Consolidated Financial Statements

Indiana University Health, Inc. and subsidiaries
Years Ended December 31, 2016 and 2015
With Report of Independent Auditors

Ernst & Young LLP

Building a better
working world

Indiana University Health, Inc. and subsidiaries

Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Contents

Building a better working world

Ernst & Young LLP
Suite 4000
111 Monument Circle
Indianapolis, IN 46204

Tel: +1 317 681 7000
Fax: +1 317 681 7216
ey.com

Report of Independent Auditors

The Board of Directors
Indiana University Health, Inc. and subsidiaries

We have audited the accompanying consolidated financial statements of Indiana University Health, Inc. and subsidiaries, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

A member firm of Ernst & Young Global Limited

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Indiana University Health, Inc. and subsidiaries at December 31, 2016 and 2015, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

March 10, 2017

Indiana University Health, Inc. and subsidiaries

Consolidated Balance Sheets
(Dollars in Thousands)

	December 31 2016	December 31 2015
Assets		
Current assets:		
Cash and cash equivalents	**$ 415,860**	$ 516,702
Short-term investments	**15,502**	–
Current portion of assets limited as to use	**56,958**	30,096
Patient accounts receivable, less allowance for uncollectible accounts of $187,876 and $214,119 at 2016 and 2015, respectively	**776,180**	809,785
Other receivables	**157,207**	159,628
Prepaid expenses	**25,658**	39,199
Inventories	**77,975**	83,724
Total current assets	**1,525,340**	1,639,134
Assets limited as to use:		
Board-designated investment funds and other investments	**4,142,004**	3,625,545
Donor-restricted investment funds	**69,927**	69,502
Total assets limited as to use, less current portion	**4,211,931**	3,695,047
Property and equipment:		
Cost of property and equipment in service	**5,531,399**	5,970,516
Less accumulated depreciation	**(3,190,606)**	(3,398,994)
	2,340,793	2,571,522
Construction-in-progress	**40,593**	52,203
Total property and equipment, net	**2,381,386**	2,623,725
Other assets:		
Equity interest in unconsolidated subsidiaries	**102,175**	71,128
Interest in net assets of foundations	**13,775**	14,035
Goodwill, intangibles, and other assets	**310,066**	239,844
Total other assets	**426,016**	325,007
Total assets	**$ 8,544,673**	$ 8,282,913

	December 31	
	2016	**2015**
Liabilities and net assets		
Current liabilities:		
Accounts payable and accrued expenses	**$ 567,486**	$ 489,567
Accrued salaries, wages, and related liabilities	**241,516**	248,857
Accrued health claims	**94,793**	61,126
Estimated third-party payer allowances	**61,219**	106,859
Current portion of long-term debt	**144,389**	55,657
Total current liabilities	**1,109,403**	962,066
Noncurrent liabilities:		
Long-term debt, less current portion	**1,402,807**	1,610,097
Interest rate swaps	**92,240**	112,675
Accrued pension obligations	**100,122**	99,448
Accrued medical malpractice claims	**61,436**	60,893
Other	**95,861**	44,574
Total noncurrent liabilities	**1,752,466**	1,927,687
Total liabilities	**2,861,869**	2,889,753
Net assets:		
Indiana University Health	**5,384,110**	5,090,916
Noncontrolling interest in subsidiaries	**209,457**	211,784
Total unrestricted	**5,593,567**	5,302,700
Temporarily restricted	**22,191**	23,093
Permanently restricted	**67,046**	67,367
Total net assets	**5,682,804**	5,393,160
Total liabilities and net assets	**$ 8,544,673**	$ 8,282,913

See accompanying notes.

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Operations and Changes in Net Assets
(Dollars in Thousands)

	Year Ended December 31	
	2016	**2015**
Revenues:		
Patient service revenue (net of contractuals and discounts)	**$ 5,736,999**	$ 5,745,401
Provision for uncollectible accounts	**(254,669)**	(243,423)
Net patient service revenue	**5,482,330**	5,501,978
Member premium revenue	**598,041**	394,303
Other revenue	**153,207**	204,534
Total operating revenues	**6,233,578**	6,100,815
Expenses:		
Salaries, wages, and benefits	**2,844,228**	2,723,915
Supplies, drugs, purchased services, and other	**1,938,424**	1,838,176
Hospital assessment fee	**111,763**	109,558
Health claims to providers	**478,102**	307,769
Depreciation and amortization	**255,204**	268,920
Interest	**40,334**	53,215
Total operating expenses	**5,668,055**	5,301,553
Operating income before educational and research support	**565,523**	799,262
Educational and research support to Indiana University	**(17,500)**	(17,500)
Total operating income	**548,023**	781,762
Nonoperating loss:		
Investment income (loss), net	**261,900**	(67,220)
Gains on interest rate swaps, net	**3,060**	18,977
Loss on deconsolidation of subsidiaries, net	**(452,119)**	–
Debt extinguishment and other	**9,768**	(15,782)
Total nonoperating loss	**(177,391)**	(64,025)
Consolidated excess of revenues over expenses	**370,632**	717,737
Less amounts attributable to noncontrolling interest in subsidiaries	**110,537**	105,061
Excess of revenues over expenses attributable to Indiana University Health and subsidiaries	**260,095**	612,676

See accompanying notes.

Indiana University Health, Inc. and subsidiaries

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

(Dollars in Thousands)

	December 31, 2016			December 31, 2015		
	Total	**Controlling**	**Noncontrolling**	**Total**	**Controlling**	**Noncontrolling**
Unrestricted net assets:						
Consolidated excess of revenues over expenses	**$ 370,632**	**$ 260,095**	**$ 110,537**	$ 717,737	$ 612,676	$ 105,061
Change in pension obligations	**25,430**	**25,430**	**–**	(3,769)	(3,769)	–
Contributions for capital expenditures	**6,735**	**6,735**	**–**	8,282	8,282	–
Distributions to noncontrolling interests	**(116,384)**	**–**	**(116,384)**	(96,437)	–	(96,437)
Issuance of noncontrolling interests related to acquisition	**–**	**–**	**–**	6,068	–	6,068
Contributions from noncontrolling interests	**2,940**	**–**	**2,940**	6,721	–	6,721
Purchase of controlling interests	**–**	**–**	**–**	3,108	3,108	–
Purchase of noncontrolling interests	**–**	**–**	**–**	2,970	–	2,970
Restriction reclassification	**345**	**345**	**–**	4,610	4,610	–
Other	**1,169**	**589**	**580**	2,579	1,765	814
	290,867	**293,194**	**(2,327)**	651,869	626,672	25,197
Temporarily restricted net assets:						
Change in beneficial interest in net assets of foundations	**(419)**	**(419)**	**–**	(74)	(74)	–
Contributions	**1,619**	**1,619**	**–**	5,108	5,108	–
Investment return (loss)	**775**	**775**	**–**	(2,509)	(2,509)	–
Net assets released from restrictions	**(3,331)**	**(3,331)**	**–**	(5,727)	(5,727)	–
Restriction reclassification	**(345)**	**(345)**	**–**	(4,610)	(4,610)	–
Beneficial interest reclassification	**799**	**799**	**–**	–	–	–
	(902)	**(902)**	**–**	(7,812)	(7,812)	–
Permanently restricted net assets:						
Change in beneficial interest in net assets of foundations	**56**	**56**	**–**	(122)	(122)	–
Contributions and other	**422**	**422**	**–**	247	247	–
Beneficial interest reclassification	**(799)**	**(799)**	**–**	–	–	–
	(321)	**(321)**	**–**	125	125	–
Increase (decrease) in net assets	**289,644**	**291,971**	**(2,327)**	644,182	618,985	25,197
Net assets at beginning of year	**5,393,160**	**5,181,376**	**211,784**	4,748,978	4,562,391	186,587
Net assets at end of year	**$ 5,682,804**	**$ 5,473,347**	**$ 209,457**	$ 5,393,160	$ 5,181,376	$ 211,784

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Cash Flows
(Dollars in Thousands)

	Year Ended December 31	
	2016	**2015**
Operating activities		
Increase in net assets	**$ 289,644**	$ 644,182
Adjustments to reconcile increase in net assets to net cash (used in) provided by operating activities:		
Change in fair value of interest rate swaps	**(20,435)**	(32,664)
Change in pension liability	**(25,430)**	3,769
Loss (income) in unconsolidated subsidiaries	**39,480**	(14,620)
Provision for uncollectible accounts	**254,669**	243,423
Issuance of noncontrolling interests related to acquisition	**–**	(6,068)
Contributions from noncontrolling interests	**(2,940)**	(6,721)
Depreciation and amortization	**255,204**	268,920
Amortization of deferred gain on sale of medical office buildings	**(1,071)**	(1,617)
(Gain) loss on extinguishment of debt	**(5,532)**	15,778
Restricted contributions and investment return	**(1,654)**	(2,650)
Purchase of controlling interests	**–**	(3,108)
Purchase of noncontrolling interests	**–**	(2,970)
Distributions to noncontrolling interests	**116,384**	96,437
Trading securities	**(742,318)**	(534,451)
Net changes in operating assets and liabilities:		
Patient accounts receivable	**(295,974)**	(368,767)
Other assets	**(69,141)**	(14,464)
Accounts payable, accrued liabilities, and other liabilities	**143,463**	76,475
Accrued salaries, wages, and related liabilities	**10,823**	(44,270)
Estimated third-party payer allowances	**(44,624)**	(820)
Net cash (used in) provided by operating activities	**(99,452)**	315,794

Indiana University Health, Inc. and subsidiaries

Consolidated Statements of Cash Flows (continued)
(Dollars in Thousands)

	Year Ended December 31	
	2016	**2015**
Investing activities		
Purchase of property and equipment, net of disposals	**$ (205,350)**	$ (184,805)
Deconsolidation of subsidiaries, net of cash	**399,028**	–
Acquisition of subsidiary, net of cash received	–	(15,932)
Net cash provided by (used in) investing activities	**193,678**	(200,737)
Financing activities		
Increase in restricted net assets	**1,654**	2,650
Repayments on long-term debt	**(351,180)**	(552,787)
Proceeds from issuance of long-term debt	**267,902**	507,738
Contributions from noncontrolling interests	**2,940**	6,721
Purchase of controlling interests	–	3,108
Purchase of noncontrolling interests	–	2,970
Distributions to noncontrolling interests	**(116,384)**	(96,437)
Net cash used in financing activities	**(195,068)**	(126,037)
Decrease in cash and cash equivalents	**(100,842)**	(10,980)
Cash and cash equivalents at beginning of year	**516,702**	527,682
Cash and cash equivalents at end of year	**$ 415,860**	$ 516,702

See accompanying notes.

Indiana University Health, Inc. and subsidiaries

Notes to Consolidated Financial Statements
(Dollars in Thousands)

December 31, 2016 and 2015

Mission Statement

Indiana University Health's mission is to improve the health of our patients and community through innovation and excellence in care, education, research, and service.

Value Statement

Indiana University Health will preserve, strengthen, and build upon these values:
*Total patient **care**, including mind, body, and spirit*
*Excellence in **education** for health care providers*
*Quality of care and **respect** for life*
***Charity**, equality and justice in health care*
*Leadership in health promotion and **wellness***
*Excellence in **research***
*An internal community of mutual **trust** and respect*

1. Organization and Nature of Operations

History and Organization

Indiana University Health, Inc. (Indiana University Health) and subsidiaries operate as a health care delivery system, which includes an academic health center affiliated with Indiana University, providing health care services throughout the state of Indiana. Health care services provided by Indiana University Health and its subsidiaries (hereinafter referred to as the Indiana University Health System) include acute, nonacute, tertiary, and quaternary care services on an inpatient, outpatient, and emergency basis; medical education and research; medical management services; health care diagnostic and treatment services for individuals and families in physician clinics and physician-group practices; and personal and home health care.

Indiana University Health was formed as an Indiana nonprofit corporation through a consolidation, as of January 1, 1997, under the terms of a Definitive Health Care Resources Consolidation Agreement, as amended (the Consolidation Agreement), and certain other related agreements by and between the Trustees of Indiana University and Methodist Health Group, Inc. (formerly known as Methodist Hospital of Indiana, Inc.). The facilities and operations of Indiana University Health University Hospital (University Hospital), Riley Hospital for Children at Indiana University Health (Riley Hospital), and Indiana University Health Methodist Hospital (Methodist Hospital) (collectively, the Downtown Hospitals of the Academic Health Center)

1. Organization and Nature of Operations (continued)

were merged and consolidated to form a single corporate entity, which was then licensed as a single acute care hospital and operates as an academic health center. Members of the Board of Directors (the Board) of Indiana University Health are selected by its two classes of members: the Methodist Class (members of which are members of Methodist Health Group, Inc.) and the University Class (members of which are the individuals who are the Trustees of Indiana University).

The Consolidation Agreement requires Indiana University Health to fund the salaries and related employee benefit costs for medical doctor interns and residents of the Indiana University School of Medicine (the School of Medicine) who provide services at the Indiana University Health System's facilities. The Board annually reviews and determines the level of support to provide to the School of Medicine for these programs and the number of internships and residencies to be supported. The Consolidation Agreement also requires Indiana University Health to provide additional support to the School of Medicine to recognize, as a result of the consolidation, the enhanced and increased level of services being provided, including services to the medically indigent through medical education and research.

Nature of Operations

The Indiana University Health System operates as an integrated health care delivery system comprising nonprofit and for-profit entities, with coordinated activities and policies designed to meet the mission of the Indiana University Health System. The principal operating activities of the Indiana University Health System are conducted at majority-owned or controlled subsidiaries and consist of the following.

Downtown Hospitals of the Academic Health Center (Hospital Campuses) – Consist of three acute, tertiary, quaternary care, and diagnostic facilities, licensed as a single hospital, which constitutes the principal hospital activities of the academic health center and whose operations are located in the downtown area of Indianapolis, Indiana. These three hospitals, Methodist Hospital, University Hospital, and Riley Hospital, are located on or near the campus of Indiana University-Purdue University Indianapolis and the School of Medicine.

1. Organization and Nature of Operations (continued)

Central Indiana Facilities – Consist of three acute care hospitals, a critical access hospital, and an acute care rehabilitation hospital located in the western and northern suburban areas of metropolitan Indianapolis, Indiana. Principal hospital subsidiaries include Indiana University Health North Hospital, Inc. (North), Indiana University Health Tipton Hospital, Inc. (Tipton), Indiana University Health West Hospital, Inc. (West), and Rehabilitation Hospital of Indiana, Inc. (RHI). Indiana University Health Saxony Hospital (Saxony) operates as a division of the academic health center.

Statewide Facilities – Consist of acute care hospitals and health care systems located in Lafayette, Muncie, Hartford City, Bedford, Bloomington, Paoli, and Monticello, Indiana. Principal hospital subsidiaries include Indiana University Health Arnett, Inc. (Arnett), Indiana University Health Ball Memorial Hospital, Inc. and subsidiaries (Ball Memorial) including Indiana University Health Blackford Hospital, Inc. (Blackford), Indiana University Health Bedford, Inc. (Bedford), Indiana University Health Bloomington, Inc. and subsidiaries (Bloomington) including Indiana University Health Paoli, Inc. (Paoli), and Indiana University Health White Memorial Hospital, Inc. (White).

Physician Operations – Consist of physician offices and physician-group practices and clinics. Principal subsidiaries or divisions include Indiana University Health Physicians (IUHP), a nonprofit organization with locations primarily in Indianapolis, Indiana, Indiana University Health Arnett Physicians, Indiana University Health Ball Memorial Physicians, Inc., Indiana University Health Southern Indiana Physicians, Inc., and Indiana University Health Transplant Institute, Inc.

Ambulatory Care – Consists of personal and home health care services, occupational health services, outpatient oncology services, outpatient surgery centers, and urgent care centers that are located throughout the state of Indiana. Principal divisions or subsidiaries include Indiana University Health Home Care, Indiana University Occupational Health Centers, Workplace Health Services, Indiana University Health Central Indiana Cancer Centers, Indiana University Health Morgan, eight surgery center joint ventures, and one urgent care center joint venture.

1. Organization and Nature of Operations (continued)

Medical Risk – Consists of the medical management of health care services of members whose health care coverage is provided by the managed care networks of the Indiana University Health System. Includes health maintenance organizations and other insurance-related organizations that provide health plan services to insured and self-insured members predominantly residing in Indiana. Insurance offerings include commercial group products (self-funded and insured), products on the Health Insurance Marketplace (Exchange), Medicare Advantage products, and Medicaid management services.

Foundations – Indiana University Health is the sole corporate member of Methodist Health Foundation, Inc. (Methodist Health Foundation), which aids and supports Methodist Hospital and other programs and areas of Indiana University Health. Tipton is the sole corporate member of Tipton County Health Care Foundation, Inc. (Tipton Foundation), which aids in carrying out the mission of Tipton. Ball Memorial is the sole corporate member of Indiana University Health Ball Memorial Hospital Foundation, Inc. (BMH Foundation), which aids in carrying out the mission of Ball Memorial and Blackford. Arnett is the sole corporate member of Indiana University Health Arnett Hospital Foundation, Inc. (Arnett Foundation), which aids and supports Arnett. RHI is the sole corporate member of RHI Foundation, Inc. (RHI Foundation), which aids and supports RHI. The corporate members of Indiana University Health Paoli Hospital Foundation, Inc. (Paoli Foundation), which aids and supports Paoli, are Paoli, Bloomington, and the Board of Commissioners of Orange County, Indiana.

2. Community Benefit and Charity Care

The Indiana University Health System provides health care services and other financial support through various programs that are designed, among other matters, to enhance the health of the community, improve the health of low-income patients, and foster medical education and research through its affiliation with the School of Medicine. In addition, the Indiana University Health System provides services intended to benefit the poor and underserved, including those persons who cannot afford health insurance because of inadequate resources or those who are uninsured or underinsured. Health care services to patients under government programs, such as Medicare and Medicaid, are also considered part of the Indiana University Health System's benefit provided to the community since a substantial portion of such services is reimbursed at amounts less than cost.

2. Community Benefit and Charity Care (continued)

The Indiana University Health System's financial assistance policies are designed to provide care to all patients regardless of their ability to pay, and all uninsured patients who don't qualify for coverage are eligible for discounted care. The financial assistance policy affords charitable discounts only for uninsured patients equivalent to the amounts generally billed, and it provides eligibility for full charity for emergent encounters for uninsured patients less than 200% of the federal poverty level who meet application criteria. Patients whose liability is deemed catastrophic relative to their annual household income are also eligible for reduced charges. The policy was changed as of January 1, 2016. Prior to that date in-state patients with household incomes up to 200% of the federal poverty level were eligible for free care, and patients with household incomes between 200% and 400% of the federal poverty level were eligible for a sliding-scale discount based on household income.

Net patient service revenue is reported at estimated net realizable amounts for services rendered. The Indiana University Health System recognizes patient service revenue associated with patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, revenue is recognized on the basis of discounted rates in accordance with the uninsured discount policy.

Eligibility for full charity is determined based on the qualifying criteria, as defined in the financial assistance policies, through approved applications completed by patients and their families or beneficiaries. Eligibility is also based on analysis of patients without third-party insurance coverage who did not apply for charity but for whom all collections efforts have been exhausted and who meet other criteria, including those who are deceased and are found to have no estate. The cost to provide charity care using the consolidated cost to charge ratio was $77,407 and $139,283 for 2016 and 2015, respectively.

In addition, the Indiana University Health System provides a significant amount of uncompensated care to other uninsured and underinsured patients, which is included in the provision for uncollectible accounts in the consolidated statements of operations and changes in net assets.

The Patient Protection and Affordable Care Act (the Affordable Care Act) required, among other things, that hospital organizations establish a financial assistance policy and a policy relating to emergency medical care. The hospital organizations of the Indiana University Health System have adopted a financial assistance policy that includes financial assistance eligibility criteria,

2. Community Benefit and Charity Care (continued)

the basis for calculating amounts charged to patients, the method for applying for financial assistance, billing and collections policies with regard to actions that may be taken in the case of nonpayment, as well as measures to widely publicize the policy within the communities served. Additionally, the Indiana University Health System's hospital organizations have adopted policies requiring the organizations to provide, without discrimination, care for emergency medical conditions to individuals regardless of their eligibility under their financial assistance policy. These hospital organizations have also adopted policies to limit the amount charged for emergency or other medically necessary care that is provided to individuals eligible for assistance under the organizations' financial assistance policy to not more than the amounts generally billed to individuals who have insurance covering such care.

Reimbursements are received by the Indiana University Health System for Medicare and Medicaid beneficiaries in accordance with federal and state reimbursement agreements and related regulatory rules and regulations. Also, the Indiana University Health System receives certain additional Medicaid Disproportionate Share (DSH) payments and payments under the Medicaid Assessment Fee program from the state of Indiana (see Note 3). These reimbursements and payments are less than the cost of providing the related services.

The Indiana University Health System also provides: education for health care providers, including support to the School of Medicine; chaplaincy programs that support patients' medical, spiritual, and emotional needs; programs to enhance quality of and respect for life, including neighborhood revitalization, community health clinics, and school-based health programs; charity, equality, and justice programs, including education programs available to independent health providers, and obesity prevention programs such as Garden on the Go® and Indy Urban Acres; other medical research including support to the Children's Values Fund; and the fostering of an internal community of trust, respect, and empowerment.

Through the statewide facility-by-facility community health needs assessments Indiana University Health conducted, the following community health needs were identified and selected as priority areas in which Indiana University Health will focus on community benefit efforts: access to affordable health care; behavioral health; obesity prevention; and pre-K education. The costs of providing these programs and services are included in expenses in the accompanying consolidated statements of operations and changes in net assets.

3. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Indiana University Health and all majority-owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Fair Values of Financial Instruments

Financial instruments include cash and cash equivalents, patient and other accounts receivable, assets limited as to use, accounts payable and accrued expenses, estimated third-party payer allowances, notes payable to banks, long-term debt, derivative financial instruments (i.e., fixed-pay and basis swaps), and certain other current assets and liabilities.

The fair values for cash and cash equivalents, patient and other accounts receivable, accounts payable and accrued expenses, estimated third-party payer allowances, and certain other current assets and liabilities approximate the carrying amounts reported in the consolidated balance sheets and, in the opinion of management, represent highly liquid assets or short-term obligations. The fair values for assets limited as to use, debt, and derivative financial instruments are described in Notes 5, 7, 8, and 9.

Derivative Financial Instruments

The Indiana University Health System has entered into certain interest rate swap transactions (fixed-pay swaps and basis swaps). As of and for the years ended December 31, 2016 and 2015, the Indiana University Health System's fixed-pay swap and basis swap agreements did not qualify for hedge accounting. Therefore, the changes in fair value of these interest rate swaps during these years are reported in nonoperating loss in the consolidated statements of operations and changes in net assets.

3. Summary of Significant Accounting Policies (continued)

Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payers, and others at the time services are rendered. Certain revenue is subject to estimated retroactive revenue adjustments under reimbursement agreements with third-party payers due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period that the related services are rendered, and such amounts are adjusted in future periods as adjustments become known.

For the year ended December 31, 2016, the percentage of patient service revenue (net of contractuals and discounts) derived under Medicare, Medicaid, and managed care programs approximated 24%, 9%, and 59%, respectively (23%, 10%, and 58%, respectively, for the year ended December 31, 2015). One managed care payer represented 31% and 30% of patient service revenue for 2016 and 2015, respectively. Provision has been made, by a charge to contractual allowances as an offset to patient service revenue, for the differences between gross charges for patient services and estimated reimbursement from these government and insurance programs.

During 2012, the Indiana General Assembly approved a hospital assessment fee program (Medicaid Assessment Fee). Under this program, the Office of Medicaid Policy and Planning collects a fee from eligible hospitals. The fee is used in part to increase reimbursement to eligible hospitals for services provided in both fee-for-service and managed care programs, and as the state share of DSH payments. The program was effective retroactively from July 1, 2011, and continued through June 30, 2013, and was subsequently extended through June 30, 2017.

For the year ended December 31, 2016, increased reimbursement related to the Medicaid Assessment Fee program was recorded within net patient revenue in the consolidated statement of operations and changes in net assets totaling $203,850. For the year ended December 31, 2015, increased reimbursement related to the Medicaid Assessment Fee program was recorded within net patient revenue on the consolidated statement of operations and changes in net assets totaling $221,422. During the year ended December 31, 2016, an assessment fee was recognized of $111,763. During the year ended December 31, 2015, an assessment fee was recognized of $109,558. This fee was recorded within the hospital assessment fee on the consolidated statements of operations and changes in net assets.

3. Summary of Significant Accounting Policies (continued)

Indiana University Health is a Medicaid DSH provider under Indiana law (IC 12-15-16(1-3)) and, as such, is eligible to receive state DSH payments. The amount of these additional state DSH funds is dependent on regulatory approval by agencies of the federal and state governments and is determined by the level, extent, and cost of uncompensated care (as defined) and various other factors. For the years ended December 31, 2016 and 2015, state DSH payments have been made by the state of Indiana, and amounts were recorded as revenue based on data acceptable to the state of Indiana, less any amounts management believes may be subject to adjustment. State DSH payments by the state of Indiana are based on the fiscal year of the state, which ends June 30 of each year. State DSH reimbursement is recognized as revenue after eligibility is determined by the state and payments are probable and reasonably estimable. For the state fiscal years 2014 and 2016, state DSH payments of $27,165 were recognized by Indiana University Health and certain subsidiaries, which amount was recorded in net patient service revenue in the accompanying consolidated statement of operations and changes in net assets for the year ended December 31, 2016. For the state fiscal years 2014 and 2015, state DSH payments of $104,089 were recognized by Indiana University Health and certain subsidiaries, which amount was recorded in net patient service revenue in the accompanying consolidated statement of operations and changes in net assets for the year ended December 31, 2015.

Laws and regulations governing Medicare, Medicaid, and other governmental programs are extremely complex and subject to interpretation, and sometimes provide for retroactive adjustments. As a result, there is a reasonable possibility that recorded estimated settlements could change by a material amount in the near term. The Indiana University Health System believes it is in compliance with applicable laws and regulations governing Medicare, Medicaid, and other governmental programs and that adequate provisions have been recorded for any adjustments that may result from final settlements. However, any adjustments to the currently estimated settlements are recorded in future periods.

3. Summary of Significant Accounting Policies (continued)

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

	Year Ended December 31	
	2016	**2015**
Third-party payers	**$ 5,584,323**	$ 5,716,509
Self-pay patients	**152,676**	28,892
Total payers	**$ 5,736,999**	$ 5,745,401

The increase in self-pay patients' revenue for 2016 is due to the identification of prior year accounts requiring reclassification from the provision for bad debts to charity care for the year ended December 31, 2015.

Member Premium Revenue and Health Claims

The Indiana University Health System has agreements to provide medical services to subscribing participants or members that generally provide for predefined payments (on a per member, per month basis) regardless of services actually performed. The cost to provide health care services under these agreements is accrued in the period in which the health care services are provided to a member based, in part, on estimates, including an accrual for medical services provided but not yet reported. Expenses to providers are reported as health claims to providers in the accompanying consolidated statements of operations and changes in net assets. The accrual for medical services provided but not yet reported is reflected as accrued health claims in the accompanying consolidated balance sheets.

Cash Equivalents

Investments in highly liquid instruments with an original maturity of three months or less when purchased, excluding assets limited as to use, are considered by management to be cash equivalents.

3. Summary of Significant Accounting Policies (continued)

The Indiana University Health System routinely invests in money market funds, including treasury and agency money market funds that are considered by management to be cash equivalents. Such instruments, as well as bank deposits, are potentially subject to concentrations of credit risk. In order to mitigate such risk, the Indiana University Health System generally places its cash and cash equivalents with institutions of high credit quality.

Patient Accounts Receivable and Allowance for Uncollectible Accounts

The Indiana University Health System does not require collateral or other security for the delivery of health care services from its patients, substantially all of whom are residents of the state of Indiana. However, assignment of benefit payments payable under patients' health insurance programs and plans (e.g., Medicare, Medicaid, health maintenance organizations, and commercial insurance policies) is routinely obtained, consistent with industry practice.

The provision for uncollectible accounts, for all payers, is recognized when services are provided based upon management's assessment of historical and expected net collections, taking into consideration business and economic conditions, changes and trends in health care coverage, and other collection indicators. Periodically, management assesses the adequacy of the allowance for uncollectible accounts based upon accounts receivable payer composition and aging, the significance of individual payers to outstanding accounts receivable balances, and historical write-off experience by payer category, as adjusted for collection indicators. The results of this review are then used to make any modifications to the provision for uncollectible accounts and the allowance for uncollectible accounts. In addition, the Indiana University Health System follows established guidelines for placing certain past-due patient balances with collection agencies. Patient accounts that are uncollected, including those placed with collection agencies, are initially charged against the allowance for uncollectible accounts in accordance with collection policies of the Indiana University Health System and, in certain cases, are reclassified to charity care if deemed to otherwise meet financial assistance policies of the Indiana University Health System.

3. Summary of Significant Accounting Policies (continued)

The composition of net patient accounts receivable is summarized as follows as of December 31:

	2016	**2015**
Managed care	**58%**	54%
Medicare	**16**	17
Medicaid	**9**	13
Other third-party payers	**9**	11
Patients	**8**	5
	100%	100%

One managed care payer represented 21% and 22% of net patient accounts receivable at December 31, 2016 and 2015, respectively.

The allowance for uncollectible accounts for self-pay patients, including self-pay discounts and charity care, was 81% and 80% of self-pay accounts receivable as of December 31, 2016 and 2015, respectively. Overall, the net of self-pay discounts and write-offs has not changed significantly for the years ended December 31, 2016 or 2015.

Inventories

Inventories consist primarily of drugs and supplies, are stated at the lower of cost or market, and are generally valued using the average cost method.

Assets Limited as to Use

Assets limited as to use include the following: (i) cash and cash equivalents and designated investment assets, including those funds held by the consolidated foundations, set aside by the Board for future capital improvements, over which the Board retains control and may, in certain circumstances, use for other purposes, and (ii) donor-restricted investment assets, the use of which has been specified by the donor. Substantially all assets limited as to use are invested and managed by professional investment managers and are held in custody by financial institutions. These funds are classified as trading securities. Accordingly, changes in unrealized gains and losses in the fair value of investments are included in nonoperating loss within investment

3. Summary of Significant Accounting Policies (continued)

income in the accompanying consolidated statements of operations and changes in net assets. The Indiana University Health System is a limited partner in certain funds that employ hedged investment strategies and funds that employ investment strategies that require long holding periods to create value. These investments are accounted for using the equity method of accounting, based on the fund's financial information.

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets.

Property and equipment under capital lease obligations are amortized on the straight-line method over the lease term or the estimated useful life of the equipment, whichever period is shorter. Such amortization is included with depreciation in the accompanying consolidated statements of operations and changes in net assets. Interest cost incurred on borrowed funds during the period of construction and other interest costs related to tax-exempt bonds are capitalized as a component of the cost of constructing the assets. In addition, interest earnings on unexpended borrowed funds related to tax-exempt financings offset capitalized tax-exempt interest. Repair and maintenance costs are expensed when incurred.

The Indiana University Health System evaluates when events or changes in circumstances have occurred that would indicate that the remaining estimated useful life of long-lived assets warrant revision or that the remaining balance of such assets may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or asset group. If undiscounted cash flows are insufficient to recover the carrying value of the long-lived asset, such asset is written down to its fair value.

Equity Interest in Unconsolidated Subsidiaries

Indiana University Health or its subsidiaries have also entered into certain limited liability company agreements with third parties that provide health care-related services. Where applicable, these arrangements are accounted for using the equity method of accounting.

3. Summary of Significant Accounting Policies (continued)

Indiana University Health has a 50% membership interest in MDwise, Inc., which holds a health maintenance organization license and manages a network of health care providers serving Medicaid patients throughout the state of Indiana, and a 50% membership interest in MDwise Medicaid Network, which assumes risk for Medicaid products. MDwise Medicaid Network has announced that it will not assume risk for certain Medicaid products as of April 1, 2017. The Indiana University Health System also has joint venture arrangements for the operation of urgent care facilities and other health care related service providers.

Summarized financial information for MDwise, Inc. and MDwise Medicaid Network as of and for the years ended December 31 is as follows:

	2016	**2015**
	(Unaudited)	
Net assets	**$ (2,259)**	$ 69,925
Total revenues	**2,429,177**	1,031,174
Deficit/excess of revenues over expenses	**(72,184)**	9,640

Total equity interest in unconsolidated subsidiaries was $102,175 and $71,128 as of December 31, 2016 and 2015, respectively. As of December 31, 2016, Indiana University Health had a liability of $52,895 related to its interest in MDwise Medicaid Network. The Indiana University Health System has recorded its equity in the income of its unconsolidated subsidiaries within other operating revenue, totaling $(39,480) and $14,620 for the years ended December 31, 2016 and 2015, respectively.

Unamortized Bond Issuance Costs and Bond Discount or Premium

Costs incurred in connection with the issuance of long-term debt and bond discounts or premiums are amortized or accreted using the effective interest rate method. Amortization and accretion are included in interest expense in the accompanying consolidated statements of operations and changes in net assets (see Note 7).

3. Summary of Significant Accounting Policies (continued)

Contributions

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is made. Conditional promises to give, including indications of an intention to give, are reported at fair value at the date the gift is made. If the gifts are made with donor stipulations that limit the use of the donated assets, the gifts are reported as either temporarily or permanently restricted. Donor-restricted contributions for which restrictions are met in the same year as made are reported as unrestricted contributions in the accompanying consolidated financial statements.

Noncontrolling Interest in Subsidiaries

The Indiana University Health System attributed income of $110,537 and $105,061 for the years ended December 31, 2016 and 2015, respectively, to the noncontrolling interests based on the ownership percentage of the noncontrolling interests in certain of the Indiana University Health System's consolidated subsidiaries. These amounts primarily relate to the eight surgery center joint ventures and are reflected in unrestricted net assets in the consolidated balance sheets. For the years ended December 31, 2016 and 2015, the eight surgery center joint ventures accounted for $117,243 and $102,625, respectively, of the income attributed to the noncontrolling interests. The eight surgery center joint ventures realized operating revenue of $280,614 and $253,422 and operating income of $158,297 and $139,115 in 2016 and 2015, respectively. The operating revenue and operating income are reflected in total operating revenue and total operating income, respectively, on the consolidated statement of operations and changes in net assets.

Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets are those assets whose use has been limited by donors to a specific time period or purpose. These net assets are generally restricted for medical education and research programs, medical supplies and equipment, and patient care services.

Interests in net assets of unconsolidated foundations are included in other assets in the accompanying consolidated balance sheets (see Note 14). The underlying assets of these interests in foundations consist primarily of cash and cash equivalents, money market and mutual funds, and marketable equity and debt securities.

3. Summary of Significant Accounting Policies (continued)

Business Combinations

The Indiana University Health System allocates the purchase price of an acquisition to the various components of the acquisition based upon the fair value of each component, which may be derived from various observable or unobservable inputs and assumptions. Also, the Indiana University Health System may utilize third-party valuation specialists. These components typically include buildings, land, and equipment and may also include intangibles related to noncompete agreements or other specifically identified intangible assets. The excess of the fair value of assets acquired over liabilities assumed and the fair value of any noncontrolling interest is recorded as an inherent contribution within the performance indicator as defined below. Goodwill is recorded to the extent that liabilities assumed and noncontrolling interests exceed the fair value of assets acquired.

Goodwill and Intangible Assets

In connection with business combinations, the Indiana University Health System has recorded goodwill and definite-lived intangible assets in the accompanying consolidated balance sheets.

The Indiana University Health System evaluates goodwill for impairment annually, or more frequently if events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. The goodwill impairment analysis, performed at the reporting unit level, generally includes estimating the fair value and comparing that to the carrying value. If fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired. These valuation methods require the Indiana University Health System to make estimates and assumptions regarding future operating results, cash flows, changes in working capital, capital expenditures, profitability, and the cost of capital.

The Indiana University Health System also reviews whether events or changes in circumstances suggest impairment may have occurred related to the carrying value of the definite-lived intangible assets, which are amortized over periods of 5 to 35 years. It has been determined that there was no impairment to goodwill or definite-lived intangible assets during 2016 or 2015. Intangible assets included in other assets in the accompanying consolidated balance sheets as of December 31, 2016 and 2015, were $189,361 and $199,485, respectively, which include goodwill of $176,036 and $184,509, respectively.

3. Summary of Significant Accounting Policies (continued)

Operating and Performance Indicators

The activities of the Indiana University Health System are primarily related to providing health care services, and accordingly, expense information by functional classification is not used as a basis for measuring performance. Furthermore, since substantially all resources are derived from providing health care services, similar to that if provided by a business enterprise, the following indicators are considered important in evaluating how well management has discharged its stewardship responsibilities:

Operating Indicator (Operating Income) – Includes all unrestricted revenue, gains, donor contributions to offset operating expenses, other support, equity income or loss of unconsolidated health care subsidiaries, and expenses directly related to the recurring and ongoing health care operations during the reporting period. The operating indicator excludes investment income or losses on assets limited as to use (including changes in unrealized gains and losses on investments), changes in the fair value of fixed-pay and basis swaps, gain or loss on the extinguishment of debt, inherent contribution of acquired entities, noncontrolling interest, and gains and losses deemed by management not to be directly related to providing health care services.

Performance Indicator (Excess of Revenues Over Expenses) – Includes operating income and nonoperating loss. The performance indicator excludes certain changes in pension obligations and contributions for capital expenditures, distributions, and net assets released from restricted funds.

Income Taxes

The Internal Revenue Service (IRS) has determined that Indiana University Health and certain of its affiliated entities are tax-exempt organizations as defined in Section 501(c)(3) of the Internal Revenue Code (IRC). Indiana University Health and its tax-exempt affiliates are, however, subject to federal and state income taxes on unrelated business income under the provision of IRC Section 511.

3. Summary of Significant Accounting Policies (continued)

Deferred income taxes, which as of December 31, 2016 and 2015, have no net carrying value, reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. As of December 31, 2016 and 2015, the Indiana University Health System had gross deferred tax assets of $116,490 and $79,469, respectively, primarily relating to net operating loss carryovers. Management determined that a full valuation allowance at both December 31, 2016 and 2015 was necessary to reduce the deferred tax assets to the amount that would more likely than not be realized. ASC Topic 740-10-50-3, Income Taxes: Disclosure, requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The change in the valuation allowance for the current year is $37,021. At December 31, 2016, the Indiana University Health System has available net operating loss carryforwards of $291,226. These net operating losses will expire between 2018 and 2036.

Certain subsidiaries of Indiana University Health are taxable entities. The tax expense and liabilities of these subsidiaries are not material to the consolidated financial statements.

Subsequent Events

For the consolidated financial statements as of and for the year ended December 31, 2016, management has evaluated subsequent events through March 10, 2017, the date that these consolidated financial statements were issued.

On January 9, 2017, OptumCare, a division of UnitedHealth Group, announced that it agreed to acquire Surgical Care Affiliates (SCA). Indiana University Health owns a controlling interest (51%) in holding companies that hold and control interests in eight ambulatory surgery centers, and SCA holds the non-controlling interests (49%) in these holding companies. The closing of the transaction between OptumCare and SCA will trigger a call under which Indiana University Health can purchase, at fair market value, all or a portion of SCA’s ownership interests in the holding companies. Indiana University Health has not yet determined whether it will exercise this right (see Noncontrolling Interest in Subsidiaries – Note 3).

3. Summary of Significant Accounting Policies (continued)

Reclassifications

Certain amounts in the 2015 consolidated financial statements have been reclassified to conform to the 2016 presentation. Such reclassifications had no effect on previously reported excess of revenues over expenses, or net assets.

New Accounting Guidance Not Yet Applicable

In August 2016, the FASB issued guidance to clarify the classification of eight types of transactions in the statement of cash flows to reduce diversity in practices. Indiana University Health is required to adopt this new guidance for the fiscal year 2019, and is currently evaluating the impact this guidance will have on its consolidated financial statements.

In August 2016, the FASB issued guidance related to improving the usefulness of information provided to donors, grantors, creditors, and other users of the financial statements by eliminating the distinction between resources with permanent restrictions and temporary restrictions from the face of the financial statements, as well as enhancing or providing additional information in the financial statements and notes related to liquidity, expense classifications, allocation methodology, underwater endowment funds, and investment returns. The amendments in this update are effective for fiscal years beginning after December 15, 2017 and should be applied retrospectively. Early adoption of these amendments is permitted. As of December 31, 2016, Indiana University Health has not adopted these amendments. Upon adoption, changes reflected in the consolidated financial statements will be presentation only.

In March 2016, the FASB issued guidance related to derivatives and hedging. This new guidance clarifies the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. This amendment is effective for fiscal years beginning after December 15, 2017 and interim periods within fiscal years beginning after December 15, 2018. Indiana University Health is evaluating the effect this guidance will have on its consolidated financial statements.

3. Summary of Significant Accounting Policies (continued)

In February 2016, the FASB issued guidance related to leases. One of the primary changes brought about by the new standard is the reporting of operating leases on the balance sheet. This new guidance dictates that the implementation of the new standard would recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2018. Indiana University Health is evaluating the effect this guidance will have on its consolidated financial statements.

In May 2015, the FASB issued guidance related to fair value disclosures of certain investments. Investments for which fair value is measured at net asset value per share (or its equivalent) using the practical expedient provisions of the fair value measurement guidance are no longer required to be included within the fair value hierarchy leveling tables. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2016, with early adoption permitted. Indiana University Health has not early adopted. No changes to fair value measurements will result from adopting this guidance, only changes to amounts disclosed within the consolidated footnotes.

In May 2014, the FASB issued guidance related to recognizing revenue from contracts with customers. This new guidance dictates that the standard be applied either retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the revenue recognition standard recognized at the date of initial application. Subsequently, the FASB issued updates to this guidance to provide clarification to the aspects of collectability criterion, identifying performance obligations and the licensing implementation guidance and recognizing revenue when another party is involved in providing goods or services to a customer. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2017. Indiana University Health is evaluating the effect this guidance will have on its consolidated financial statements.

4. Significant Transactions

Goshen

On December 6, 2016, a Separation Agreement was executed, effective on December 31, 2016, between Indiana University Health and Goshen. As of the effective date, Indiana University Health withdrew as the sole corporate member of Goshen. Under the agreement, Goshen agreed to pay Indiana University Health a separation payment of $20,000 payable over a ten-year period, with the first installment of $2,000 due at closing. The Indiana University Health System recognized a nonoperating loss, net of the separation payment of $20,000, of $295,214 related to the transaction for the year ended December 31, 2016. Just prior to the closing of this transaction, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of Goshen from the Obligated Group and Affiliates (see Note 7).

For the years ended December 31, 2016 and 2015, Goshen represented approximately 4.3% and 4.1%, respectively, of the total operating revenues of the Indiana University Health System.

La Porte

On December 24, 2015, a Contribution and Sale Agreement was executed by and among Indiana University Health, La Porte, Frankfort Health Partner, Inc. and Community Health Systems, Inc. (CHS) and other affiliated entities. In anticipation of the agreement, Indiana University Health and La Porte formed a limited liability company with Indiana University Health holding a 20% interest and La Porte holding 80%. Upon closing of the agreement, La Porte and certain of its affiliated entities contributed assets to the limited liability company and certain of its affiliated entities. Also upon the closing, Frankfort Health Partner, Inc., a subsidiary of CHS, purchased La Porte's 80% interest in the limited liability company for $96,489, plus the net working capital minus any long-term debt or capital leases. Pursuant to the limited liability company agreement, 20% of the assets contributed to the limited liability company are deemed to have been contributed on behalf of Indiana University Health. The proceeds of the sale, net of the settlement of La Porte's liabilities existing on the date of sale and a portion to be retained by Indiana University Health under the agreement, were contributed to a foundation in support of the La Porte community. This transaction closed on March 1, 2016. The Indiana University Health System recognized a nonoperating loss, net of the value of Indiana University Health's investment in the new limited liability company, of $156,809 related to the transaction in the first quarter of 2016. In anticipation of the closing of this transaction, during 2015, Indiana University

4. Significant Transactions (continued)

Health, acting as Obligated Group Agent, effectuated the removal of La Porte from the Obligated Group (see Note 7). Also, during 2016 Indiana University Health approved the termination of the La Porte defined benefit pension plan, effective December 31, 2016. Accordingly, the outstanding net actuarial loss of $17,933 was accelerated and is reflected in the consolidated statement of operations and changes in net assets as part of the nonoperating loss on deconsolidation of subsidiaries, net and change in pension obligation.

For the years ended December 31, 2016 and 2015, La Porte represented approximately 0.6% and 3.6%, respectively, of the total operating revenues of the Indiana University Health System.

Frankfort

On November 10, 2016, Indiana University Health entered into a lease agreement with Clinton County to lease the hospital building and other related property and equipment and to assume the operations of Frankfort Hospital, the Clinton County-owned hospital, effective June 1, 2017. Under the agreement, Indiana University Health agreed to a five-year lease with renewal options for the 25-bed county-owned critical access hospital and affiliated medical offices. The annual minimum rental rate is $1,000. Additional rent can be triggered if the hospital reaches certain net income targets, which is not expected to occur in 2017.

Academic Health Center

In support of the newly designed model of care of Indiana University Health, in April 2015, the Indiana University Health Board approved a plan to consolidate downtown Indianapolis adult services to one medical campus centered on Capitol Avenue and 16th Street (current site of Methodist Hospital), with women's services consolidated at or near the existing Riley Hospital campus. As Indiana University Health is committed to improving the health of its patients and communities, the plan also includes the development of an array of ambulatory care services for residents of the neighborhoods around the downtown Indianapolis campus. The adult service medical campus is expected to include a medical education building and faculty offices on-site to enhance ongoing collaboration with the School of Medicine and support the tripartite mission of clinical care, research, and education. The Board has not yet approved the capital expenditures related to the plan. In response to this plan, the useful lives of assets currently in place were evaluated, resulting in accelerated depreciation of $5,400 and $3,600 reflected in the December 31, 2016 and 2015 consolidated financial statements, respectively.

4. Significant Transactions (continued)

Bloomington

The Indiana University Health Board recently approved a plan to build a regional health campus in Bloomington, Indiana, which will increase Bloomington's ability to improve patient care by providing more opportunities for collaboration among clinical, research, and medical staff and faculty. This plan will allow the School of Medicine to expand its medical education programs and research opportunities on the Indiana University Bloomington campus. As part of this plan, Bloomington will build a replacement hospital, which will further its mission of providing cutting-edge health services to the region. The site of the new hospital will be located on the campus of Indiana University. The Board has not yet approved the capital expenditures related to the plan. In response to this plan, the useful lives of assets currently in place were evaluated, resulting in accelerated depreciation of $8,031 and $5,354 reflected in the December 31, 2016 and 2015 consolidated financial statements, respectively.

5. Assets Limited as to Use

Board-designated and donor-restricted investment funds are invested in accordance with Board-approved policies. The estimated fair value of the assets limited as to use is determined using market information and other appropriate valuation methodologies. The methods and assumptions used to estimate the fair value of assets limited as to use are as follows: (i) cash and cash equivalents: the carrying amounts reported in the consolidated balance sheets approximate fair value; (ii) marketable securities: the fair values are based on quoted market prices or, if quoted market prices are not available, quoted market prices of comparable instruments and other observable inputs; and (iii) other investments, including alternative investments. Certain alternative investments (such as hedged strategies and private investments) are accounted for using the equity method of accounting based upon the net asset values as determined by third-party valuation firms and/or administrators of each fund in consultation with and approval of the fund investment managers.

The Indiana University Health System is a limited partner in funds that employ hedged investment strategies and private funds that employ investment strategies that require long holding periods to create value, both of which are designed to reduce overall portfolio volatility.

5. Assets Limited as to Use (continued)

In the case of hedge funds, redemptions generally may be made quarterly with written notice ranging from 30 to 90 days; however, some funds employ lock-up periods that restrict redemptions or charge a redemption fee during the lock-up period. Lock-up periods range from one to three years with redemption charges of up to 5% of net asset value for redemptions made on or before the anniversary date of the initial investment or additional contribution. Upon complete redemption, many of the funds have "hold-back" provisions that allow the fund to retain up to 10% of the assets until the fund completes its audited financial statements for the redemption period. These investments are accounted for using the equity method of accounting, based on the fund's financial information.

In the case of private funds, capital is returned as monetization events occur, which may be infrequent in nature. Generally, capital is committed to a partnership for a period of five to ten years with the ability of the general partner to extend the life of the fund one to three additional years. Generally, during the first three to five years of a fund life, the general partner, in order to facilitate its funding of investments, will call capital from the limited partners up to the amount of its commitment. As of December 31, 2016, there is $306,798 of unfunded commitments relating to private funds, which is expected to be funded over the next five years. As of December 31, 2015, there was $201,089 of unfunded commitments relating to private fund investments.

Alternative investments include certain other risks which may not exist with other investments that are more widely traded. These include reliance on the skill of the fund managers, who often employ complex strategies utilizing various financial instruments, including futures contracts, foreign currency contracts, structured notes, interest rate, total return, and credit default swaps. Additionally, alternative investments may provide limited information on a fund's underlying assets and have restrictive liquidity provisions. Management believes that the Indiana University Health System, in consultation with its investment consultants, has the capacity to analyze and interpret the risks associated with alternative investments and, with this understanding, has determined that these investments represent a prudent approach for use in its portfolio management.

The largest fund allocation to any fund manager, which is an alternative fund of funds investment, is $264,670 at December 31, 2016, and there are no investments in any individual fund greater than 27.5% of that fund's net assets. Changes in the value of these funds are included in nonoperating loss in the accompanying consolidated statements of operations and changes in net assets.

5. Assets Limited as to Use (continued)

The composition of assets limited as to use is set forth below.

	December 31	
	2016	**2015**
Board-designated investments and trustee-held funds:		
Cash and cash equivalents	**$ 55,071**	$ 31,983
Debt securities:		
Asset backed	**111,153**	56,556
Bank loans	**265,794**	192,260
Corporate debt	**218,956**	321,165
Government and agencies	**163,453**	279,191
Bond funds	**315,319**	241,384
Total debt securities	**1,074,675**	1,090,556
Equity securities:		
Domestic equities	**68,918**	53,610
Domestic equity funds	**747,219**	594,162
International equities	**75,869**	66,520
International equity funds	**573,554**	450,333
Commodities	**167,494**	107,545
Total equity securities	**1,633,054**	1,272,170
Alternatives:		
Hedge funds	**1,293,040**	1,224,697
Private	**213,049**	105,737
Total alternatives	**1,506,089**	1,330,434
Less current portion of assets limited to use	**(56,958)**	(30,096)
Total assets limited to use	**$ 4,211,931**	$ 3,695,047

5. Assets Limited as to Use (continued)

Assets limited as to use include funds held by the foundations whose fair values as of December 31, 2016, aggregated $173,416, of which $121,647 is considered board-designated investment funds and $51,769 is considered donor-restricted investment funds. Assets limited as to use include funds held by the foundations whose fair values as of December 31, 2015, aggregated $177,193, of which $126,792 is considered board-designated investment funds and $50,401 is considered donor-restricted investment funds.

The composition and presentation of investment income (loss) recognized in the accompanying consolidated statements of operations and changes in net assets are as follows:

	Year Ended December 31	
	2016	**2015**
Investment income (loss):		
Interest and dividend income	**$ 63,563**	$ 41,055
Investment management and administration fees	**(8,122)**	(6,610)
Realized gains (losses) on sales of investments, net	**17,704**	(13,009)
Unrealized gains (losses) on investments	**148,164**	(105,627)
Equity gains on alternative investments	**40,591**	16,971
	$ 261,900	$ (67,220)

6. Property and Equipment

The cost of property and equipment in service is summarized as follows:

	December 31	
	2016	**2015**
Land and improvements	**$ 232,837**	$ 267,086
Buildings and improvements	**3,191,141**	3,383,914
Equipment	**2,107,421**	2,319,516
	$ 5,531,399	$ 5,970,516

6. Property and Equipment (continued)

Useful lives of each category of assets are based on the estimated useful time frame that the particular assets are expected to be in service, generally in accordance with guidelines established by the American Hospital Association. Assets are depreciated on a straight-line basis beginning in the month when placed in service, with asset lives ranging as follows: 20–30 years for land improvements; 15–40 years for buildings and improvements; and 3–10 years for equipment, including software developed for internal use.

Construction-in-progress for assets currently under development was $40,593 and $52,203 at December 31, 2016 and 2015, respectively, and includes commitments for the construction, refurbishment, and replacement of facilities and equipment.

Firm commitments for construction-in-progress totaled $48,317 at December 31, 2016.

Certain buildings, equipment, and software are accounted for as capital leases expiring in various years through 2037 and are included in property and equipment. Amortization of assets under capital leases is included in depreciation expense.

The following is a summary of property held under capital leases:

	December 31	
	2016	**2015**
Equipment	**$ 5,571**	$ 8,347
Buildings	**95,990**	100,785
	101,561	109,132
Less accumulated amortization	**(16,449)**	(19,676)
	$ 85,112	$ 89,456

Interest rates are imputed based on the lower of the incremental borrowing rate at the inception of each lease or the lessor's implicit rate of return.

7. Debt

Obligated Groups

The Indiana University Health System operates under two separate Master Trust Indentures (MTIs). Each MTI provides for the issuance of long-term debt and sets forth the terms pursuant to which underlying debt is issued. These MTIs set forth the provisions governing membership for the respective obligated groups, which presently consist of the following specific separate entities: (1) the Indiana University Health Obligated Group includes Indiana University Health (which entity includes divisions such as the Downtown Hospitals of the Academic Health Center, Saxony, and Morgan) as the sole member, and (2) the Rehabilitation Hospital of Indiana Obligated Group includes RHI as the sole member. During 2015, in anticipation of the sale transaction described in Note 4, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of La Porte from the Indiana University Health Obligated Group. Additionally, during 2016, as part of the separation transaction described in Note 4, Indiana University Health, acting as Obligated Group Agent, effectuated the removal of Goshen from the Indiana University Health Obligated Group and Affiliates. Each obligated group is required to meet certain covenants, and future members, if any, together with existing members will be jointly and severally liable for the obligations under their respective MTI. Each is subject to financial performance covenants that, among other compliance requirements, require the maintenance of debt service ratios and limit its ability to encumber certain of its respective assets. As of December 31, 2016, the Indiana University Health System was in compliance with all financial covenants.

Issuance, Modification, and Extinguishment of Debt

The Indiana University Health Obligated Group has executed direct-pay letter-of-credit agreements in support of all of its publicly remarketed variable-rate bond series, which require the credit provider to purchase bonds in the event the bonds are not remarketed. In addition, it has executed direct purchase agreements whereby the credit provider purchases bonds for a predetermined period of time, after which the agreement must be extended or the bonds must be remarketed or reissued. In each of these two instances, the bonds have a longer nominal maturity than the agreement, but the existence and terms of these agreements allow for the long-term classification of the associated variable-rate bond series. When these agreements have expiration dates within the succeeding 12-month period, a greater portion of the associated debt is classified as current, because if not otherwise extended, these agreements would require the principal

7. Debt (continued)

balance of the related bonds to be repaid over a shortened time frame. Accordingly, $6,263 and $8,429 was reclassified to current portion of long-term debt as of December 31, 2016 and 2015, respectively, to reflect the associated amount for 2017 and 2016, respectively.

On October 31, 2016, through the Indiana Finance Authority, RHI reissued its Series 2011A tax-exempt, variable-rate bonds and converted them to a tax-exempt, fixed-rate, direct-purchase interest rate mode. The expiration date of the direct-purchase agreement is the same date as the final maturity of the bonds.

On June 29, 2016, Indiana University Health provided notice of intent to exercise its one-time contractual option to prepay, without penalty, the remaining debt balance relating to a capital lease obligation. The transaction closed on January 3, 2017 and resulted in the acquisition of the leased building and termination of the lease. Accordingly, $92,278 was reclassified from long-term debt to the current portion of long-term debt as of December 31, 2016.

On February 18, 2016, through the Indiana Finance Authority, Indiana University Health issued $158,205 in par value of Series 2016A tax-exempt, fixed-rate bonds at a premium of $32,406. Proceeds were used to refund (on a current basis) $189,415 in par of the Series 2006B tax-exempt, fixed-rate bonds and to pay certain costs related to the issuance.

Additionally, on February 18, 2016, through the Indiana Finance Authority, Indiana University Health issued at par $100,000 of Series 2016B and 2016C tax-exempt, variable-rate bonds. Proceeds were used to refund (on a current basis) $99,555 in par of the Series 2006B tax-exempt, fixed-rate bonds and to pay certain costs related to the issuance.

Also on February 18, 2016, Indiana University Health drew $10,050 under its existing revolving line of credit to refund (on a current basis) $10,050 in par of the Series 2006B tax-exempt, fixed-rate bonds. The remaining $21,590 in par (after a routine principal payment of $6,490 on February 15, 2016) of the Series 2006B tax-exempt, fixed-rate bonds was repaid with cash.

The refunding of Series 2006B was accounted for as a debt extinguishment, resulting in a gain of $5,532 based upon carrying values in excess of the funds expended plus unamortized premium less unamortized issuance costs associated with the refunded debt. This gain is shown within debt extinguishment and other nonoperating loss on the consolidated statement of operations and changes in net assets.

7. Debt (continued)

On May 7, 2015, through the Indiana Finance Authority, Indiana University Health issued $287,395 in par value of Series 2015A tax-exempt fixed-rate bonds at a premium of $27,022. Proceeds were used to advance refund $117,130 in par of the Series 2006A tax-exempt, fixed-rate bonds; to refund the Series 2011J and 2011K taxable, variable-rate bonds outstanding in the amount of $151,550; to refund a variable-rate commercial bank loan in the amount of $37,975; and to pay certain costs related to the issuance.

Additionally, on May 7, 2015, through the Indiana Finance Authority, Indiana University Health issued at par $193,675 of Series 2015B and 2015C tax-exempt variable-rate bonds. Proceeds were used to advance refund $184,550 in par of the Series 2006A tax-exempt fixed-rate bonds and to pay certain costs related to the issuance.

Also on May 7, 2015, Indiana University Health drew $26,717 under its existing revolving line of credit to advance refund the final $25,490 in par of the Series 2006A tax-exempt, fixed-rate bonds. Subsequently, on June 25, 2015, this line of credit agreement was amended to defer the expiration date until June 30, 2018. Accordingly, the balance drawn is included as long-term debt at December 31, 2015.

The refunding of the Series 2006A, 2011J, and 2011K bonds and the commercial bank loan were all accounted for as debt extinguishments, resulting in losses aggregating $15,778 based upon the funds expended in excess of the carrying values net of unamortized discount and unamortized issuance costs associated with the refunded debt. This loss is shown within debt extinguishment and other nonoperating loss on the consolidated statement of operations and changes in net assets.

7. Debt (continued)

Long-term debt consists of the following:

	December 31 2016	December 31 2015
Indiana University Health Obligated Group		
Indiana Finance Authority:		
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2016A Serial Bonds, payable in varying principal installments through 2025, with an interest rate of 5.00% at December 31, 2016	**$ 158,205**	$ –
Variable-Rate, Tax-Exempt Hospital Revenue Bonds, Series 2016B and C, payable in varying installments through 2031, with variable interest rates of 0.68% and 0.70% for 2016B and C, respectively, at December 31, 2016	**100,000**	–
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2015A Serial and Term Bonds, payable in varying principal installments through 2040, with interest rates ranging from 4.00% to 5.00% at December 31, 2016	**287,395**	287,395
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2014A Serial Bonds, payable in varying principal installments through 2030, with interest rates ranging from 4.00% to 5.00% at December 31, 2016	**62,235**	66,130
Fixed-Rate, Tax-Exempt Hospital Revenue Refunding Bonds, Series 2011N Serial and Term Bonds, payable in varying principal installments through 2038, with interest rates ranging from 3.00% to 5.13% at December 31, 2016	**139,605**	155,060
Variable-Rate, Tax-Exempt Hospital Revenue Bonds, Series 2011A, B, C, D, E, H, I, L, and M, and Series 2015B and C, payable in varying installments through 2046, with variable interest rates ranging from 0.68% to 1.27% at December 31, 2016	**610,220**	623,995
Indiana Health and Educational Facility Financing Authority:		
Fixed-Rate, Tax-Exempt Hospital Revenue Bonds, Series 2006B Serial and Term Bonds, repaid in 2016	**–**	327,100
Variable Rate Commercial Bank Revolving Line of Credit, maturing June 30, 2018	**–**	26,717

7. Debt (continued)

	December 31 2016	December 31 2015
Rehabilitation Hospital of Indiana Obligated Group		
Indiana Finance Authority: Fixed-Rate, Tax-Exempt Hospital Revenue Bonds, Series 2011A, payable in varying principal installments through 2031, with an interest rate of 2.22% at December 31, 2016	**$ 13,695**	$ 14,365
Variable-Rate, Subordinated Promissory Note, principal payable in full at maturity in 2017, with an interest rate of 0.31% at December 31, 2016	**1,500**	1,500
Other Debt		
Mortgage obligations related to Goshen	**–**	2,837
Capital lease obligations	**96,320**	98,614
Other	**14,841**	18,003
Total long-term debt	**1,484,016**	1,621,716
Unamortized premium, net of unamortized discount	**69,851**	51,185
Unamortized bond issuance costs	**(6,671)**	(7,147)
Less current portion	**(144,389)**	(55,657)
Long-term debt, less current portion	**$ 1,402,807**	$ 1,610,097

7. Debt (continued)

The scheduled maturities and mandatory redemptions of long-term debt, assuming remarketing of variable-rate bonds, are as follows:

	Indiana University Health Obligated Group MTI Debt	RHI Obligated Group MTI Debt	Other	Total
Year ending December 31:				
2017	$ 46,273	$ 695	$ 97,421	$ 144,389
2018	54,302	740	4,168	59,210
2019	56,592	785	3,966	61,343
2020	53,038	840	3,397	57,275
2021	50,830	890	998	52,718
Thereafter	1,096,625	11,245	1,211	1,109,081
	$ 1,357,660	$ 15,195	$ 111,161	$ 1,484,016

The estimated valuation of the revenue bonds is obtained from a third-party pricing service and is derived by utilizing well-priced, liquid bonds with similar characteristics such as currency, market type, industry, and credit rating. Pricing data for these reference bonds incorporates simple averages of indicative and executable price quotes obtained from various contributors, including brokers and other market makers, over a specified time window. These prices are used to construct a fair value curve, which in turn is used to discount the future cash flows of the revenue bonds. Based on the inputs used in determining the estimated fair value of these securities, this liability would be classified as Level 2 in the fair value hierarchy described in Note 9.

The estimated fair value of the revenue bonds at December 31, 2016 and 2015, amounted to $1,435,853 (which includes RHI – $13,695) and $1,531,322 (which includes RHI – $14,365), respectively. The carrying value of the revenue bonds at December 31, 2016 and 2015, amounted to $1,371,355 and $1,474,045, respectively. The recorded value of all debt obligations not traded in the secondary credit markets approximated fair value at December 31, 2016 and 2015.

7. Debt (continued)

As of December 31, 2016 and 2015, the Indiana University Health System maintained several lines of credit totaling $105,000. There was no balance drawn on the lines of credit as of December 31, 2016. As of December 31, 2015, the total balance drawn of the lines of credit was $26,717, and is included in long-term debt.

Total interest paid on long-term debt for the years ended December 31, 2016 and 2015, aggregated $42,749 and $74,164, respectively. Total interest capitalized during the years ended December 31, 2016 and 2015, amounted to $789 and $510, respectively.

8. Derivative Financial Instruments

Long-term interest rate swap arrangements have been entered into with the primary objective being to mitigate interest rate risk. The following fixed-pay swaps, stated at current notional amounts, remain in place as of December 31, 2016:

Notional Amount	Effective Date	Maturity Date	Rate Received	Rate Paid
$ 32,475	11/15/2005	2/16/2021	62.30% LIBOR plus 0.24%	3.19%
58,225	6/23/2011	3/1/2036	62.30% LIBOR plus 0.24%	2.68
66,625	11/15/2005	2/15/2030	62.30% LIBOR plus 0.24%	3.35
66,925	6/20/2011	2/15/2030	62.30% LIBOR plus 0.24%	3.35
55,000	6/26/2003	3/1/2033	LIBOR	4.92
18,328	6/16/2011	3/1/2033	LIBOR	4.92
73,310	6/16/2011	3/1/2033	LIBOR	4.92
18,325	6/16/2011	3/1/2033	LIBOR	4.92
18,325	6/26/2003	3/1/2033	LIBOR	4.92
6,300	1/27/2006	11/2/2020	Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA)	3.98

8. Derivative Financial Instruments (continued)

After giving effect to the above derivative transactions, the Indiana University Health System's variable-rate debt was approximately 19.3% and 14.1% of total debt outstanding as of December 31, 2016 and 2015, respectively.

In addition, long-term basis swap arrangements were entered into for the purpose of managing the effect of interest rates on cash flows and were in place as of December 31, 2016, as follows:

Notional Amount	Effective Date	Maturity Date	Swap Type	Rate Received	Rate Paid
$ 140,446	3/10/2021	2/15/2033	Forward starting basis	75.00% three-month LIBOR minus 0.05%	SIFMA
309,200	3/10/2021	1/7/2033	Forward starting basis	75.00% three-month LIBOR minus 0.04%	SIFMA
309,200	1/7/2020	1/7/2033	Forward starting basis	75.0% one-month LIBOR	SIFMA

Guidance on fair value accounting stipulates that a credit valuation adjustment (CVA) should be applied to the mark-to-market valuation position of interest rate swaps to more closely capture the fair value of such instruments. Collateral arrangements reduce the credit exposure and are considered in determining the CVA. As of December 31, 2016, the fair value of interest rate swaps was a liability of $92,240, which is net of CVA of $7,232. As of December 31, 2015, the fair value of interest rate swaps was a liability of $112,675, which is net of CVA of $11,841. The fair values of the swaps have been included with noncurrent liabilities in the accompanying consolidated balance sheets.

8. Derivative Financial Instruments (continued)

The Indiana University Health System recorded the following gains (losses), within nonoperating loss, in the accompanying consolidated statements of operations and changes in net assets related to these derivative financial instruments:

	Year Ended December 31	
	2016	**2015**
Gains on interest rate swaps, net:		
Unrealized gains on interest rate swaps	**$ 18,434**	$ 34,367
Realized losses on interest rate swaps	**(15,374)**	(15,390)
	$ 3,060	$ 18,977

As of December 31, 2016, interest rate swaps had a total notional amount of $1,172,684, including $413,838 of fixed-pay swaps and $758,846 of forward basis swaps. Under agreements executed with counterparties, Indiana University Health is obligated to fund collateral amounts when the aggregate market value of swaps with a given counterparty exceeds a threshold set forth in the related agreement. The aggregate fair value of all derivative instruments, consisting of fixed-pay and basis swaps, with credit-risk-related contingent features that are in a liability position on December 31, 2016 and 2015, was $81,280 and $101,208, respectively. No collateral was posted as of December 31, 2016 or 2015.

During August 2016, Indiana University Health terminated two identical basis swaps, both with a notional amount of $250,000 and a maturity date of September 30, 2038, for a one-time cash payment of $1,375 each, which were recorded as realized losses, after which no payments or other amounts are owed to either party with respect to these swaps.

During December 2015, Indiana University Health terminated a basis swap with a notional amount of $168,952 and a maturity date of February 15, 2033, for a one-time cash payment of $1,450, which was recorded as a realized gain, after which no payments or other amounts are owed to either party with respect to this swap. Also during December 2015, Indiana University Health partially terminated three additional basis swaps: (1) a basis swap with a notional amount of $309,200 and a maturity date of January 7, 2033, for a one-time cash receipt of $1,280, which was recorded as a realized gain whereby no payments will accrue until January 7, 2020; (2) two identical basis swaps, both with notional amounts of $250,000 and maturity dates of September 30, 2038, for one-time cash receipts of $270 each, which were recorded as realized gains, whereby no payments will accrue until June 1, 2016.

8. Derivative Financial Instruments (continued)

During July 2015, Indiana University Health terminated a basis swap with a notional amount of $309,200 and a maturity date of March 7, 2021, for a one-time cash receipt of $44, which was recorded as a realized gain, after which no payments or other amounts are owed to either party with respect to this swap.

During June 2015, Indiana University Health terminated a basis swap with a notional amount of $168,952 and a maturity date of February 15, 2021, for a one-time cash receipt of $37, which was recorded as a realized gain, after which no payments or other amounts are owed to either party with respect to this swap.

9. Fair Value Measurements

The accounting guidance for the application of fair value provides, among other matters, for the following: defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establishes a framework for measuring fair value; establishes a three-level hierarchy for fair value measurements based upon the observability of inputs to the valuation of an asset or liability as of the measurement date; requires consideration of nonperformance risk when valuing liabilities; and expands disclosures about instruments measured at fair value. The three-level hierarchy is based upon the nature of valuation techniques and whether such techniques are based upon observable or unobservable inputs, as defined.

Observable inputs are intended to reflect market data obtained from independent sources, while unobservable inputs may reflect market assumptions made by management or measurements made by financial specialists generally associated with the financial asset or liability. These two types of inputs create the following fair value hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities as of the reporting date. Includes debt issued by U.S. agencies.

- Level 2 – Pricing inputs other than quoted prices included in Level 1 that are either directly observable or that can be derived or supported from observable data as of the reporting date. Includes all collective trusts and offshore mutual funds.

9. Fair Value Measurements (continued)

- Level 3 – Pricing inputs include those that are significant to the fair value of the financial asset or financial liability and are not observable from objective sources. In evaluating the significance of inputs, the Indiana University Health System generally classifies assets or liabilities as Level 3 when their fair value is determined using unobservable inputs that, individually or when aggregated with other unobservable inputs, represent more than 10% of the fair value of the assets or liabilities. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

The following tables set forth by level within the fair value hierarchy the Indiana University Health System's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2016 and 2015. The financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The assessment of the significance of a particular input to the fair value measurement requires judgment, could be subject to change or variation, and may affect the valuation of fair value assets and liabilities and their classification within the fair value hierarchy levels.

9. Fair Value Measurements (continued)

	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
December 31, 2016						
Assets						
Cash and cash equivalents	$ 130,156	$ –	$ –	$ 130,156	$ –	$ 130,156
Short-term investments:						
Corporate debt	–	15,343	–	15,343	–	15,343
Government and agencies	159	–	–	159	–	159
Debt securities:						
Asset backed	–	111,153	–	111,153	–	111,153
Bank loans	–	252,081	13,713	265,794	–	265,794
Corporate debt	–	218,932	24	218,956	–	218,956
Government and agencies	163,453	–	–	163,453	–	163,453
Bond funds	157,974	157,345	–	315,319	–	315,319
Equity securities:						
Domestic equities	68,918	–	–	68,918	–	68,918
Domestic equity funds	191,904	555,315	–	747,219	–	747,219
International equities	75,869	–	–	75,869	–	75,869
International equity funds	149,249	424,305	–	573,554	–	573,554
Commodities	167,494	–	–	167,494	–	167,494
Alternatives:						
Hedge funds	–	–	–	–	1,293,040	1,293,040
Private	–	–	–	–	213,049	213,049
Beneficial interests in charitable remainder and perpetual trusts	–	9,468	–	9,468	–	9,468
Total assets measured at the respective value on a recurring basis	$1,105,176	$1,743,942	$ 13,737	$2,862,855	$1,506,089	$4,368,944
Liabilities						
Interest rate swaps	$ –	$ 92,240	$ –	$ 92,240	$ –	$ 92,240
Total liabilities measured at fair value on a recurring basis	$ –	$ 92,240	$ –	$ 92,240	$ –	$ 92,240

9. Fair Value Measurements (continued)

	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
December 31, 2015						
Assets						
Cash and cash equivalents	$ 388,045	$ –	$ –	$ 388,045	$ –	$ 388,045
Debt securities:						
Asset backed	–	56,556	–	56,556	–	56,556
Bank loans	–	180,696	11,564	192,260	–	192,260
Corporate debt	–	321,165	–	321,165	–	321,165
Government and agencies	279,191	–	–	279,191	–	279,191
Bond funds	115,253	126,131	–	241,384	–	241,384
Equity securities:						
Domestic equities	53,610	–	–	53,610	–	53,610
Domestic equity funds	230,469	363,693	–	594,162	–	594,162
International equities	66,520	–	–	66,520	–	66,520
International equity funds	137,794	312,539	–	450,333	–	450,333
Commodities	107,545	–	–	107,545	–	107,545
Alternatives:						
Hedge funds	–	–	–	–	1,224,697	1,224,697
Private	–	–	–	–	105,737	105,737
Beneficial interests in charitable remainder and perpetual trusts	–	9,462	–	9,462	–	9,462
Total assets measured at the respective value on a recurring basis	$1,378,427	$1,370,242	$ 11,564	$2,760,233	$1,330,434	$4,090,667
Liabilities						
Interest rate swaps	$ –	$ –	$ 112,675	$ 112,675	$ –	$ 112,675
Total liabilities measured at fair value on a recurring basis	$ –	$ –	$ 112,675	$ 112,675	$ –	$ 112,675

9. Fair Value Measurements (continued)

The fair value of cash and cash equivalents is based on quoted market prices and classified as Level 1. The fair value of Level 1 trading securities is based on quoted market prices from an active exchange or deemed to have similar liquidity characteristics. The fair value of Level 2 trading securities is based on third-party market quotes in an inactive market or similar securities in an active market and other observable inputs. The fair value of interest rate swaps is based upon forward interest rate curves, as adjusted for CVA (see Note 8).

Cash and cash equivalents not held in money market funds aggregated $340,775 and $160,640 as of December 31, 2016 and 2015, respectively, and are not included in the tables. The beneficial interests in charitable remainder and perpetual trusts are shown within other long-term assets in the accompanying consolidated balance sheets.

The following table is a rollforward of the amounts included in the consolidated balance sheets for assets classified within Level 3 of the valuation hierarchy defined above:

Fair value at January 1, 2015	$ 2,600
Bank loan paydown	(1,536)
Bank loan purchase	8,560
Transfers in	1,843
Other	97
Fair value at December 31, 2015	11,564
Bank loan paydown	**(1,109)**
Bank loan purchase	**4,469**
Transfers (out)	**(1,248)**
Other	**61**
Fair value at December 31, 2016	**$ 13,737**

9. Fair Value Measurements (continued)

The following table is a rollforward of the amounts included in the consolidated balance sheets for derivative financial instruments classified within Level 3 of the valuation hierarchy defined above:

Fair value at January 1, 2015	$ –
Transfer in	145,339
Unrealized gains	(34,367)
Other	1,703
Fair value at December 31, 2015	112,675
Unrealized gains	**(18,434)**
Other	**(2,001)**
Transfer out	**(92,240)**
Fair value at December 31, 2016	**$ –**

The Indiana University Health System engages a third party to assist in valuing the CVA. The third party uses the income approach to present value the cash flows using the relevant rate of return for the corresponding swap contracts. Where observable, this return would be the observed market rate(s) of return associated with the swap counterparty in a liability position. Collateral amounts posted, if any, are also taken into consideration. The CVA depicts the difference in the mark to market absent any credit risk, and the fair value of the swap that incorporates the credit risk of the party holding the swap in a liability position at that point in time. For swaps for which Indiana University Health is in a liability position, this credit risk is measured by comparing the mark-to-market value derived using the LIBOR swap curve to the fair value derived using a published AA-rated Municipal Healthcare curve (or the AA+ rated Municipal General Obligation curve for the swaps insured by Assured Guaranty Municipal Corporation) or comparable market data, adjusted to a taxable basis using the relevant SIFMA/LIBOR ratio.

9. Fair Value Measurements (continued)

The value of the CVA may vary depending upon the following factors:

- Whether the Indiana University Health System is required to post collateral under the swap agreements, or

- To the extent that the credit rating of the Indiana University Health System increases or decreases, in which case the CVA would decrease or increase, respectively (assuming the swaps are in a liability position), or

- To the extent that the spread between the swap curves discussed above expands or compresses.

Generally, swaps are transferred between Level 2 and Level 3 when the CVA exceeds 10% of the gross valuation of the swap. Transfers are generally recorded at the end of the reporting period.

10. Commitments and Contingencies

The Indiana University Health System is from time to time subject to various legal proceedings and claims arising in the ordinary course of business. The Indiana University Health System's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any other claims, individually or collectively, will have a material adverse effect on the Indiana University Health System's consolidated financial condition, results of operations, or cash flow.

10. Commitments and Contingencies (continued)

Leases

Buildings and medical and office equipment are leased under non-cancelable operating and capital leases. Future minimum lease payments as of December 31, 2016, are as follows:

	Operating Leases	Capital Leases
Year ending December 31:		
2017	$ 33,062	$ 198,092
2018	25,511	1,047
2019	19,406	665
2020	24,359	633
2021	8,238	296
Thereafter	18,941	57
Total minimum lease payments	$ 129,517	200,790
Less amount representing interest		(104,470)
Present value of net minimum lease payments		$ 96,320

Rent and lease expense, included in supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, amounted to $55,541 and $57,862 for the years ended December 31, 2016 and 2015, respectively.

11. Medical Malpractice

The Indiana University Health System's medical malpractice coverage is provided through the Indiana University Health Risk Retention Group, Inc. (IUHRRG), a wholly owned subsidiary. The program of medical malpractice coverage considers limitations in claims and damages prescribed by the Indiana Medical Malpractice Act (the Act), which limits the amount of individual claims to $1,250 and annual aggregate claims to $7,500, of which up to $1,000 would be paid by the State of Indiana Patient Compensation Fund (the Fund) and $250 by the Indiana University Health System for each occurrence of malpractice. The Act also requires that health care providers meet certain requirements, including making funding payments to the Fund and maintaining certain insurance levels. The Indiana University Health System has met these requirements and is a qualified provider under the Act, retaining risk of $250 per occurrence and $7,500 in the annual aggregate.

11. Medical Malpractice (continued)

The Indiana University Health System's medical malpractice program includes coverage offered by IUHRRG and reinsured by Indiana University Health Assurance SPC, a wholly owned subsidiary. This reinsurance also serves as excess insurance for general liability, automobile liability, employer's liability, managed care errors and omissions, and professional liability. This coverage is provided on a claims-made basis (aggregating $70,000 as of July 1, 2014, and $100,000 prior).

Contributions for coverage provided by the captive insurance companies are expensed as incurred, and loss reserves are established for incurred but not yet reported claims. Laws in the jurisdictions in which the captive insurance companies are domiciled require, among other matters, that certain capital and funding requirements be met. The actuarially determined amount of accrued medical malpractice claims is included in noncurrent liabilities in the accompanying consolidated balance sheets.

12. Retirement Plans

Defined Contribution Plans

Retirement benefits are provided to substantially all employees of the Indiana University Health System, primarily through defined contribution plans. Contributions, which are included in benefits expense, to the defined contribution plans are based on compensation of qualified employees and amounted to $96,619 and $94,716 in 2016 and 2015, respectively (net of forfeitures of $1,708 and $2,048 in 2016 and 2015, respectively).

Defined Benefit Plans

Defined benefit pension plans sponsored by Indiana University Health, La Porte, Ball Memorial, and Bloomington have been curtailed, with benefits frozen and no new participants allowed. The defined benefit pension plans applicable to Indiana University Health were principally limited to current and former employees who elected not to participate in the defined-contribution plan established at the time of Indiana University Health's formation.

Pension benefits are based on years of service and compensation of employees (as defined) and are actuarially determined. Where applicable, the funding policy is to annually contribute the amount required to comply with applicable legislation and IRS regulations. Adjustments to pension liabilities to reflect funded status are charged or credited to unrestricted net assets.

12. Retirement Plans (continued)

During the third quarter of 2016, Indiana University Health offered a lump sum benefit payout option to participants of three defined benefit pension plans who were terminated and fully vested as of December 31, 2015. The lump sum offering window closed in November 2016. Additionally, terminated and fully vested participants of one defined benefit pension plan may elect lump sum benefit payout. Accordingly, as of December 31, 2016, Indiana University Health recognized $16,066 of settlement losses, included in salaries, wages, and benefits in the accompanying consolidated statements of operations and changes in net assets, not included in net periodic pension income (cost).

The following table sets forth the funded status of the defined benefit pension plans and amounts recognized in the consolidated financial statements. The discount rates used vary with each plan based on plan characteristics such as the average age of participants.

	December 31	
	2016	**2015**
Changes in benefit obligation of the plans:		
Benefit obligation at beginning of year	**$ 498,230**	$ 531,681
Interest cost	**21,843**	21,464
Actuarial (loss) gain	**10,635**	(28,856)
Benefits paid	**(72,522)**	(26,059)
Benefit obligation at end of year	**$ 458,186**	$ 498,230
Changes in assets of the plans:		
Fair value of assets at beginning of year	**$ 398,782**	$ 435,470
Actual (loss) return on assets	**22,221**	(11,185)
Employer contributions	**9,583**	556
Benefits paid	**(72,522)**	(26,059)
Fair value of assets at end of year	**$ 358,064**	$ 398,782
Funded deficiency at December 31	**$ (100,122)**	$ (99,448)
Items not yet recognized as a component of net periodic pension cost (income):		
Net actuarial loss	**$ 148,268**	$ 155,765
Acceleration of termination loss	**(17,933)**	–
	$ 130,335	$ 155,765

12. Retirement Plans (continued)

	December 31 2016	December 31 2015
Components of net pension benefit cost (income):		
Interest cost	**$ 21,843**	$ 21,464
Expected return on assets	**(24,105)**	(27,268)
Amortization of unrecognized net loss	**3,993**	4,183
Termination benefit and settlement expense	**16,066**	1,608
Net periodic pension cost (income)	**$ 17,797**	$ (13)
Weighted average actuarial assumptions to determine benefit cost (income):		
Discount rate for net periodic pension cost (income)	**4.49%**	4.08%
Discount rate for benefit obligations	**4.12**	4.49
Expected rate of return on plan assets	**4.78**	6.25
Expected future benefit payments:		
2017		$ 78,338
2018		24,915
2019		25,491
2020		25,844
2021		26,230
2022–2026		129,972

Accumulated adjustments to unrestricted net assets at December 31, 2016, include amounts related to net actuarial loss and acceleration of termination loss (see Note 4) that have not yet been recognized in net pension benefit cost. Expected amortization of amounts in unrestricted net assets is expected to increase net periodic pension costs by $3,994 during the year ending December 31, 2017. Contributions are expected to aggregate $81,735 to the defined benefit pension plans during 2017.

12. Retirement Plans (continued)

The plans' assets are held in a group trust. The principal long-term determinant of a plan's investment return is the asset allocation of the group trust. The group trust's allocations are weighted toward growth-oriented assets vs. duration-oriented investments. The expected long-term rate of return assumption is based on the mix of assets in the plans and the long-term earnings expected to be associated with each asset class. These assumptions are periodically benchmarked against peer plans.

The weighted average asset allocations of the plans, by asset category, are as follows:

	December 31	
	2016	**2015**
Asset category		
Cash and cash equivalents	**1%**	1%
Debt securities:		
Asset backed	**2**	–
Bank loans	**–**	1
Corporate debt	**8**	6
Government and agencies	**9**	12
Bond funds	**26**	19
Equity securities:		
Domestic equity funds	**18**	19
International equity funds	**16**	20
Alternatives:		
Hedge funds	**20**	22
	100%	100%

The allocation strategy for the group trust in which the plans participate is currently composed of approximately 60% to 70% of growth-oriented investments and 30% to 40% of duration-oriented investments. The largest component of these growth-oriented assets is public equity securities that are diversified and invested in U.S. and international companies.

12. Retirement Plans (continued)

The following tables present the plans' financial instruments, measured at fair value on a recurring basis within the fair value hierarchy as disclosed in Note 9:

	Level 1	Level 2	Level 3	Total
December 31, 2016				
Assets				
Cash and cash equivalents	**$ 3,103**	**$ –**	**$ –**	**$ 3,103**
Debt securities:				
Asset backed	**–**	**5,492**	**–**	**5,492**
Bank loans	**–**	**1,438**	**–**	**1,438**
Corporate debt	**–**	**29,880**	**–**	**29,880**
Government and agencies	**33,357**	**–**	**–**	**33,357**
Bond funds	**27,209**	**65,700**	**–**	**92,909**
Equity securities:				
Domestic equity funds	**15,885**	**47,660**	**–**	**63,545**
International equity funds	**30,431**	**27,117**	**–**	**57,548**
Alternatives:				
Hedge funds	**–**	**70,792**	**–**	**70,792**
Total assets measured at fair value on a recurring basis	**$ 109,985**	**$ 248,079**	**$ –**	**$ 358,064**

12. Retirement Plans (continued)

	Level 1	Level 2	Level 3	Total
December 31, 2015				
Assets				
Cash and cash equivalents	$ 5,794	$ –	$ –	$ 5,794
Debt securities:				
Bank loans	–	2,722	–	2,722
Corporate debt	–	24,522	–	24,522
Government and agencies	48,333	–	–	48,333
Bond funds	48,599	25,436	–	74,035
Equity securities:				
Domestic equity funds	18,454	58,891	–	77,345
International equity funds	39,130	39,627	–	78,757
Alternatives:				
Hedge funds	–	87,274	–	87,274
Total assets measured at fair value on a recurring basis	$ 160,310	$ 238,472	$ –	$ 398,782

The fair value of cash equivalents is based on quoted market prices and classified as Level 1. The fair value of Level 1 investments is based on quoted market prices from an active exchange. The fair value of Level 2 investments is based on third-party quotes in an inactive market or similar securities in an active market and other observable inputs.

The plans invest in hedged funds for which the net asset value per share represents the fair value of the investment held. Risks and redemption restrictions for these investments are similar to the alternative investments described in Note 5.

13. Endowments

Endowment funds of Methodist Health Foundation and BMH Foundation consist of donor-restricted endowment funds held for various specific purposes. As required by GAAP, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

13. Endowments (continued)

The board of directors of both foundations have interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the foundations classify as permanently restricted net assets the following: (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the foundations in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the foundations consider the various factors in making a determination to appropriate or accumulate donor-restricted endowment funds, such as the duration and preservation of the fund, the purposes of the foundations and the donor-restricted endowment fund, general economic conditions, the possible effect of inflation and deflation, the expected total return from income and the appreciation of investments, other resources of the organization, and the investment policies of the foundations.

Changes in and composition of donor-restricted endowment net assets for both foundations were as follows:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets at January 1, 2015	$ 14,077	$ 45,354	$ 59,431
Contributions	–	247	247
Investment loss	(710)	–	(710)
Appropriation of endowment assets for expenditures	(1,423)	–	(1,423)
Endowment net assets at December 31, 2015	11,944	45,601	57,545
Contributions	**5**	**373**	**378**
Investment loss	**3,420**	**–**	**3,420**
Reclassification	**5**	**–**	**5**
Appropriation of endowment assets for expenditures	**(2,014)**	**–**	**(2,014)**
Endowment net assets at December 31, 2016	**$ 13,360**	**$ 45,974**	**$ 59,334**

13. Endowments (continued)

Methodist Health Foundation and BMH Foundation have adopted separate investment and spending policies for endowment assets. Policies for both foundations attempt to preserve capital, maximize the return within reasonable and prudent levels of risk, and provide a return to the restricted funds. Endowment assets are invested in a manner that is intended to produce results that exceed the initial recorded value of the investment and yield a targeted long-term rate while assuming a moderate level of investment risk. Disbursements are made for the purposes of supporting various Indiana University Health and Ball Memorial program services. Each foundation has set a threshold for the amount available to distribute each year.

14. Related-Party Transactions

Indiana University School of Medicine

The Consolidation Agreement requires that Indiana University Health fund salaries and related employee benefit costs for medical doctor interns and residents of the School of Medicine who provide services at the Indiana University Health System's facilities. These costs totaled $45,458 and $41,950 in 2016 and 2015, respectively, and have been reported with salaries, wages, and benefits expense in the accompanying consolidated statements of operations and changes in net assets.

The Indiana University Health System purchases certain services from the School of Medicine. These expenses, principally for certain physician and staff salaries, medical directors, medical care case management services, utilities, laboratory services, and other services, totaled $72,271 and $64,660 for the years ended December 31, 2016 and 2015, respectively, and have been reported within salaries, wages, and benefits, and supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets.

The Indiana University Health System also provides additional support to the School of Medicine to assist with medical education and research. During 2016 and 2015, Indiana University Health expensed $54,550 and $52,402, respectively, within educational and research support to Indiana University and supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets.

14. Related-Party Transactions (continued)

Additionally, in 2012, Indiana University Health committed to support ratably for a five-year period ended December 31, 2016, certain basic, clinical, and translational research programs of the School of Medicine. The total commitment aggregates $75,000, subject to board approval annually, and will be used to reimburse expenses incurred by the School of Medicine. For the years ended December 31, 2016 and 2015, the Indiana University Health System expensed $15,000 under this agreement within supplies, drugs, purchased services, and other expenses in the accompanying consolidated statements of operations and changes in net assets, of which $37,380 and $31,462 was accrued within accounts payable and accrued expenses at December 31, 2016 and 2015, respectively.

Other Foundations

Bloomington Hospital Foundation, Inc., Tipton County Foundation, Inc., IU Health White Memorial Hospital Foundation, Inc., and the Community Foundation of Greater Lafayette, Inc. are tax-exempt organizations under Section 501(c)(3) of the IRC; these foundations hold funds solely on behalf of Bloomington, Tipton, White, and Arnett Foundation, respectively.

The financial statements of these foundations are not included in the consolidated financial statements. The interests in net assets of these other foundations, which totaled $13,775 and $14,035 at December 31, 2016 and 2015, respectively, are included with other assets and net assets in the accompanying consolidated balance sheets and principally represent donor-restricted funds. These foundations also hold other net assets that are subject to the direction of their respective boards of directors. Other changes in the net assets of these foundations are generally reflected within temporarily and permanently restricted net assets.

15. Health Care Legislation and Regulation

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

15. Health Care Legislation and Regulation (continued)

government health care programs together with the imposition of significant fines and penalties, significant repayments for patient services previously billed, and disruptions or delays in processing administrative transactions, including the adjudication of claims and payment.

In the opinion of management, there are no known regulatory inquiries that are expected to have a material adverse effect on the consolidated financial statements of the Indiana University Health System; however, compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

The Affordable Care Act and its associated legislation are designed, in part, to expand access to coverage to substantively all U.S. citizens through a combination of states' expansion of their Medicaid programs and the health insurance marketplace. For Indiana, the Centers for Medicare and Medicaid Services approved the Healthy Indiana Plan 2.0, which was Indiana's response to expanding its Medicaid program. Changes to existing Medicare and Medicaid coverage and payments have also occurred as a result of this legislation. With the presidential election of 2016, there is uncertainty regarding the future of the Affordable Care Act, but the specific impact of any changes or new legislation on the Indiana University Health System is not determinable at this time.

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 Ernst & Young LLP.
All Rights Reserved.

ey.com