receivables, accounts payable, accrued salaries, wages and vacation payable and related accruals, estimated third-party payor settlements, and other liabilities: The carrying amounts approximate fair value because of the short maturity of these instruments.

Investments and deposits with bond trustees: Reported at fair value as of the date of the consolidated financial statements. The Health System has approximately $1,262,000 and $1,176,000 of fund investments that are classified as Levels 2 and 3 and are reported at estimated fair value as of June 30, 2013 and 2012, respectively.

Capital lease obligations: Estimated as the present value of future minimum lease payments during the lease term.

Derivative instruments: Based on a mid-market position obtained from the swap counterparties. The Health System engages a management advisor to validate the reasonableness of the swaps' recorded fair value. Collateral posting requirements are determined each month using the mid-market positions.

Indebtedness: The carrying amount of indebtedness with variable interest rates approximates its fair value because the variable rates reflect current market rates for indebtedness with similar maturities and credit quality. The fair value of indebtedness with fixed interest rates is based on rates assumed to be currently available for indebtedness with similar terms and average maturities. Fair value measurements of indebtedness are based on observable interest rates and maturity schedules that fall within Level 2 of the hierarchy of fair value inputs. The estimated fair value and carrying amount of these fixed interest rate bonds payable at June 30, 2013 approximated $619,061 and $593,360, respectively. The estimated fair value and carrying amount of these fixed interest rate bonds payable at June 30, 2012 approximated $666,138 and $600,000, respectively.

(In thousands)

The following tables present additional information about Level 3 assets measured at fair value. Both observable and unobservable inputs may be used to determine the fair value of positions that the Health System has classified within the Level 3 category. As a result, the unrealized gains and losses for assets within the Level 3 category in the tables below may include changes in fair value that were attributable to both observable and unobservable inputs.

| | Balance as of June 30, 2012 | Net realized and unrealized gains (losses) | Purchases | Sales | Net transfers (from) to Level 3 | Balance as of June 30, 2013 |
|---|---|---|---|---|---|---|
| Asset category: | | | | | | |
| Fixed income | $ — | 2 | 1,626 | (1,628) | — | — |
| Equities | 46,143 | 12,307 | 37,449 | (15,679) | (30,534) | 49,686 |
| Hedged strategies | 115,831 | 22,604 | 15,099 | (33,420) | 5,882 | 125,996 |
| Private capital | 249,488 | 33,272 | 35,712 | (59,599) | — | 258,873 |
| Real assets | 286,132 | 19,253 | 42,762 | (46,288) | — | 301,859 |
| Other | 20,535 | 1,662 | 1,563 | — | — | 23,760 |
| Total | $ 718,129 | 89,100 | 134,211 | (156,614) | (24,652) | 760,174 |

| | Balance as of June 30, 2011 | Net realized and unrealized gains (losses) | Purchases | Sales | Net transfers (from) to Level 3 | Balance as of June 30, 2012 |
|---|---|---|---|---|---|---|
| Asset category: | | | | | | |
| Fixed income | $ — | 133 | 53,753 | (53,886) | — | — |
| Equities | 118,739 | (19,821) | 6,870 | (9,597) | (50,048) | 46,143 |
| Hedged strategies | 298,528 | 11,226 | 15,350 | (47,827) | (161,446) | 115,831 |
| Private capital | 232,564 | 15,688 | 39,915 | (38,939) | 260 | 249,488 |
| Real assets | 270,140 | (301) | 52,679 | (36,386) | — | 286,132 |
| Other | 21,313 | (721) | 319 | (376) | — | 20,535 |
| Total | $ 941,284 | 6,204 | 168,886 | (187,011) | (211,234) | 718,129 |

During years 2013 and 2012, net transfers of $24,652 and $211,494, respectively, were made between Level 2 and Level 3 related to changes in liquidity. During 2012, Level 1 securities totaling $260 became private, restricted, or not priced publicly and were consequently transferred to Level 3. The change in net unrealized gains related to Level 3 assets still held at June 30, 2013 and 2012 was $75,477 and $37,055, respectively. There were no transfers between Level 1 and Level 2 investments during 2013 and 2012.

## (10) Professional Liability Risk Program

The accompanying consolidated financial statements include the assets and liabilities of DCC, a wholly owned subsidiary of the Health System, that insures a portion of the medical malpractice risks and patient general liability risks of Health System clinical providers and the PDC. Policy limits for the years ended June 30, 2013 and 2012 were $110,000 per incident and $155,000 and $160,000 in the aggregate, respectively. DCC limits its exposure to loss through reinsurance and excess loss agreements.

Estimated professional liability costs include the estimated cost of professional liability in 2013 and 2012 for reported claims incurred in the DCC program. DCC evaluates its estimated professional liability on a discounted actuarial basis. The discount rate at June 30, 2013 and 2012 is 3.5%. Accrued professional liability costs as of June 30, 2013 and 2012 amounted to $60,368 and $64,639, respectively. Cash, other receivables and investments in this amount have been designated by the Health System to settle these claims. Also included in estimated professional liability costs are estimated claims incurred but not reported related to the Health System in the amounts of $8,252 and $9,017 as of June 30, 2013 and 2012, respectively.

The estimated liability for professional and patient general liability claims will be significantly affected if current and future claims differ from historical trends. While management monitors reported claims closely and considers potential outcomes as estimated by its actuaries when determining its professional and general liability accruals, the complexity of the claims, the extended period of time to settle the claims and the wide range of potential outcomes complicate the estimation. In the opinion of management, adequate provision has been made for this related risk.

## (11) Benefit Plans

### *(a) Pension Plans*

Staff members of the Health System are eligible to participate in the University's defined contribution pension plan. For the years ended June 30, 2013 and 2012, the Health System contributed approximately $35,900 and $33,600, respectively, to this plan, which is reported in salaries, wages, and benefits expense in the consolidated statements of operations. The Health System expects to contribute $37,000 to the plan in 2014.

In addition, other full time Health System employees participate in the University's noncontributory defined benefit pension plan (ERP). The benefits for the defined benefit plan are based on years of service and the employee's compensation during the last ten years of employment. The Health System expects to contribute $13,322 to this plan in 2014. The allocation of the prepaid pension asset or pension liability between the University and the Health System is based primarily on compensation expense of covered employees.

### *(b) Postretirement Medical Plan*

In addition to the Health System's pension plans, the Health System sponsors an unfunded, defined benefit postretirement medical plan that covers all its full time employees who elect coverage and satisfy the plan's eligibility requirements when they retire. The plan is contributory with retiree contributions established as a percentage of the total cost for retiree healthcare and for the healthcare of their dependents. The Health System pays all benefits on a current basis. Employees hired after June 30, 2002 are not eligible for Health System contribution to the cost of this benefit and must bear the full cost themselves if elected at retirement. As a healthcare provider, the Health System utilizes an incremental cost approach to determine its liability for the postretirement medical plan. The total liability reflects estimated additional costs to provide healthcare benefits to retirees within the Health System plus the full cost to provide healthcare benefits to retirees at facilities other than Health System facilities.

(In thousands)

### *(c) Pension and Postretirement Medical Plans*

The measurement date for both the defined benefit pension plan and the postretirement health benefit plan is June 30. Pension and postretirement expense, pension contributions, and the associated liabilities are included in the following tables, which provide a reconciliation of the changes in the Health System's portion of the plans' benefit obligations and fair value of assets for the years ended June 30:

| | | Pension Benefits | | Postretirement Benefits | |
|---|---|---|---|---|---|
| | | **2013** | **2012** | **2013** | **2012** |
| Reconciliation of projected benefit obligation: | | | | | |
| Obligation at beginning of year | $ | 809,801 | 600,920 | 76,591 | 66,603 |
| Service cost | | 43,470 | 30,614 | 1,098 | 544 |
| Interest cost | | 33,988 | 34,021 | 3,208 | 3,751 |
| Actuarial (gain) loss | | (59,001) | 163,280 | (23,569) | 8,467 |
| Benefits payments | | (19,173) | (17,862) | (2,233) | (3,160) |
| Administrative expenses (estimated) | | (1,198) | (1,172) | — | — |
| Retiree drug subsidy payments | | — | — | — | 386 |
| Projected benefit obligation at end of year | | 807,887 | 809,801 | 55,095 | 76,591 |

(In thousands)

| | Pension Benefits | | Postretirement Benefits | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Reconciliation of fair value of plan assets: | | | | |
| Fair value of plan assets at beginning of year | $ 683,329 | 689,565 | — | — |
| Actual return on plan assets | 94,030 | 3,121 | — | — |
| Employer contributions | 13,332 | 9,595 | — | — |
| Benefits payments | (19,173) | (17,862) | — | — |
| Administrative expenses | (1,194) | (1,090) | — | — |
| Fair value of plan assets at end of year | 770,324 | 683,329 | — | — |
| Funded status: | | | | |
| Net amount recognized (accrued benefit liability) | $ (37,563) | (126,472) | (55,095) | (76,591) |

The pension and postretirement benefits expected to be paid for the ten years subsequent to June 30, 2013 are as follows:

| | Pension Benefits | Postretirement Benefits |
|---|---|---|
| 2014 | $ 21,421 | 2,944 |
| 2015 | 23,081 | 3,217 |
| 2016 | 25,057 | 3,494 |
| 2017 | 27,623 | 3,729 |
| 2018 | 30,765 | 3,883 |
| 2019-2023 | 210,207 | 19,769 |

The expected benefits to be paid are based on the same assumptions used to measure the Health System's benefit obligation at June 30 and include estimated future employee service.



(Continued)

(In thousands)

The following table provides the components of net periodic benefit cost for the plans for years ended June 30:

| | | Pension Benefits | | Postretirement Benefits | |
|---|---|---|---|---|---|
| | | 2013 | 2012 | 2013 | 2012 |
| Service cost | $ | 43,470 | 30,614 | 1,098 | 544 |
| Interest cost | | 33,988 | 34,021 | 3,208 | 3,751 |
| Expected return on plan assets | | (52,438) | (51,394) | — | — |
| Amortization of prior-service cost (asset) | | 1,518 | 2,242 | 260 | (354) |
| Recognized actuarial loss (gain) | | 11,905 | — | — | (1,243) |
| Net periodic benefit cost | $ | 38,443 | 15,483 | 4,566 | 2,698 |

The prior-service costs are amortized on a straight-line basis over the average remaining service period of active participants. The expected amortization of prior-service cost (asset) for 2014 is $865 and $(214) for the pension benefits and postretirement benefits, respectively. The expected amortization of actuarial losses (gains) for 2014 is $2,837 for the pension benefits and $(2,702) for postretirement benefits. Included in unrestricted net assets are the following amounts that have not been recognized in net periodic benefit cost at June 30, 2013 and 2012, respectively:

| | | Pension Benefits | | Postretirement Benefits | |
|---|---|---|---|---|---|
| | | 2013 | 2012 | 2013 | 2012 |
| Unrecognized prior service cost (asset) | $ | 3,618 | 5,136 | (588) | (328) |
| Unrecognized actuarial losses (gains) | | 29,414 | 141,916 | (35,579) | (12,010) |

The assumptions used in the measurement of the Health System's benefit obligation and benefit cost are shown in the following table:

| | Pension Benefits | | | | Postretirement Benefits | | | |
|---|---|---|---|---|---|---|---|---|
| | 2013 | | 2012 | | 2013 | | 2012 | |
| | Obligation | Cost | Obligation | Cost | Obligation | Cost | Obligation | Cost |
| Weighted average assumptions as of measurement date: | | | | | | | | |
| Discount rate | 4.75% | 4.25% | 4.25% | 5.75% | 4.75% | 4.25% | 4.25% | 5.75% |
| Expected return on plan assets | N/A | 8.50 | N/A | 8.50 | N/A | N/A | N/A | N/A |
| Rate of compensation increase | 3.00% | 3.00 | 3.00% | 3.50 | N/A | N/A | N/A | N/A |

In order to determine the benefit obligation as of June 30, 2013, the per capita costs of covered healthcare benefits was assumed to increase to 9.0% for non-Medicare eligible employees and 8.1%

(In thousands)

for Medicare eligible employees, declining to an ultimate annual rate of increase of 5.0% by 2023. The benefit expense for 2013 was driven by the rates used to determine the benefit obligation as of June 30, 2012, which were 9.5% for non-Medicare eligible employees and 8.5% for Medicare eligible employees, declining to an ultimate annual rate of 5.0% by 2023.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for healthcare plans. A 1.0% change in assumed healthcare cost trend rates would have the following effects:

| | | 1% Increase | 1% Decrease |
|---|---|---|---|
| Effect on net periodic postretirement healthcare benefit cost | $ | 706 | (571) |
| Effect on accumulated postretirement benefit obligation | | 6,491 | (5,459) |

The defined benefit pension plan's investment strategy focuses on maximizing total return and places limited emphasis on liability matching and no emphasis on generating income. Over the long term, the plan's average exposure target is 49% equity (public and private investments in companies), 13% commodity (direct commodity exposure, commodity related equities, and private investments in energy, power, infrastructure and timber), 11% real estate (private real estate and REITs), 13% credit (investment-grade bonds, corporate bonds, bank debt, asset backed securities, etc.), 5% interest rates (public obligations including treasuries and agencies) and 9% other (U.S. Treasury Inflation Protected Securities, non-U.S. inflation linked bonds and absolute return oriented hedge funds).

The expected return on plan assets is established at an amount that reflects the targeted asset allocation and expected returns for each component of the plan assets. The expected return on pension plan assets was developed using a stochastic forecast model of long term expected returns for each asset class. The rate is reviewed periodically and adjusted as appropriate to reflect changes in the expected market performance or in targeted asset allocation ranges.

(In thousands)

The same levels of the fair value hierarchy as described in note 9 are used to categorize the pension plan assets. The fair value of the Health System's portion of assets available for pension benefits as of the June 30, 2013 measurement date is as follows:

| | June 30, 2013 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Asset category: | | | | |
| Short-term investments | $ 81,970 | (149) | 82,119 | — |
| Fixed income | 49,233 | (238) | 49,471 | — |
| Equities | 216,350 | 66,140 | 128,021 | 22,189 |
| Hedged strategies | 162,625 | 142 | 102,574 | 59,909 |
| Private capital | 111,837 | 323 | — | 111,514 |
| Real assets | 146,866 | 338 | — | 146,528 |
| Other investments | 1,443 | (237) | 1,680 | — |
| | $ 770,324 | 66,319 | 363,865 | 340,140 |

The fair value of the Health System's portion of assets available for pension benefits as of the June 30, 2012 measurement date is as follows:

| | June 30, 2013 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Asset category: | | | | |
| Short-term investments | $ 63,892 | 388 | 63,504 | — |
| Fixed income | 49,849 | (12,256) | 62,105 | — |
| Equities | 187,082 | 41,739 | 119,124 | 26,219 |
| Hedged strategies | 142,552 | 470 | 82,344 | 59,738 |
| Private capital | 103,344 | 202 | — | 103,142 |
| Real assets | 135,555 | 573 | — | 134,982 |
| Other investments | 1,055 | 199 | 856 | — |
| | $ 683,329 | 31,315 | 327,933 | 324,081 |

(In thousands)

The following tables present additional information about the Level 3 pension benefit assets measured at fair value. Both observable and unobservable inputs may be used to determine the fair value of positions that the Health System has classified within the Level 3 category. As a result, the unrealized gains and losses for assets within the Level 3 category in the table below may include changes in fair value that were attributable to both observable and unobservable inputs:

| | Balance as of June 30, 2012 | Net realized and unrealized gains (losses) | Purchases | Sales | Net transfers (from) to Level 3 | Balance as of June 30, 2013 |
|---|---|---|---|---|---|---|
| Asset category: | | | | | | |
| Fixed income | $ — | 1 | 632 | (633) | — | — |
| Equities | 26,219 | 8,693 | 5,953 | (10,811) | (7,865) | 22,189 |
| Hedged strategies | 59,738 | 9,604 | 4,171 | (11,763) | (1,841) | 59,909 |
| Private capital | 103,142 | 14,245 | 17,054 | (22,927) | — | 111,514 |
| Real assets | 134,982 | 11,957 | 20,623 | (21,034) | — | 146,528 |
| | $ 324,081 | 44,500 | 48,433 | (67,168) | (9,706) | 340,140 |

| | Balance as of June 30, 2012 | Net realized and unrealized gains (losses) | Purchases | Sales | Net transfers (from) to Level 3 | Balance as of June 30, 2012 |
|---|---|---|---|---|---|---|
| Asset category: | | | | | | |
| Fixed income | $ — | 14 | 1,665 | (1,679) | — | — |
| Equities | 33,570 | (3,058) | 1,172 | (3,422) | (2,043) | 26,219 |
| Hedged strategies | 74,260 | 1,255 | 5,796 | (16,072) | (5,501) | 59,738 |
| Private capital | 91,422 | 8,682 | 18,687 | (15,792) | 143 | 103,142 |
| Real assets | 124,669 | 1,936 | 23,660 | (15,283) | — | 134,982 |
| | $ 323,921 | 8,829 | 50,980 | (52,248) | (7,401) | 324,081 |

During 2013 and 2012, transfers of $9,706 and $7,544, respectively, were made between Level 2 and Level 3 related to changes in liquidity. During 2012, Level 1 investments totaling $143 became private, restricted, or not priced publicly and were consequently transferred to Level 3. The change in net unrealized gains related to Level 3 assets still held at June 30, 2013 and 2012 was $38,426 and $19,708, respectively, and was recorded within change in funded status of defined benefit plans on the consolidated statements of changes in net assets. There were no transfers between Level 1 and Level 2 investments during 2013 or 2012.

At June 30, 2013 and 2012, the accumulated benefit obligation for pension benefits is $718,851 and $718,247, respectively, as compared to the fair value of the plan assets of $770,324 and $683,329, respectively. At June 30, 2013 and 2012, the plan is over (under) funded in relation to accumulated benefits by $51,473 and $(34,918), respectively.

(In thousands)

## (12) Functional Expenses

The Health System provides general healthcare services to residents within its geographic location. Expenses related to providing these services for each year ended June 30 are as follows:

| | | 2012 | 2013 |
|---|---|---|---|
| Healthcare services | $ | 1,714,011 | 1,667,956 |
| General and administrative | | 640,903 | 554,524 |
| | $ | 2,354,914 | 2,222,480 |

## (13) Commitments and Contingencies

### *(a) Leases*

**Capital**

The DRH facility lease, which is a forty year evergreen lease, is classified as a capital lease. The Health System made principal and interest payments for this lease of $9,324 and $9,162 in 2013 and 2012, respectively.

**Operating**

The Health System leases various machinery, equipment, healthcare facilities and office space under operating leases expiring at various dates through 2029. Total rental expense in 2013 for all operating leases is $36,858, consisting of $8,149 for machinery and equipment leases and $28,709 for facilities and office space leases. Total rental expense in 2012 for all operating leases is $37,825, consisting of $8,228 for machinery and equipment leases and $29,597 for facilities and office space leases.

(In thousands)

**Commitments**

The following is a schedule by year of future minimum lease payments under leases as of June 30, 2013 that have initial or remaining lease terms in excess of one year and future minimum capital lease payments:

| | Capital leases | Operating leases | Total |
|---|---|---|---|
| Year ending June 30: | | | |
| 2014 | $ 9,443 | 36,858 | 46,301 |
| 2015 | 9,590 | 32,885 | 42,475 |
| 2016 | 9,739 | 29,575 | 39,314 |
| 2017 | 9,898 | 26,681 | 36,579 |
| 2018 | 10,062 | 21,803 | 31,865 |
| Thereafter | 316,424 | 77,302 | 393,726 |
| Total minimum lease payments | 365,156 | 225,104 | 590,260 |
| Less sublease rentals from the PDC | — | (26,013) | (26,013) |
| Total minimum lease payments less subleases | 365,156 | $ 199,091 | 564,247 |
| Less interest portion | (238,267) | | |
| Capital lease obligations | 126,889 | | |
| Less current portion capital lease obligations | (893) | | |
| Capital lease obligations, net of current portion | $ 125,996 | | |

***(b) Construction and Purchase Commitments***

At June 30, 2013, open contracts for the construction of physical properties and other capital expenditures amounted to approximately $75,700 and outstanding purchase orders for normal operating supplies and equipment amounted to approximately $2,800.

***(c) Line of Credit***

The Health System has an agreement with a commercial bank for a line of credit providing unsecured advances to the Health System of up to $50,000 for working capital needs. At June 30, 2013 and 2012, there was no balance due under the agreement. Management expects to renew this line of credit annually under the same general terms and conditions as the existing facility.

***(d) Self Insurance***

The Health System provides employee healthcare benefits, long term disability benefits, unemployment benefits and workers' compensation benefits primarily through employer contributions, participant contributions, and excess loss insurance and manages those programs through third party administrators. In the opinion of management, adequate provision has been made for the related risks.

***(e) Legal Considerations***

Laws and regulations governing Medicare and Medicaid programs are complex and subject to interpretation. The Health System, in part through its Compliance Program, seeks to ensure compliance with such laws and regulations, and to rectify instances of noncompliance with governmental program (Medicare, Medicaid and Tricare) rules. The Health System 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 that would have a material effect on the Health System's consolidated financial statements. Compliance with such laws and regulations is subject to future government review and interpretation as well as significant regulatory action, including fines, penalties and exclusion from the Medicare and Medicaid programs.

In addition to the above, the Health System is involved in various legal actions occurring in the normal course of business. While the final outcomes cannot be determined at this time, management is of the opinion that the resolution of these matters will not have a material adverse effect on the Health System's financial position.

## (14) Subsequent Events

The Health System has evaluated subsequent events from the balance sheet date through October 3, 2013, the date at which the consolidated financial statements were issued, and determined that there are no other items to disclose.

**Schedule 1**

**DUKE UNIVERSITY HEALTH SYSTEM, INC.**
**AND AFFILIATES**

Combined Group under April 13, 1999 Master Trust Indenture (MTI) and Consolidated

Combining and Consolidating Balance Sheet Information

June 30, 2013

(In thousands)

| **Assets** | **Duke University Hospital** | **Duke Regional Hospital** | **Duke Raleigh Hospital** | **Other MTI** | **MTI Combined Group** | **Duke Univ. Affiliated Physicians** | **Durham Casualty Company** | **Other Non-MTI** | **2013 total DUHS consolidated** |
|---|---|---|---|---|---|---|---|---|---|
| Current assets: | | | | | | | | | |
| Cash and cash equivalents | $ 11 | (4) | 3 | 164,918 | 164,928 | 4 | 12,265 | (2) | 177,195 |
| Patient accounts receivable, net | 225,828 | 31,929 | 37,132 | 2,985 | 297,874 | 6,195 | — | 1,298 | 305,367 |
| Estimated third-party payor settlements, net | 25,620 | 4,528 | 212 | — | 30,360 | — | — | — | 30,360 |
| Other receivables | 14,318 | 2,026 | 1,693 | 10,623 | 28,660 | 1,013 | — | 818 | 30,491 |
| Inventories of drugs and supplies | 48,187 | 6,481 | 9,931 | 4,119 | 68,718 | — | — | 755 | 69,473 |
| Other assets | 2,671 | 671 | 297 | 10,576 | 14,215 | 627 | — | 1,265 | 16,107 |
| Short-term investments | — | — | — | 151,490 | 151,490 | — | — | — | 151,490 |
| Assets limited as to use | — | — | — | 3,504 | 3,504 | — | 16,083 | — | 19,587 |
| Total current assets | 316,635 | 45,631 | 49,268 | 348,215 | 759,749 | 7,839 | 28,348 | 4,134 | 800,070 |
| Assets limited as to use | — | — | — | 114,876 | 114,876 | — | 44,285 | — | 159,161 |
| Investments | — | — | — | 1,936,107 | 1,936,107 | — | 104,577 | — | 2,040,684 |
| Property and equipment, net | 986,741 | 154,488 | 121,718 | 204,653 | 1,467,600 | 19,727 | — | 27,906 | 1,515,233 |
| Due from parent | — | — | — | 1,093 | 1,093 | — | — | — | 1,093 |
| Other noncurrent assets | — | — | 3,300 | 15,192 | 18,492 | — | — | 698 | 19,190 |
| Total assets | $ 1,303,376 | 200,119 | 174,286 | 2,620,136 | 4,297,917 | 27,566 | 177,210 | 32,738 | 4,535,431 |
| **Liabilities and Net Assets** | | | | | | | | | |
| Current liabilities: | | | | | | | | | |
| Accounts payable | $ 115,058 | 9,031 | 13,726 | 47,839 | 185,654 | 1,885 | 133 | 6,862 | 194,534 |
| Due to parent, net | 10,774 | (900) | 830 | (13,091) | (2,387) | (6,578) | 2,866 | 8,244 | 2,145 |
| Other current liabilities | 24,602 | 5,442 | 3,239 | 18,886 | 52,169 | 821 | — | 1,380 | 54,370 |
| Accrued salaries, wages and vacation payable | 58,972 | 12,862 | 10,564 | 36,025 | 118,423 | 9,041 | — | 10,905 | 138,369 |
| Current portion of postretirement and postemployment benefit obligations | — | — | — | 6,133 | 6,133 | — | — | — | 6,133 |
| Current portion of indebtedness | — | — | — | 20,740 | 20,740 | — | — | — | 20,740 |
| Current portion of capital lease obligations | — | — | — | 893 | 893 | — | — | — | 893 |
| Current portion of estimated professional liability costs | — | — | — | — | — | — | 16,083 | — | 16,083 |
| Total current liabilities | 209,406 | 26,435 | 28,359 | 117,425 | 381,625 | 5,169 | 19,082 | 27,391 | 433,267 |
| Other noncurrent liabilities | 4,512 | 4,277 | 1,912 | 45,558 | 56,259 | 1,385 | — | 2,312 | 59,956 |
| Postretirement and postemployment benefit obligations, net of current portion | — | — | — | 96,969 | 96,969 | — | — | — | 96,969 |
| Indebtedness, net of current portion | — | — | — | 1,087,088 | 1,087,088 | — | — | — | 1,087,088 |
| Capital lease obligations, net of current portion | — | — | — | 125,996 | 125,996 | — | — | — | 125,996 |
| Derivative instruments | — | — | — | 93,448 | 93,448 | — | — | — | 93,448 |
| Estimated professional liability costs, net of current portion | — | — | — | 8,252 | 8,252 | — | 44,285 | — | 52,537 |
| Total liabilities | 213,918 | 30,712 | 30,271 | 1,574,736 | 1,849,637 | 6,554 | 63,367 | 29,703 | 1,949,261 |
| Net assets: | | | | | | | | | |
| Unrestricted | 1,089,458 | 169,407 | 144,015 | 998,453 | 2,401,333 | 21,012 | 113,843 | 3,035 | 2,539,223 |
| Temporarily restricted | — | — | — | 36,083 | 36,083 | — | — | — | 36,083 |
| Permanently restricted | — | — | — | 10,864 | 10,864 | — | — | — | 10,864 |
| Total net assets | 1,089,458 | 169,407 | 144,015 | 1,045,400 | 2,448,280 | 21,012 | 113,843 | 3,035 | 2,586,170 |
| Total liabilities and net assets | $ 1,303,376 | 200,119 | 174,286 | 2,620,136 | 4,297,917 | 27,566 | 177,210 | 32,738 | 4,535,431 |

See accompanying independent auditors' report.

Schedule 2

**DUKE UNIVERSITY HEALTH SYSTEM, INC.
AND AFFILIATES**

Combined Group under April 13, 1999 Master Trust Indenture (MTI) and Consolidated

Combining and Consolidating Statement of Operations Information

Year ended June 30, 2013

(In thousands)

| | Duke University Hospital | Duke Regional Hospital | Duke Raleigh Hospital | Other MTI | MTI Group eliminations | MTI Combined Group | Duke Univ. Affiliated Physicians | Durham Casualty Company | Other Non-MTI | Other eliminations | 2013 total DUHS consolidated |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Unrestricted revenues, gains and other support: | | | | | | | | | | | |
| Net patient service revenue (net of contractual allowances and discounts | $ 1,765,718 | 262,762 | 305,541 | 30,919 | — | 2,364,940 | 82,415 | — | 12,820 | — | 2,460,175 |
| Provision for bad debts | (42,961) | (13,472) | (14,997) | (387) | — | (71,817) | (2,414) | — | (338) | — | (74,569) |
| Net patient revenue less provision for bad debts | 1,722,757 | 249,290 | 290,544 | 30,532 | — | 2,293,123 | 80,001 | — | 12,482 | — | 2,385,606 |
| Other revenue | 52,036 | 6,771 | 7,524 | 132,706 | (97,391) | 101,646 | 3,610 | 19,675 | 133,881 | (105,396) | 153,416 |
| Total unrestricted revenues, gains and other support | 1,774,793 | 256,061 | 298,068 | 163,238 | (97,391) | 2,394,769 | 83,611 | 19,675 | 146,363 | (105,396) | 2,539,022 |
| Expenses: | | | | | | | | | | | |
| Salaries, wages and benefits | 619,754 | 132,989 | 103,581 | 189,933 | — | 1,046,257 | 65,964 | — | 99,703 | — | 1,211,924 |
| Medical supplies | 365,831 | 35,976 | 73,632 | 34,938 | — | 510,377 | 5,770 | — | 3,706 | — | 519,853 |
| Interest | 16,040 | 3,663 | 2,505 | 513 | — | 22,721 | — | — | 6 | — | 22,727 |
| Depreciation and amortization | 55,917 | 11,205 | 12,245 | 21,866 | — | 101,233 | 1,414 | — | 2,393 | — | 105,040 |
| Other operating expenses | 558,274 | 78,544 | 70,031 | (79,976) | (97,391) | 529,482 | 20,685 | 12,081 | 38,518 | (105,396) | 495,370 |
| Total expenses | 1,615,816 | 262,377 | 261,994 | 167,274 | (97,391) | 2,210,070 | 93,833 | 12,081 | 144,326 | (105,396) | 2,354,914 |
| Operating income (loss) | 158,977 | (6,316) | 36,074 | (4,036) | — | 184,699 | (10,222) | 7,594 | 2,037 | — | 184,108 |
| Nonoperating income: | | | | | | | | | | | |
| Investment income | 6 | 1 | — | 244,295 | — | 244,302 | — | 11,427 | — | — | 255,729 |
| Other | 60 | 40 | 3 | 1 | — | 104 | — | — | — | — | 104 |
| Total nonoperating income | 66 | 41 | 3 | 244,296 | — | 244,406 | — | 11,427 | — | — | 255,833 |
| Excess (deficit) of revenues over expenses | 159,043 | (6,275) | 36,077 | 240,260 | — | 429,105 | (10,222) | 19,021 | 2,037 | — | 439,941 |
| Change in funded status of defined benefit plans | 21,122 | 5,097 | 3,811 | 106,559 | — | 136,589 | 1,258 | — | — | — | 137,847 |
| Net assets released from restrictions for purchase of property and equipment | (1,380) | 9 | — | — | — | (1,371) | — | — | — | — | (1,371) |
| Intracompany transfers, net | (30,549) | (2,429) | 34,792 | (1,136) | — | 678 | (9,046) | — | 8,368 | — | — |
| Transfers to parent, net | (57,139) | 59 | (42) | 104 | — | (57,018) | (244) | — | 722 | — | (56,540) |
| Increase (decrease) in unrestricted net assets | $ 91,097 | (3,539) | 74,638 | 345,787 | — | 507,983 | (18,254) | 19,021 | 11,127 | — | 519,877 |

See accompanying independent auditors' report.