



ALLINA HEALTH SYSTEM

Consolidated Financial Statements

December 31, 2018 and 2017

(With Independent Auditors' Reports Thereon)

ALLINA HEALTH SYSTEM

Table of Contents

	Page(s)
Independent Auditors' Report	1–2
Consolidated Financial Statements:	
Consolidated Balance Sheets	3
Consolidated Statements of Operations and Changes in Net Assets	4–5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7–43
Independent Auditors' Report	44
Supplemental information:	
Consolidating Balance Sheet information as of December 31, 2018	45
Consolidating Statement of Operations and Changes in Net Assets information for the year ended December 31, 2018	46–47
Consolidating Balance Sheet information as of December 31, 2017	48
Consolidating Statement of Operations and Changes in Net Assets information for the year ended December 31, 2017	49–50



KPMG LLP
4200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402

Independent Auditors' Report

The Board of Directors
Allina Health System:

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Allina Health System and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the 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 consolidated financial statements.

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



Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Allina Health System and its subsidiaries as of December 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.

KPMG LLP

Minneapolis, Minnesota
March 12, 2019

ALLINA HEALTH SYSTEM
Consolidated Balance Sheets
December 31, 2018 and 2017
(Dollars in thousands)

Assets	2018	2017
Current assets:		
Cash and cash equivalents	\$ 135,580	147,520
Short-term investments	278,587	404,934
Patient accounts receivable, net	511,662	506,044
Inventories	72,552	65,751
Other current assets	112,728	99,459
	<u>1,111,109</u>	<u>1,223,708</u>
Investments	1,824,119	1,701,240
Investments with limited uses	153,813	158,934
Land, buildings, and equipment, net	1,223,828	1,221,692
Other assets	325,148	337,188
	<u>4,638,017</u>	<u>4,642,762</u>
Total assets	\$ 4,638,017	4,642,762
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued expenses	\$ 453,622	439,373
Current portion of long-term debt	27,491	26,235
Other current liabilities	110,174	104,330
	<u>591,287</u>	<u>569,938</u>
Long-term debt	920,885	949,048
Other liabilities	405,249	421,857
	<u>1,917,421</u>	<u>1,940,843</u>
Total liabilities	1,917,421	1,940,843
Net assets:		
Without donor restriction	2,565,547	2,530,561
With donor restriction	155,049	171,358
	<u>2,720,596</u>	<u>2,701,919</u>
Total net assets	2,720,596	2,701,919
Total liabilities and net assets	\$ 4,638,017	4,642,762

See accompanying notes to consolidated financial statements.

ALLINA HEALTH SYSTEM

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2018 and 2017

(Dollars in thousands)

	2018	2017
Revenues:		
Net patient service revenue	\$ 4,071,714	3,851,703
Other operating revenue	298,725	329,629
Total revenues	<u>4,370,439</u>	<u>4,181,332</u>
Expenses:		
Salaries and benefits	2,701,224	2,572,526
Supplies and services	979,609	916,677
Depreciation and amortization	181,647	175,378
Financing costs	43,893	39,204
State assessments and taxes	75,792	86,157
Utilities and maintenance	78,842	76,650
Other operating expenses	223,174	166,530
Total expenses	<u>4,284,181</u>	<u>4,033,122</u>
Operating income	86,258	148,210
Nonoperating gains (losses):		
Investment return	(59,647)	166,794
Gain (losses) on interest rate swap agreements	2,653	(6,656)
Loss on debt refinancing	—	(6,767)
Nonservice periodic pension costs	921	(2,343)
Other	(7,801)	(3,836)
Excess of revenues over expenses	<u>\$ 22,384</u>	<u>295,402</u>

ALLINA HEALTH SYSTEM

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2018 and 2017

(Dollars in thousands)

	2018	2017
Net assets without donor restrictions:		
Excess of revenues over expenses	\$ 22,384	295,402
Net assets released from restrictions for capital purposes	14,037	14,649
Amortization of unrealized loss on interest rate swap agreement	874	874
Other	(2,309)	(2,605)
Increase in net assets without donor restrictions	34,986	308,320
Net assets with donor restrictions		
Contributions	16,962	19,492
Investment return	(5,259)	12,822
Net assets released from restrictions	(25,718)	(26,818)
Other	(2,294)	(33)
(Decrease) increase in net assets with donor restrictions	(16,309)	5,463
Increase in net assets	18,677	313,783
Net assets at beginning of year	2,701,919	2,388,136
Net assets at end of year	\$ 2,720,596	2,701,919

See accompanying notes to consolidated financial statements.

ALLINA HEALTH SYSTEM

Consolidated Statements of Cash Flows

Years ended December 31, 2018 and 2017

(Dollars in thousands)

	<u>2018</u>	<u>2017</u>
Operating activities:		
Increase in net assets	\$ 18,677	313,783
Adjustments to reconcile increase in net assets to net cash and cash equivalents provided by operating activities:		
Depreciation and amortization	181,647	175,378
Gain on sale of land, buildings, and equipment	(1,981)	(19,413)
Change in fair value of interest rate swaps	(12,170)	(4,788)
Loss on debt refinancing	—	6,767
Change in realized and unrealized gains on investments, net	113,636	(146,768)
Restricted contributions including cash for long-lived assets	(16,962)	(19,492)
Earnings on joint ventures	(8,742)	(28,431)
Distributions received from joint ventures	6,282	24,169
Changes in assets and liabilities:		
Change in accounts receivable and other current assets	(26,393)	(41,529)
Change in accounts payable and other current liabilities	(9,320)	(401)
Change in other assets and liabilities	1,067	130
Net cash and cash equivalents provided by operating activities	<u>245,741</u>	<u>259,405</u>
Investing activities:		
Proceeds from sales of land, buildings, and equipment	16,730	9,518
Purchases of land, buildings, and equipment	(198,206)	(241,479)
Contributions of cash for long-lived assets	265	2,370
Purchases of investments classified as trading, net	(107,998)	(186,306)
Sales of investments with limited uses, net	2,951	1,113
Contributions to joint ventures	(1,400)	(6,855)
Net cash and cash equivalents used in investing activities	<u>(287,658)</u>	<u>(421,639)</u>
Financing activities:		
Restricted contributions, net	27,015	17,183
Change in outstanding checks payable	29,412	(4,593)
Refinancing of long-term debt	—	(159,990)
Proceeds from issuance of long-term debt	—	310,977
Deferred debt acquisition costs	—	(2,602)
Principal payments of long-term debt	(26,450)	(23,931)
Net cash and cash equivalents provided by financing activities	<u>29,977</u>	<u>137,044</u>
Decrease in cash and cash equivalents	(11,940)	(25,190)
Cash and cash equivalents at beginning of year	<u>147,520</u>	<u>172,710</u>
Cash and cash equivalents at end of year	<u>\$ 135,580</u>	<u>147,520</u>

See accompanying notes to consolidated financial statements.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(1) Organization and Basis of Presentation

Allina Health System (the System) is a not-for-profit corporation whose consolidated financial statements include the accounts of its owned subsidiaries and controlled affiliates.

The System consists of five hospitals located in the Minneapolis and Saint Paul metropolitan area, seven hospitals located outside the metropolitan area, physician clinics employing approximately 1,400 providers, various other health care-related entities, and seven foundations supporting health-related services.

All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

(2) Summary of Significant Accounting Policies

(a) Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and accompanying notes. Although estimates are considered to be fairly stated at the time the estimates are made, actual results could differ from those estimates.

(b) Cash and Cash Equivalents

Cash and cash equivalents include bank deposits and short-term investments with an original maturity of three months or less from the date of purchase that have not otherwise been classified as long-term assets due to a designation for long-term purposes.

(c) Outstanding Checks

Outstanding checks that are book or bank overdrafts are classified as cash flows from financing activities in the consolidated statements of cash flows. Outstanding checks are presented on the consolidated financial statements as a component of accounts payable and accrued expenses.

(d) Pledges Receivable

Pledges are recorded in the period that the pledges are made and represent unconditional promises to give. Pledges that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. A discount on each pledge is computed using the risk-free interest rate available at the time the pledge was made for the duration of the pledge. An allowance for uncollectible pledges receivable is determined based on a review of estimated collectibility and historical experience.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(e) *Derivative Financial Instruments*

The System uses interest rate swaps as part of its risk management strategy to manage exposure to fluctuations in interest rates and to manage the overall cost of its debt. Interest rate swaps are used to hedge identified and approved exposures. Interest rate swaps are recognized as either assets or liabilities in accordance with the netting provisions in the counterparty agreement and are measured at fair value in accordance with Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*.

For interest rate swaps that are not designated as cash flow hedges, gains or losses resulting from changes in the fair values of the interest rate swaps are reported as nonoperating gains or losses. Any differences between interest received and paid under nonhedged swap agreements are reported with the change in fair value of the swaps as nonoperating gains or losses.

For interest rate swaps that are designated and qualify as cash flow hedges, the effective portion of the gains or losses resulting from changes in the fair value is reported as a component of unrestricted net assets. The ineffective portion, if any, is reported in excess of revenues over expenses in the current period. If hedging relationships cease to be highly effective, gains or losses on the interest rate swaps would be reported in excess of revenues over expenses, and accumulated losses would be amortized into excess of revenues over expenses over the remaining life of the debt. Any differences between interest received and paid under the interest rate swap designated as a cash flow hedge is recorded as a component of interest expense.

As of December 31, 2018 and 2017, the System does not have any swaps designated as cash flow hedges.

(f) *Inventories*

Inventories include drugs and supplies and are recorded at the lower of cost or market on a first-in, first-out basis.

(g) *Bond Issue Costs*

Costs of bond issuance are deferred and amortized on a straight-line basis over the shorter of the term of the related indebtedness or related liquidity facility.

(h) *Investments in Unconsolidated Entities*

Investments in entities in which the System has the ability to exercise significant influence over operating and financial policies but does not have operational control are recorded under the equity method of accounting and included in other assets in the consolidated balance sheets. The System's share of net earnings or losses of the entities is included in other operating revenue (note 8).

(i) *Investments with Limited Uses*

Investments with limited uses are reported at fair value and include assets held by trustees for repayment of long-term debt, assets in escrow for capital projects, vendor deposits, and donor-restricted funds.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(j) Land, Buildings, and Equipment

Land, buildings, and equipment are carried at cost and depreciated using the straight-line method over their estimated useful lives. Interest cost, net of related interest income, incurred during the period for construction of capital assets is capitalized as a component of the cost of acquiring those assets and totaled \$913 and \$2,883 for 2018 and 2017, respectively.

The following useful lives are used in computing depreciation:

Land improvements	5–25 years
Buildings	25–40 years
Building additions and improvements	10–20 years
Equipment	2–15 years

(k) Deferred Income Taxes

The System's taxable subsidiaries record deferred income taxes due to temporary differences between financial reporting and tax reporting for certain assets and liabilities. The System accounts for income taxes under the asset-and-liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

The System follows ASC 740, *Income Taxes* (ASC 740), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. ASC 740 prescribes a more-likely-than-not recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken. Under ASC 740, tax positions will be evaluated for recognition, derecognition, and measurement using consistent criteria and will provide more information about the uncertainty in income tax assets and liabilities. As of December 31, 2018 and 2017, the System does not have any significant assets or liabilities recorded for uncertain tax benefits. The System has not recorded any reserves or related accruals for interest and penalties for uncertain income tax positions.

(l) Self-Insurance

The System insures its general and professional liability exposures under claims-made policies. Under these policies, the System has self-insured deductible amounts. In 2017, the System established a wholly owned captive insurance subsidiary for a portion of the self-insured deductible. Premiums paid to the captive insurance subsidiary are based on claims in the reimbursement layer and are eliminated upon consolidation. Claim payments required in excess of certain occurrence and annual aggregate amounts are covered under umbrella policies. An insurance trust has been established, which covers specific claims periods. Actuarially determined amounts are contributed to pay for the estimated cost of claims. The System also self-insures workers' compensation exposures. If claims-made policies

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

presently in force are not renewed or replaced with equivalent insurance, claims asserted after the end of the policy term will be uninsured.

The provision for estimated claims includes estimates of ultimate costs for both reported claims and claims incurred but not reported.

(m) Net Assets With Donor Restrictions

Net assets with donor restrictions are those whose use by the System has been limited by donors to a specific time period or purpose and those that are required to be maintained in perpetuity.

(n) Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. Gifts are reported as restricted if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, net assets with donor restrictions are reclassified to net assets without donor restrictions in the consolidated statements of operations and changes in net assets. In the absence of a donor specification that restricts income and gains on restricted gifts, such income and gains are reported as income of net assets without donor restrictions. In order to protect permanently restricted gifts from a loss of purchasing power, the System uses a spending rate policy to determine the portion of investment return that can be used to support operations of the current period.

The System reports gifts of equipment or other long-lived assets as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the System reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

(o) Other Operating Revenue

Other operating revenue includes income from investments in unconsolidated entities, rental income, pharmacy and ancillary sales, grant revenue, and services charged to unconsolidated entities as cost recoveries.

(p) Excess of Revenues over Expenses

Excess of revenues over expenses includes operating income and nonoperating gains and losses. Changes in net assets without donor restrictions, which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments classified as available for sale – nonequity securities and interest rate swaps designated as cash flow hedges, and changes in liability relating to defined-benefit plans not marked to market.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(q) *Investment Securities*

The System classifies its investments as trading or available-for-sale. The available-for-sale investments include debt service funds whose uses are limited. All other investments are classified as trading. Trading and available-for-sale investments, including bond funds and construction funds, are recorded at fair value. Investments in alternative investments are recorded at net asset value as a practical expedient to fair value. Unrealized gains and losses on trading securities are included in excess of revenues over expenses. Unrealized gains and losses on available-for-sale – nonequity securities are excluded from excess of revenues over expenses and are reported as a separate component of other changes in unrestricted net assets.

(r) *Fair Value Measurements*

The System utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The System determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the System follows the fair value hierarchy, as outlined in the fair value measurements and disclosures accounting guidance, which distinguishes between observable and unobservable inputs.

(s) *Reclassifications*

Certain reclassifications have been made to the 2017 consolidated financial statements to conform to the 2018 presentation. Reclassifications relate to the adoption of new accounting standards as discussed in note 2(t) below as well as correcting for an immaterial classification error identified by the System during 2018 resulting in grossing up \$46,232 of other revenue and (\$2,859) of salaries and benefits expense that was previously presented as a credit to other expense of \$49,091.

(t) *Recently Issued Accounting Standards*

The System adopted ASC 606, *Revenue from Contracts with Customers*, effective December 31, 2018 using a full retrospective approach. The standard requires an entity to recognize revenue when the entity transfers control of promised goods and services to the customer. Revenue is recognized in an amount that reflects the consideration an entity expects to receive in exchange for those goods and services. An entity is also required to disclose sufficient quantitative and qualitative information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The adoption of ASC 606 resulted in changes to the presentation and disclosure of revenue related to uninsured or underinsured patients. Prior to the adoption of ASC 606, the System presented a separate provision for bad debts related to self-pay patients, as well as copays and deductibles owed by patients with insurance. Under ASC 606, the estimated uncollectible amounts due from these patients are generally considered a direct reduction to net operating revenues and, correspondingly, result in a material reduction in the amounts presented separately as provision for bad debts. As such, the 2017 provision for bad debts of \$118,272 has been reclassified and presented as a reduction to net patient services revenue for 2018 presentation. The System also assessed the impact of the new standard on various reimbursement programs that represent variable consideration and concluded that accounting for these programs under the new standard is substantially consistent with the historical accounting practices. ASC 606 did

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

not materially impact the financial position, results of operations, or cash flows of the System and there was no cumulative effect of a change in accounting principle recorded related to the adoption.

ASC 958 – *Not-for-Profit Entities* (ASC 958), was adopted by the System effective December 31, 2018 with retroactive application. ASC 958 changed the way a not-for-profit entity (NFP) classifies and presents net assets on the face of the financial statements and presents information in the financial statements and notes about the NFP's liquidity, financial performance, and cash flows. The amendment changed the way the System reports classes of net assets, from the previously required three classes to two. As a result of this adoption, 2017 temporarily restricted net assets of \$115,478 and permanently restricted net assets of \$55,880 have been combined for presentation in 2018 as net assets with donor restrictions. The standard did not have a material effect on the consolidated financial statements, other than the additional disclosure required by the standard.

Effective December 31, 2018, the System adopted Financial Accounting Standards Board Accounting Standards Update, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost* (ASU 2017-07). As a result of adopting the standard, the System reclassified the component of net benefit cost, excluding the service cost component, totaling \$2,343 from salaries and benefits to other nonservice periodic pension costs in the consolidated statements of operations and changes in net assets for the year ended December 31, 2017.

ASC 842 – *Leases* (ASC 842) was adopted by the System effective January 1, 2019. ASC 842 requires lessees to recognize leases on balance sheet and disclose key information about leasing arrangements. The new standard establishes a right-of-use (ROU) model that requires a lessee to recognize an ROU asset and lease liability on the balance sheet for all leases with a term longer than 12 months. Leases are classified as finance or operating, with classification affecting the pattern and classification of the expense recognition in the statement of operations. As of January 1, 2019, the System recorded ROU assets of approximately \$190,000 and a corresponding leasing obligation of the same amount as part of the adoption. The System also derecognized assets of \$8,620 and a financing obligation of \$17,024 for a historical build-to-suit transaction that had a failed sale-leaseback as part of the adoption.

(3) Net Patient Service Revenue

Net patient service revenue is reported at the amount that reflects the consideration to which the System expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payers (managed care and government programs), and others and includes variable consideration for retroactive revenue adjustments due to settlement of audits, reviews, and investigations. Revenue is recognized as performance obligations are satisfied.

Performance obligations are determined based on the nature of the services provided. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred in relation to total charges. Performance obligations satisfied over time relate to inpatient acute care services. Revenue for performance obligations satisfied at a point in time is recognized when goods or services are provided and the System does not believe it is required to provide additional goods or services to the patient. Performance obligations for patients that are in house at period end generally complete within days or possibly weeks of period end therefore are estimated on a pro rata basis.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

The System determines the transaction price based on standard charges for goods and services provided, reduced by contractual adjustments provided to third-party payers, discounts provided to uninsured patients in accordance with the System's policy, and/or implicit price concessions provided to uninsured patients. Estimates of contractual adjustments and discounts are based on contractual agreements, its discount policy (or policies), and historical experience. Estimate of implicit price concessions are based on its historical collection experience with this class of patients.

Agreements with third-party payers typically provide for payments at amounts less than established charges. A summary of the payment arrangements with major third-party payers follows:

- **Medicare:** Certain inpatient acute care services are paid at prospectively determined rates per discharge based on clinical, diagnostic, and other factors. Certain services are paid based on cost-reimbursement methodologies subject to certain limits. Physician services are paid based upon established fee schedules. Outpatient services are paid using prospectively determined rates.
- **Medicaid:** Reimbursements for Medicaid services are generally paid at prospectively determined rates per discharge, per occasion of service, or per covered member.
- **Other:** Payment agreements with managed care payers provide for payment using prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates, shared savings, pay for performance, care management, or medical home management per patient fees.

Laws and regulations concerning government programs, including Medicare and Medicaid, are complex and subject to interpretation. Compliance with such laws and regulations may also be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and potential exclusion from the related programs. There can be no assurance that regulatory authorities will not challenge the System's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon the System. In addition, contracts with commercial payers also provide for retroactive audit and review of claims.

Settlements with third-party payers for retroactive adjustments due to audits, reviews, or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payer, correspondence from the payer and historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known (that is, new information becomes available), or as years are settled or are no longer subject to such audits, reviews, and investigations. The System utilizes a process to identify and appeal certain settlements by government payers. Additional reimbursement is recorded in the year the appeal is successful. During 2018 and 2017, successful appeals, cost report settlements, and other adjustments to prior year estimates of variable consideration resulted in an increase in net patient service revenue of \$17,556 and \$21,529, respectively.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

Generally patients who are covered by third-party payers are responsible for related deductibles and coinsurance, which vary in amount. The System also provides services to uninsured patients, and offers those uninsured patients a discount, either by policy or law, from standard charges. The System estimates the transaction price for patients with deductibles and coinsurance and from those who are uninsured based on historical experience and current market conditions. The initial estimate of the transaction price is determined by reducing the standard charge by any contractual adjustments, discounts, and implicit price concessions. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change,

The System provides care to patients regardless of their ability to pay. Therefore, the System has determined it has provided implicit price concessions to uninsured patients and patients with other uninsured balances (for example, copays and deductibles). The implicit price concessions included in estimating the transaction price represent the difference between amounts billed to patients and the amounts the System expects to collect based on its collection history with those patients.

Patients who meet the System's criteria for charity care are provided care without charge or at amounts less than established rates. Such amounts determined to qualify as charity care are not reported as revenue.

Net patient service revenue recognized in the period by type of service is as follows:

	2018	2017
Inpatient	\$ 1,641,666	1,554,550
Outpatient/ambulatory	1,398,365	1,322,238
Clinic	1,012,180	955,848
Transitional rehabilitation program	19,503	19,067
	\$ 4,071,714	3,851,703

Net patient service revenue net of explicit allowances and discounts (but before implicit price concessions) recognized in the period by major payer is as follows:

	2018	2017
Medicare and Medicaid	41 %	41 %
Managed care	54	54
Commercial and other	3	2
Self-pay	2	3
	100 %	100 %

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

The System grants credit without collateral to its patients, most of whom are residents in the communities that it serves and are insured under third-party payer agreements. The mix of net patient accounts receivable by major payer as of December 31 consists of the following:

	<u>2018</u>	<u>2017</u>
Medicare and Medicaid	38 %	36 %
Managed care	45	40
Commercial and other	9	14
Self-pay	<u>8</u>	<u>10</u>
	<u>100 %</u>	<u>100 %</u>

Two managed care payers accounted for approximately 36% and 37% of net patient service revenue in 2018 and 2017, respectively. Amounts due from these two managed care payers accounted for approximately 25% and 26% of net patient accounts receivable at December 31, 2018 and 2017, respectively.

(4) Community Benefits

The System follows Internal Revenue Service reporting guidelines for categories of community benefit provided in the service areas of the System. The major components are defined below.

(a) Cost of Providing Charity Care (Also Referred to as Financial Assistance)

The System provides medical care without charge or at reduced cost to residents of the communities that it serves through the provision of charity care. Policies have been established to identify charity care cases that meet certain guidelines for a patient's ability to pay for services. The cost of providing charity care is measured by applying a cost-to-charge ratio to the charges identified as charity care.

(b) Costs in Excess of Medicaid Payments

The System provides services to public program enrollees (Medicaid). Such public programs typically reimburse at amounts less than cost.

(c) Medicaid Surcharge

The System is a participant in the Medicaid Surcharge program. The current program includes a 1.56% surcharge on a hospital's net patient service revenue (excluding Medicare revenue). Reported amounts are net of any disproportionate share adjustments.

(d) Costs of Other Means-Tested Government Programs (MinnesotaCare Tax)

The System also participates in the funding of medical care for the uninsured through a MinnesotaCare tax of 2% on certain net patient service revenue. Patients who are unable to get insurance through their employer are eligible to participate in MinnesotaCare.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(e) Community Health Improvement Services

In the furtherance of its charitable purpose, the System provides a wide variety of community health improvement programs and activities to the various communities that it serves in response to specific needs within those communities. Examples are programs and activities designed to improve the quality of life and build healthier communities. Community services activities include, but are not limited to, health screenings, support counseling for patients and families, crisis intervention, health enhancement and wellness programs, classes on specific conditions, and telephone information services. Examples of community benefit and engagement programs operated by the System include Backyard Initiative, Free Bikes 4 Kidz, Neighborhood Health Connection, Health Powered Kids, and Change to Chill.

(f) Subsidized Health Services

The System provides necessary health care services, which include 24-hour emergency services to the community and behavioral health services. These clinical services are provided despite financial losses so significant that negative margins remain after removing the effects of charity care and Medicaid shortfalls. These services are provided because they meet an identified community need and, if no longer offered, would either be unavailable in the area or fall to the responsibility of government or another not-for-profit organization to provide.

(g) Health Profession Education

The System provides education and training programs and financial assistance for providers, health care students, and other health professionals.

(h) Research

The System participates in clinical and community health research that is shared with the health care community, including clinical research related to integrative medicine and cancer interventions, as well as community health research related to care model innovations and population health. Research costs are reported net of restricted grants designated and released for research purposes for the reporting of community benefit.

(i) Cash and In-Kind Contributions

The System donates funds and in-kind services to individuals and/or the community at large and other not-for-profit organizations. Examples are the donation of space for use by community groups, event sponsorships, donation of food, equipment and supplies, and grants.

(j) Other Community Benefit Cost

The System allocates staff time to manage community benefit reporting, assess community benefit programs and needs, and develop and implement programs and activities in response to those needs.

The System contributes additional resources to the communities in which it provides services. The major components are defined below:

Costs in Excess of Medicare Payments – The System provides services to public program enrollees (Medicare). Such public programs typically reimburse at amounts less than cost.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

Other Care Provided without Compensation (Implicit Price Concessions) – The System provides medical care in which charges are uncollected beyond what is provided under the definition of charity care.

Discounts Offered to Uninsured Patients – The hospitals in the System provide a discount on billed charges for medically necessary care delivered to patients who are uninsured and ineligible for government programs or otherwise medically indigent. The unbilled portion of uninsured care is excluded from net patient service revenue.

Taxes and Fees – The System pays property taxes to local and state government used in funding civil and education services to the community.

Community Building – The System engages in community activities that address root causes of health problems, such as poverty, homelessness, and environmental issues by participating in activities, including economic development work, workforce development, public safety efforts, and community health improvement work.

The following is an estimate of the community benefits provided by the System:

	<u>2018</u>	<u>2017</u>
Cost of providing charity care (charges foregone of \$50,028 and \$48,965, respectively)	\$ 20,700	20,700
Costs in excess of Medicaid payments	45,000	38,500
Medicaid surcharge	26,000	25,400
MinnesotaCare tax	53,700	51,100
Community health improvement services	8,500	8,800
Subsidized health services	4,900	7,700
Health professions education	15,700	19,600
Research	2,800	3,800
Cash and in-kind contributions	5,700	3,000
Other community benefit cost	<u>4,000</u>	<u>4,200</u>
Total cost of community benefit	187,000	182,800
Costs in excess of Medicare payments	258,200	255,900
Other care provided without compensation (implicit price concession)	108,300	118,300
Discounts offered to uninsured patients	39,100	35,600
Taxes and fees	4,700	4,600
Community building	<u>300</u>	<u>300</u>
Total value of community contributions	<u>\$ 597,600</u>	<u>597,500</u>

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(5) Cash and Cash Equivalents and Investments

As of December 31, cash and cash equivalents and investments, including those with limited uses, consist of the following:

	2018	2017
Cash and cash equivalents	\$ 135,580	147,520
Money market collective fund and short-term fixed income	32,394	58,184
Fixed income	1,083,870	1,022,956
Equity securities	336,027	416,800
Real return mutual fund	145,404	133,397
Investments accounted for at net asset value	658,824	633,771
	<u>\$ 2,392,099</u>	<u>2,412,628</u>

The System holds cash balances that optimize large and predictable cash flows. To efficiently manage liquidity and capital, the System continually determines the necessary amount of cash and cash equivalents to hold in cash and money market funds to meet operational needs, and allocates the excess to a separate investment account that is expected to generate higher yielding returns while still maintaining a high degree of liquidity and a focus on capital preservation. As added insurance, a line of credit is also maintained in the unlikely event there is an unexpected immediate cash need (note 11). In relation to the long-term investments of the System, approximately 90% of the funds can be liquidated within one month and approximately 5.25% may be liquid between one to two years, although access to these funds can be attained in less than one year if a penalty is paid.

As of December 31, unrestricted financial assets, reduced by amounts that are considered to be illiquid within one year, consist of the following:

	2018	2017
Cash and cash equivalents	\$ 135,580	147,520
Short-term investments	278,587	404,934
Patient accounts receivable, net	511,662	506,044
Long-term investments	1,824,119	1,701,240
Less assets with liquidity over one year	<u>(70,197)</u>	<u>(66,247)</u>
	<u>\$ 2,679,751</u>	<u>2,693,491</u>

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

Certain investments are held for the following limited uses as of December 31:

	2018	2017
By trustee for repayment of long-term debt	\$ 56	87
By trustee for swap collateralization	—	2,920
Donor-restricted funds	151,314	153,484
Vendor deposits	2,443	2,443
	<u>\$ 153,813</u>	<u>158,934</u>

Total investment return consists of the following:

	2018	2017
Investment earnings in unrestricted net assets:		
Interest and dividend income	\$ 46,168	31,810
Realized gains on investments	19,060	2,086
Change in unrealized gains and losses on investments	(124,875)	132,898
	<u>(59,647)</u>	<u>166,794</u>
Investment earnings in restricted net assets:		
Interest and dividend income	2,562	1,038
Realized gains on investments	1,369	4,644
Change in unrealized gains and losses on investments	(9,190)	7,140
	<u>(5,259)</u>	<u>12,822</u>
	<u>\$ (64,906)</u>	<u>179,616</u>

Total investment return is reported in the consolidated statements of operations and changes in net assets as follows:

	2018	2017
Nonoperating gains	\$ (59,647)	166,794
Changes in net assets with donor restrictions	(5,259)	12,822
	<u>\$ (64,906)</u>	<u>179,616</u>

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

(6) Other Current Assets

Other current assets as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Pledges and notes receivable	\$ 2,472	3,177
Prepaid expenses	21,719	15,387
Third-party payer settlement receivables	27,274	12,851
Other miscellaneous receivables	61,263	68,044
	<u>\$ 112,728</u>	<u>99,459</u>

(7) Land, Buildings, and Equipment

Land, buildings, and equipment as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Land and land improvements	\$ 96,798	98,462
Buildings	1,696,524	1,626,638
Equipment	1,653,535	1,634,570
	3,446,857	3,359,670
Less accumulated depreciation and amortization	2,273,579	2,190,506
	1,173,278	1,169,164
Construction in progress	50,550	52,528
	<u>\$ 1,223,828</u>	<u>1,221,692</u>

(8) Other Assets

Other assets as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Cash surrender value of insurance policies	\$ 4,040	4,477
Pledges and notes receivable, less current portion	4,460	19,201
Investment in unconsolidated entities	104,990	121,165
Deferred compensation	164,440	174,704
Other	47,218	17,641
	<u>\$ 325,148</u>	<u>337,188</u>

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

The following table represents the System's investment in and share of net earnings of unconsolidated entities recorded under the equity method of accounting as of and for the years ended December 31:

	Percentage ownership	Equity investment		Distributions received		Share of net earnings	
		2018	2017	2018	2017	2018	2017
St. Francis Regional Medical Center	47.50 %	\$ 56,780	49,704	—	(9,001)	7,076	11,171
Other entities	10%–50%	48,210	71,461	(6,282)	(15,168)	1,666	17,260
		<u>\$ 104,990</u>	<u>121,165</u>	<u>(6,282)</u>	<u>(24,169)</u>	<u>8,742</u>	<u>28,431</u>

The following table reflects summarized financial information for St. Francis Regional Medical Center as of and for the years ended December 31:

	2018	2017
Total assets	\$ 189,378	175,734
Total liabilities	<u>63,574</u>	<u>64,991</u>
Total net assets	<u>\$ 125,804</u>	<u>110,743</u>
Total revenue	\$ 170,733	159,843
Total operating expenses	153,900	142,339
Total investment return and other nonoperating	<u>(1,956)</u>	<u>5,864</u>
Excess of revenues over expenses	<u>\$ 14,877</u>	<u>23,368</u>

The following table reflects summarized financial information for all other entities as of and for the years ended December 31 (Unaudited):

	2018	2017
Total assets	\$ 198,462	218,103
Total liabilities	<u>68,892</u>	<u>121,434</u>
Total net assets	<u>\$ 129,570</u>	<u>96,669</u>
Total revenue	\$ 139,301	159,503
Total operating expenses	130,928	135,477
Total investment return and other nonoperating	<u>(1,545)</u>	<u>(640)</u>
Excess of revenues over expenses	<u>\$ 6,828</u>	<u>23,386</u>

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

(9) Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Outstanding checks	\$ 72,937	43,525
Trade accounts payable	55,507	76,431
Accrued payroll, taxes, and vacation	192,739	196,117
MinnesotaCare tax payable	17,851	16,596
Other	114,588	106,704
	<u>\$ 453,622</u>	<u>439,373</u>

(10) Other Current Liabilities

Other current liabilities as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Current portion of estimated reserves for professional and general liability claims	\$ 14,752	10,586
Current portion of estimated reserves for workers' compensation claims	12,175	12,484
Employee health plan claims incurred but not reported	19,082	19,540
Defined-contribution retirement plan	47,607	45,452
Due to third-party payers	16,558	16,268
	<u>\$ 110,174</u>	<u>104,330</u>

(11) Long-Term Debt

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

	<u>2018</u>	<u>2017</u>
Fixed Rate Revenue Bonds, Series 2009A-1 (Allina Health System), maturing annually through 2029 annual interest rates from 4.50% to 5.25%	\$ 49,715	51,915
Fixed Rate Revenue Bonds, Series 2009A-2 (Allina Health System), maturing annually through 2028 annual interest rate from 3.25% to 5.50%	34,760	34,940

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

	<u>2018</u>	<u>2017</u>
Variable Rate Revenue Bonds, Series 2009B and C (Allina Health System), Variable Rate Demand Notes maturing annually through 2035, annual interest rate of 1.38% during 2018 and 0.80% during 2017; and 1.74% and 1.76% at December 31, 2018 and 2017, respectively	\$ 164,525	164,525
Variable Rate Revenue Bonds, Series 2007C (Allina Health System), Variable Rate Demand Notes maturing annually through 2034, average annual interest rate of 1.42% during 2018 and 0.83 during 2017 and 1.70% and 1.73% at December 31, 2018 and 2017, respectively	118,300	119,125
Variable Rate Revenue Bonds, Series 1998A (Allina Health System) Periodic Auction Reset, maturing annually through 2022 average annual interest rate of 2.74% during 2018 and 1.50% during 2017; 3.55% and 2.15% at December 31, 2018 and 2017, respectively	14,575	14,575
Fixed Rate Taxable Bonds, Series 2015 (Allina Health System), maturing annually through 2045 annual interest rate of 4.805%	250,000	250,000
Fixed Rate Health Care Facilities Revenue Note, Series 2014 (Allina Health System), maturing annually through 2028 annual interest rate of 3.01%	17,300	17,710
Fixed Rate Revenue Bonds, Series 2017A (Allina Health System), maturing annually through 2029 annual interest rate of 5.00%	78,515	78,515
Fixed Rate Health Care Facilities Revenue Note, Series 2017B (Allina Health System), maturing annually through 2022 annual interest rate of 2.13%	57,590	77,845
Fixed Rate Taxable Bonds, Series 2017 (Allina Health System), maturing annually through 2047 annual interest rate of 4.43%	150,000	150,000
Other	6,841	9,139
	942,121	968,289
Unamortized portion of original issue premium	11,897	12,995
Unamortized deferred financing	(5,642)	(6,001)
Current portion	(27,491)	(26,235)
	<u>\$ 920,885</u>	<u>949,048</u>

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

Certain divisions of the System are members of the Allina Obligated Group (Obligated Group), which is subject to the terms and conditions of the Master Trust Indenture dated October 1, 1998, as amended, between the System and Wells Fargo Bank Minnesota, National Association, and is jointly and severally liable for any debts and/or other obligations of each Obligated Group member and the Obligated Group as a whole. The Obligated Group members include the hospitals, nonhospital specialty care services, and certain physician clinics. The System also operates several wholly owned direct and indirect subsidiaries outside of the Obligated Group, including clinics and foundations.

In November 2017, the City of Minneapolis, on behalf of the System, issued fixed-rate Revenue Refunding Bonds, Series 2017B, in the aggregate principal amount of \$77,845. The 2017B Bonds are secured by the Obligated Group's pledged revenue and was used to refinance the Series 2007A Fixed Rate Revenue Bonds. The gain on the refinancing of the debt was \$1,769.

In April 2017, the System issued a fixed-rate Taxable Bond, Series 2017, in the aggregate principal amount of \$150,000. The 2017 Bonds are secured by the Obligated Group's pledged revenue and were issued for the purpose of funding new projects and strategic initiatives.

In April 2017, the City of Minneapolis and the Housing and Redevelopment Authority of the City of Saint Paul, on behalf of the System, issued fixed-rate Revenue Bonds, Series 2017A, in the aggregate principal amount of \$78,515. The 2017A Bonds are secured by the Obligated Group's pledged revenue and were used to refinance and legally defease, in part, the Series 2009A-1 and 2009A-2 Bonds. The loss on the refinancing of the debt was \$8,536.

The Series 2009B and C Bonds are secured by letters of credit issued by two banks. Repayment of draws against the letters is secured by term credit agreements with the banks in the amount of \$114,525, which expires on January 4, 2021, and \$50,000, which expires on January 4, 2021. If the bonds were put and not remarketed, the banks would be required to purchase the bonds. Draws under the term credit agreements to repay the banks for the purchase of the bonds are payable in an amount equal to the principal payments necessary to repay the draws over five years in equal quarterly installments, beginning 367 days after the draw, based on the bank's base rate plus 2.00%.

Payment of principal and interest on the Series 1998A Bonds is insured. Interest rates on the variable rate Series 1998A is determined by auction. If an auction fails, interest rates payable to the existing bondholders are determined by a formula incorporated in the bond documents for these two series of bonds.

On June 18, 2008, the System completed a conversion of the Series 2007C Bonds from auction rate securities to variable-rate demand bonds. This conversion included the insurer's consent to remove the insurance and for a bank to support the bonds with a direct pay letter of credit. Repayment of draws against the letter is secured by a term credit agreement with the bank in the aggregate amount of \$118,300, which expires on January 4, 2021. If the bonds were put and not remarketed, the bank would be required to purchase the bonds. Draws under the term credit agreement to repay the bank for the purchase of the bonds are payable in an amount equal to the principal payments necessary to repay the draws over five years, beginning 367 days after the draw, based on the bank's base rate plus 2.00%.

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

Aggregate annual maturities of long-term debt and mandatory sinking fund requirements, as stated under the actual debt terms, for each of the five years and thereafter following December 31, 2018 are as follows:

2019	\$	27,491
2020		27,272
2021		26,832
2022		27,425
2023		29,117
Thereafter		803,984

Aggregate principal payments of long-term debt based on the variable-rate demand notes being put back to the System and a corresponding draw being made on underlying liquidity facilities for each of the five years and thereafter following December 31, 2018 are as follows:

2019	\$	27,491
2020		82,886
2021		82,422
2022		82,940
2023		78,357
Thereafter		588,025

The System uses interest rate swaps as a part of its risk management strategy to manage exposure to fluctuations in interest rates and to manage the overall cost of its debt. Four of the five interest rate swaps are used to hedge identified debt, or interest rate exposures, and are not used for speculative purposes. One of the interest rate swaps was established for speculative purposes and is not tied directly to outstanding debt.

As of December 31, 2018, the System was not required to post collateral. As of December 31, 2017, the System posted collateral of \$2,920, related to one of the System's swaps due to changes in interest rates. The following table provides details regarding the System's fair value of the derivative instruments at December 31, 2018, none of which are designated as cash flow hedging instruments:

Fixed payer interest rate swaps							
Swap	Balance sheet location	Fair value	Notional amount outstanding	Rate paid	Rate received	Average rate received in 2018	Counterparty
2009BC	Other liabilities	\$ 8,978	41,131	3.74 %	% of LIBOR	1.52 %	Wells Fargo
2009BC	Other liabilities	26,861	123,394	3.73	% of LIBOR	1.52	JP Morgan
2007C	Other liabilities	18,924	118,300	3.58	% of LIBOR	1.44	US Bank
2001	Other liabilities	13,193	50,000	5.17	SIFMA	1.42	Goldman Sachs
1998A	Other liabilities	726	15,075	4.44	SIFMA	1.42	Goldman Sachs
Total		<u>\$ 68,682</u>	<u>347,900</u>				

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

The following table provides details regarding the System's fair value of the derivative instruments at December 31, 2017, none of which are designated as cash flow hedging instruments:

Fixed payer interest rate swaps							
Swap	Balance sheet location	Fair value	Notional amount outstanding	Rate paid	Rate received	Average rate received in 2017	Counterparty
2009BC	Other liabilities	\$ 10,431	41,131	3.74 %	% of LIBOR	1.00 %	Wells Fargo
2009BC	Other liabilities	31,217	123,394	3.73	% of LIBOR	1.00	JP Morgan
2007C	Other liabilities	22,671	119,125	3.58	% of LIBOR	0.16	US Bank
2001	Other liabilities	15,318	50,000	5.17	SIFMA	0.66	Goldman Sachs
1998A	Other liabilities	1,215	15,075	4.44	SIFMA	0.66	Goldman Sachs
Total		<u>\$ 80,852</u>	<u>348,725</u>				

The following table provides details regarding the gains (losses) from the System derivative instruments in the consolidated statements of operations and changes in net assets, none of which are currently designated as hedging instruments. The 1998A swap was designated as a hedging instrument until December 31, 2008.

	Amount of gain on change in fair value recognized as nonoperating: gains on interest rate swap agreements		Amount of loss reclassified from unrestricted net assets into revenues over expenses as nonoperating: losses on interest rate swap agreements		Amount of interest paid to counterparty recognized as nonoperating: losses on interest rate swap agreements		Total	
	2018	2017	2018	2017	2018	2017	2018	2017
2009BC \$	5,808	1,672	—	—	(3,711)	(4,557)	2,097	(2,885)
2007C	3,747	1,855	—	—	(2,567)	(3,281)	1,180	(1,426)
2001	2,126	771	—	—	(1,908)	(2,190)	218	(1,419)
1998A	489	490	(874)	(874)	(457)	(542)	(842)	(926)
\$	<u>12,170</u>	<u>4,788</u>	<u>(874)</u>	<u>(874)</u>	<u>(8,643)</u>	<u>(10,570)</u>	<u>2,653</u>	<u>(6,656)</u>

The System records the swaps' liability at fair value, which requires nonperformance risk (i.e., credit risk), to be included in the valuation. Nonperformance risk is defined as the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. This nonperformance risk is determined by adjusting the discounting rate by a credit spread as of the reporting date. The addition of the credit spread to the discounting rate reduces the reported liability. Because of market volatility, the fair value reported liability of the swaps is \$960 and \$1,809 less as of December 31, 2018 and 2017, respectively, than the mark-to-market valuations (note 14).

Interest paid, net of amounts capitalized, was \$34,032 and \$30,193 during 2018 and 2017, respectively.

The System has a Revolving Credit Agreement with Wells Fargo Bank through June 17, 2019, which consists of a line of credit of \$26,000. The interest rate on the line of credit is the Reserve Adjusted London Interbank Offered Rate (LIBOR) plus 0.50% and is secured by a note under the 1998 Master Trust Indenture. The unused line fee for the revolving line of credit is 0.15% per annum. The System had

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

insurance-related letters of credit applied against the line of credit in the amount of \$4,489 at December 31, 2018 and 2017. There were no draws on the line of credit at December 31, 2018 and 2017.

(12) Other Liabilities

Other liabilities as of December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Estimated reserves for professional and general liability claims, less current portion	\$ 55,059	40,678
Estimated reserves for workers' compensation claims, less current portion	30,850	31,021
Net pension and postretirement liability	17,338	21,575
Interest rate swaps payable	68,682	80,852
Deferred compensation	186,425	197,860
Leasehold incentive allowance	14,910	15,797
Financing obligation	17,024	17,024
Other	14,961	17,050
	<u>\$ 405,249</u>	<u>421,857</u>

(13) Net Assets With Donor Restrictions

Net assets with donor restrictions have been restricted by donors for the following purposes as of December 31:

	<u>2018</u>	<u>2017</u>
Capital	\$ 4,487	13,236
Charity and indigent care	4,756	5,191
Education and research	24,729	26,255
Patient care	23,281	21,433
Other	41,797	49,363
	<u>\$ 99,050</u>	<u>115,478</u>

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

In addition, the System holds net assets with donor restrictions that are permanently endowed and only the income is available for designated purposes. Income on the following endowments is restricted for the following purposes as of December 31:

	2018	2017
Capital	\$ 165	128
Charity and indigent care	1,806	1,806
Education and research	19,031	19,014
Patient care	12,341	12,339
Other	22,656	22,593
	<u>\$ 55,999</u>	<u>55,880</u>

(14) Fair Value Measurements

The System's investments include money market, fixed income, and equity securities, which are carried at fair value based on quoted market prices and are classified as trading securities. Investment securities are exposed to various risks, such as interest rate, credit, and overall market volatility. In addition, the System invests in limited partnerships, limited liability partnerships, limited liability companies, and corporations that hold interests in hedge funds, private equity funds, and other commingled funds, which are accounted for at net asset value as a practical expedient to fair value, and the System recognizes the increase or decrease in the partnerships' net asset value in nonoperating gains (losses). The System generally has liquidity ranging from 30 to 90 days in limited partnerships and better than 30-day liquidity in commingled trusts. Certain of the underlying partnerships may hold some securities without readily determinable fair values.

For all financial instruments other than investments, derivatives, and long-term debt (note 11), the carrying value is a reasonable estimate of fair value because of the short-term nature of the financial instruments.

Realized gains and losses on investments, interest, dividends, and declines in investment value determined to be other than temporary are recorded as nonoperating gains (losses) unless the investment return is restricted by donor or law. Changes in unrealized gains and losses that are considered temporary are recorded as nonoperating gains (losses) for investments classified as trading and as other changes in unrestricted net assets for investments classified as available for sale – nonequity securities. Investment return restricted by donor or law is recorded as changes in restricted net assets.

The System determines the fair value of its financial instruments based on the fair value hierarchy established in ASC Topic 820, *Fair Value Measurement*, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 inputs: Quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date

Level 2 inputs: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly through corroboration with observable market data

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

Level 3 inputs: Unobservable inputs for the asset or liability, that is, inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing an asset or a liability (including risk assumptions) developed based on the best information available in the circumstances

Inputs and valuation techniques for significant other observable and significant unobservable inputs are as follows:

For Level 2 and Level 3 cash equivalents and fixed-income assets that rely on significant other observable inputs and significant unobservable inputs, the System employs multiple third-party information providers to help determine the fair value of the assets. Level 2 and Level 3 securities in separately managed accounts are held at Bank of New York Mellon (BNYMellon), who acts as trustee and custodian for the assets. As custodian, BNYMellon uses multiple pricing services to value the assets. The investment managers utilize their own pricing services and valuation processes. Any significant discrepancies between custodian and investment manager values are reconciled on a monthly basis by the managers and BNYMellon. The System also employs an investment consultant who researches significant pricing differences between the manager and custodian on a security-by-security basis. The consultant will notify the custodian of any significant pricing issues.

For limited partnership assets and commingled monthly valued funds, the System utilizes net asset value per share or its equivalent to determine the fair value of the assets. The System has the ability to redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date, subject to notification period and other requirements specific to each investee.

The System's financial assets and liabilities that are measured at fair value on a recurring basis were recorded using the fair value hierarchy at December 31, 2018 as follows:

	Total	Fair value measurements using		
		Level 1	Level 2	Level 3
Cash and cash equivalents:				
Cash	\$ 30,265	30,265	—	—
Money market funds	105,315	105,315	—	—
Total cash and cash equivalents	135,580	135,580	—	—
Short-term and long-term investments – trading securities:				
Short-term fixed income	2,928	2,551	377	—
Money market fund	19,019	19,019	—	—
Total short-term fixed income and money market	21,947	21,570	377	—

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

		Fair value measurements using		
	Total	Level 1	Level 2	Level 3
Equity:				
Financials	\$ 22,297	22,297	—	—
Consumer	11,407	11,407	—	—
Industrials	9,457	9,457	—	—
Technology	1,435	1,435	—	—
Healthcare	2,248	2,248	—	—
Global equity funds	253,847	92,767	161,080	—
Other equity	14,786	12,814	1,972	—
Total equity	315,477	152,425	163,052	—
Fixed income:				
U.S. Treasury securities	81,480	81,480	—	—
U.S. Agency securities	156,709	—	156,709	—
Corporate bonds	192,693	—	192,693	—
Mortgage, commercial, and asset-backed securities	93,609	—	93,609	—
Sovereigns	3,778	—	3,778	—
Term loan/private placement	81,715	—	80,973	742
Unconstrained fixed income mutual funds	371,866	371,866	—	—
Other	28,388	71	28,317	—
Total fixed income	1,010,238	453,417	556,079	742
Other investments – real return mutual fund	136,512	136,512	—	—
Total investments accounted for at net asset value *	618,532			
Total investments – trading securities	2,102,706	763,924	719,508	742
Investments with limited uses – trading securities:				
Short-term fixed income	176	151	25	—
Money market collective fund	10,215	10,215	—	—
Equity	20,550	9,929	10,621	—
Fixed income	65,807	29,536	36,223	48
Real return funds	8,892	8,892	—	—
Restricted foundation trusts (fixed income)	7,825	—	7,825	—
Investments accounted for at net asset value *	40,292			
Total investments with limited uses – trading securities	153,757	58,723	54,694	48

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

	Total	Fair value measurements using		
		Level 1	Level 2	Level 3
Investments with limited uses – available-for-sale securities:				
Money market fund	\$ 56	56	—	—
Total investments with limited uses – available-for-sale securities	56	56	—	—
Total investments with limited uses	153,813	58,779	54,694	48
Total	\$ 2,392,099	958,283	774,202	790
Liabilities:				
Interest rate swaps	\$ 68,682	—	68,682	—

* Certain investments that are measured at fair value using the net asset value per share (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to amounts presented in the statements of consolidated balance sheets.

	Fair value measurements, Level 3
Balance, December 31, 2017	\$ 392
Total realized and unrealized losses included in excess of revenues over expenses	(26)
Purchases	675
Sales	(251)
Balance, December 31, 2018	\$ 790

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

The System's financial assets and liabilities that are measured at fair value on a recurring basis were recorded using the fair value hierarchy at December 31, 2017 as follows:

		Fair value measurements using		
	Total	Level 1	Level 2	Level 3
Cash and cash equivalents:				
Cash	\$ 41,153	41,153	—	—
Money market funds	106,367	106,367	—	—
Total cash and cash equivalents	147,520	147,520	—	—
Short-term and long-term investments – trading securities:				
Short-term fixed income	2,528	1,550	978	—
Money market fund	39,090	39,090	—	—
Total short-term fixed income and money market	41,618	40,640	978	—
Equity:				
Financials	27,463	27,463	—	—
Consumer	15,366	15,366	—	—
Industrials	14,646	14,646	—	—
Technology	1,769	1,769	—	—
Healthcare	3,035	3,035	—	—
Global equity funds	306,400	105,098	201,302	—
Other equity	21,110	18,094	3,016	—
Total equity	389,789	185,471	204,318	—
Fixed income:				
U.S. Treasury securities	177,057	177,057	—	—
U.S. Agency securities	170,864	—	170,864	—
Corporate bonds	183,196	—	183,196	—
Mortgage, commercial, and asset-backed securities	85,289	—	85,289	—
Sovereigns	4,615	—	4,615	—
Term loan/private placement	75,550	—	75,183	367
Unconstrained fixed income mutual funds	225,136	225,136	—	—
Other	26,964	—	26,964	—
Total fixed income	948,671	402,193	546,111	367
Other investments – real return mutual fund	133,397	133,397	—	—
Total investments accounted for at net asset value *	592,699	—	—	—
Total investments – trading securities	2,106,174	761,701	751,407	367

ALLINA HEALTH SYSTEM
Notes to Consolidated Financial Statements
December 31, 2018 and 2017
(Dollars in thousands)

		Fair value measurements using		
	Total	Level 1	Level 2	Level 3
Investments with limited uses – trading securities:				
Short-term fixed income	\$ 107	62	45	—
Money market collective fund	16,371	16,371	—	—
Equity	27,011	12,852	14,159	—
Fixed income	57,096	25,114	31,957	25
Real return funds	9,244	9,244	—	—
Restricted foundation trusts (fixed income)	7,945	—	7,945	—
Investments accounted for at net asset value *	55,022	—	—	—
Total investments with limited uses – trading securities	172,796	63,643	54,106	25
Investments with limited uses – available-for-sale securities:				
Money market fund	88	88	—	—
Total investments with limited uses – available-for-sale securities	88	88	—	—
Total investments with limited uses	172,884	63,731	54,106	25
Total	\$ 2,426,578	972,952	805,513	392
Liabilities:				
Interest rate swaps	\$ 80,852	—	80,852	—

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

- * Certain investments that are measured at fair value using the net asset value per share (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to amounts presented in the statements of consolidated balance sheets.

	Fair value measurements, Level 3
Balance, December 31, 2016	\$ 529
Total realized and unrealized losses included in excess of revenues over expenses	(20)
Purchases	555
Sales	(672)
Balance, December 31, 2017	<u>\$ 392</u>

There were no significant transfers into or out of Level 1, Level 2, or Level 3 securities during the years ended December 31, 2018 and 2017.

Fair value measurements of investments in certain entities that calculate net asset value per share (or its equivalent), including restricted and unrestricted assets, as of December 31, 2018 and 2017 are as follows:

	December 31, 2018				
	Net asset value	Unfunded commitments	Redemption frequency (if currently eligible)	Redemption notice period	Redemption settlement period
Global bonds fund	\$ 96,213	—	Monthly	15 days	Up to 30 days
Global equity fund	111,007	—	Daily/bimonthly	10 days	Up to 5–10 days
Emerging markets equity fund	78,084	—	Daily/weekly	5/10 days	Up to 7–10 days
Equity long/short hedge funds	86,831	—	Monthly/quarterly	30–90 days	Up to 10–90 days
Opportunistic fixed-income hedge funds	177,934	—	Quarterly	45–90 days	1–90 days
Private equity funds	74,770	109,805	Not redeemable	NA	NA
Emerging market debt fund	33,985	—	Daily	Same day	Up to 15 days
Total	<u>\$ 658,824</u>	<u>109,805</u>			

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

		December 31, 2017			
	Net asset value	Unfunded commitments	Redemption frequency (if currently eligible)	Redemption notice period	Redemption settlement period
Global bonds fund	\$ 93,937	—	Monthly	15 days	Up to 30 days
Global equity fund	112,303	—	Daily/bimonthly	10 days	Up to 5–10 days
Emerging markets equity fund	100,818	—	Daily/weekly	5/10 days	Up to 7–10 days
Equity long/short hedge funds	80,900	—	Monthly/quarterly	30–90 days	Up to 10–90 days
Opportunistic fixed-income hedge funds	138,466	—	Quarterly	45–90 days	1–90 days
Private equity funds	70,838	60,713	Not redeemable	NA	NA
Emerging market debt fund	36,509	—	Daily	Same day	Up to 15 days
Total	<u>\$ 633,771</u>	<u>60,713</u>			

Global bond fund includes fixed-rate and floating-rate debt securities of governments and government-related entities, as well as derivatives. The net asset value of the fund has been estimated using the net asset value per share of the investment. The fund provides full disclosure of the underlying holdings.

Global equity fund includes one fund that invests in global equities. The net asset value of the fund has been estimated using the net asset value per share of the investment. The fund provides full disclosure of the underlying holdings.

Emerging markets equity fund includes two funds that invests in emerging market equities. The net asset value of the fund has been estimated using the net asset value per share of the investment. The fund provides full disclosure of the underlying holdings.

Equity long/short-hedge funds include investments in hedge funds that invest both long and short primarily in the United States and global common stocks through a hedge funds structure. The value of the investments in this category has been estimated using the net asset value per share of the investments.

Opportunistic fixed-income hedge funds include investments in strategic fixed income and distressed debt hedge fund managers. These managers have the ability to invest across the capital structure and around the globe. The value of the investments in this category has been estimated using the net asset value per share of the investment.

Private equity funds include two limited partnership investments that focus on health care services and information technology companies, a limited partnership that makes venture capital investments in health care companies, a limited partnership that makes direct real estate investments through senior secured and floating rate direct lending to middle market United States companies, a limited partnership that coinvests in intermediate-term opportunities sourced by absolute return, private capital, and real asset managers, as well as two limited partnerships that invest in distressed and opportunistic real estate investments. The fair value of the portfolio companies is determined using valuation techniques and

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

procedures in accordance with recommendations by the American Institute of Certified Public Accountants for valuing private companies.

Emerging market debt fund is an investment in a fund that invests in emerging market debt. The net asset value of the fund has been estimated using the net asset value per share of the investment.

The System's deferred compensation investments recorded as other assets that are measured at fair value on a recurring basis were recorded using the fair value hierarchy at December 31, 2018 as follows:

	Total	Fair value measurements using		
		Level 1	Level 2	Level 3
Assets:				
Mutual funds:				
Large cap domestic equity	\$ 56,129	56,129	—	—
International equity	23,427	23,427	—	—
Fixed income	30,670	30,670	—	—
Other	31,844	31,844	—	—
Total mutual funds	142,070	142,070	—	—
Guaranteed investment contracts	22,370	—	—	22,370
Total assets	\$ 164,440	142,070	—	22,370

	Fair value measurements, Level 3
Balance, December 31, 2017	\$ 21,445
Total interest income	341
Purchases	9,211
Sales	(8,627)
Balance, December 31, 2018	\$ 22,370

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

The System's deferred compensation investments recorded as other assets that are measured at fair value on a recurring basis were recorded using the fair value hierarchy at December 31, 2017 as follows:

	Total	Fair value measurements using		
		Level 1	Level 2	Level 3
Assets:				
Mutual funds:				
Large cap domestic equity	\$ 61,240	61,240	—	—
International equity	28,468	28,468	—	—
Fixed income	29,363	29,363	—	—
Other	34,188	34,188	—	—
Total mutual funds	153,259	153,259	—	—
Guaranteed investment contracts	21,445	—	—	21,445
Total assets	\$ 174,704	153,259	—	21,445

	Fair value measurements, Level 3
Balance, December 31, 2016	\$ 18,063
Total interest income	280
Purchases	11,617
Sales	(8,515)
Balance, December 31, 2017	\$ 21,445

(15) Benefit Plans

(a) Defined-Benefit Cash Balance Plans

The System is making contributions pursuant to provisions of a collective bargaining agreement. The assets for these active participants are in a stand-alone defined-benefit pension plan, known as the Allina Health Pension Plan for Collectively Bargained Employees. This plan holds assets of \$12,824 and \$12,383 at December 31, 2018 and 2017, respectively, which are fair value measured using Level 1 criteria except for \$64 that are measured at net asset value, as a practical expedient, as of December 31, 2017. This plan has a projected benefit obligation of \$13,105 and \$12,844 using a discount rate of 3.4% and 3.77% as of December 31, 2018 and 2017, respectively. The System made contributions of \$1,373 and \$692 and recorded a total pension expense of \$1,193 and \$719 in 2018

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

and 2017, respectively. The unfunded balance of \$281 and \$461, respectively, as of December 31, 2018 and 2017 is reported in the consolidated balance sheets as a noncurrent other liability.

The defined-benefit pension plan of Courage Center was assumed in June 2013 with the acquisition of Courage Center. This plan, which was frozen in 2009, holds assets of \$27,429 and \$27,750, which are fair value measured using Level 2 criteria, and has a projected benefit obligation of \$34,806 and \$37,280 using a discount rate of 3.5% and 4.00% as of December 31, 2018 and 2017. The System made contributions of \$1,067 and \$1,000 in 2018 and 2017, respectively, and recorded a total pension return of \$1,087 and expense of \$2,562 in 2018 and 2017, respectively. The unfunded balance of \$7,377 and \$9,530 as of December 31, 2018 and 2017, respectively, is reported in the consolidated balance sheets as a noncurrent other liability.

During 2019, the System expects to make required pension contributions totaling approximately \$1,291 for the plans, but may elect to make additional contributions.

Expected future benefit payments for the plans for the ten years following December 31, 2018 are as follows:

2019	\$	2,546
2020		2,494
2021		2,952
2022		2,880
2023		2,731
2024–2028		15,511
	\$	<u>29,114</u>

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(b) MultiEmployer Plans

Contributions to the union-sponsored multiemployer plans are made in accordance with collective bargaining agreements. The risks of participation in these multiemployer plans are different from single-employer plans in the following aspects: a) assets contributed to the multiemployer plan by one employer may be used to provide benefits to employees of other participating employers; b) if a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers; and c) if the System chooses to stop participating in some of its multiemployer plans and, if the plan is underfunded, the System may be required to pay those plans an amount based on the underfunded status of the plan, referred to as the withdrawal liability. The System's participation in these plans for the year ended December 31, 2018 is outlined in the table below. The "EIN/Pension Plan Number" column provides the Employee Identification Number (EIN) and the three-digit plan number, if applicable. Unless otherwise noted, the most recent Pension Protection Act (PPA) zone status available in 2018 and 2017 is for the plan's year-end at December 31, 2017 and 2016, respectively. The zone status is based on information that the System received from the plan and is certified by the plan's actuary. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are less than 80% funded, and plans in the green zone are at least 80% funded. The "FIP/RP Status Pending/Implemented" column indicates plans for which a financial improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented. The last column lists the expiration date(s) of the collective bargaining agreement(s) to which the plans are subject:

Pension fund	EIN/Pension plan number	PPA status		FIP/RP Status pending/implemented	Contributions of the System in plan year		Surcharge imposed	Expiration date of collective bargaining agreement
		2017	2016		2017	2016		
Twin City Hospitals Minnesota Nurses Association Pension Plan	41-6184922-001	Green	Green	N/A	\$ 43,009	39,229	No	May 31, 2019
Other funds					3,265	3,122		
Total contributions					<u>\$ 46,274</u>	<u>42,351</u>		

Total amounts expensed under the union-sponsored multiemployer plans were \$45,171 and \$48,411 for 2018 and 2017, respectively.

The System contributes more than 5% of the total contributions to all of the plans in which it participated for the plan years 2016 and 2015. The System is required to make minimum contributions each year and will make contributions of \$38,373 in 2019.

At the date the System's consolidated financial statements were issued, Forms 5500 were not available for the plan year ended December 31, 2018.

(c) Defined-Contribution Plans

Certain employees of the System are eligible to participate in defined-contribution plans, whereby 50% of the employees' initial 4.0% of salary contributions is matched. The System provides an additional annual nonelective employer contribution for eligible employees to the defined-contribution plans. The

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

additional contribution is given as a percent of pay, ranging from 3.0% to 4.5%, based on years of vesting service. Contributions are made during the year following the calendar year-end. The contribution payable to employees is recorded in other current liabilities. Total amounts expensed under defined-contribution plans were \$73,411 and \$69,032 for 2018 and 2017, respectively.

(d) *Postretirement Welfare Benefits*

The System provides postretirement welfare benefits to certain employees. Postretirement welfare cost was \$812 and \$786 for 2018 and 2017, respectively. As of December 31, 2018 and 2017, accumulated postretirement benefit obligation was \$9,821 and \$11,761, respectively, and accrued postretirement benefit cost was \$9,680 and \$11,584, respectively. A discount rate of 4.15%, a rate of return on plan assets of 5.0%, and a medical plan trend rate of 6.5% in 2018, decreasing to 5.0% in 2022 and thereafter, have been assumed.

(16) Self-Insurance Reserves

The System has made provisions for estimated professional and general liability and workers' compensation claims that have been retained by the System because of deductible provisions of various policies or because of unasserted claims and other uninsured exposures. Reserves of \$112,836 and \$94,769 as of December 31, 2018 and 2017, respectively, have been recorded based on undiscounted historical data for professional and general liability and on a present-value basis using an annual discount rate of 2% for workers' compensation claims.

Under the comprehensive welfare benefit plan, the System has made provisions for claims reported but not paid and claims incurred but not reported of \$19,082 and \$19,540 as of December 31, 2018 and 2017, respectively. Management of the plan believes the provisions are adequate to cover claims incurred.

The System has a fixed-rate surety bond in the amount of \$49,174 and \$52,547 at December 31, 2018 and 2017. The surety bond was obtained in connection with the System's self-insured workers' compensation program at a rate of 0.31% per annum.

The System also has unused letters of credit totaling \$4,489 through December 31, 2021. The letters of credit were obtained in connection with the System's self-insured automobile and construction programs and Centers for Medicare and Medicaid Services Accountable Care Organization program at a fee of 0.45% per annum.

(17) Taxes

The System has been determined to qualify as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. The System has also been determined to be exempt from federal and state income tax on related income under Section 501(a) of the Internal Revenue Code and Minnesota Statute Section 290.05, Subdivision 2. Certain of the System's subsidiaries and affiliates qualify as tax-exempt organizations, while others are taxable. The System and its subsidiaries paid taxes of \$2,696 and \$2,868 in 2018 and 2017, respectively.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

As of December 31, 2018 and 2017, the taxable subsidiaries of the System's continuing operations had a gross deferred tax asset of \$48,966 and \$48,863, respectively, resulting from net operating loss carryforwards, employee compensation and benefits accruals, and depreciation, offset by valuation allowances of \$34,509 and \$47,968, respectively, and a gross deferred tax liability of \$897 and \$896, respectively, resulting from joint venture investments and employee compensation and benefits. During 2018, the System determined that it is more likely than not that approximately \$15,000 of the deferred tax assets will be recovered and as such have reduced the carried valuation allowance. The recovery is recorded as a reduction of state assessments and taxes expense in the 2018 consolidated statement of operations and changes in net assets.

As of December 31, 2018 and 2017, the continuing operations of the System and its subsidiaries had net operating loss carryforwards of \$102,589 and \$112,217, respectively, for income tax purposes, which expire in various years through 2029 with \$3,376 having an indefinite carryover period.

The System has analyzed income tax positions taken for filing with the Internal Revenue Service and all state jurisdictions where it operates. The System believes that income tax filing positions will be sustained upon examination and does not anticipate any adjustments that would result in a material adverse effect on the System's consolidated financial statements. As of December 31, 2018 and 2017, the System does not have any significant liabilities for uncertain tax benefits. The filings for the years ended 2014 to 2017 are open to examination by federal and state authorities.

H.R. 1, originally known as the Tax Cuts and Jobs Act (the Act), was signed into law on December 22, 2017. The Act is effective for the system as of January 1, 2018. The Act contains various provisions affecting both taxable and tax-exempt entities. Tax-exempt entities are impacted in part by the inclusion of a new excise tax on excess compensation for covered employees, changes to unrelated business income, changes to tax rates, as well as their ability to advance refund bonds. In addition, tax-exempt entities may be impacted through certain for-profit subsidiaries and/or joint ventures based on the Act's provisions for tax rates, elimination of the corporate alternative minimum tax, changes to net operating loss utilization and carryover/carryback period, and measurement of deferred taxes as well as other limitations on deductions. The Act's provisions may also impact donor tax incentives for charitable giving.

(18) Commitments and Contingencies

The System has various noncancelable operating occupancy lease agreements and other operating lease agreements for computer, medical, communication, and other equipment. The terms of certain of the lease agreements contain lease escalation clauses, allow for renewal of the leases, and require the System to pay operating costs in addition to minimum base rent. Base rent expense for operating leases totaled \$32,451 and \$33,357 for the years ended December 31, 2018 and 2017, respectively.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

Aggregate future minimum lease payments required under operating lease agreements in effect on December 31, 2018 are as follows:

2019	\$	30,534
2020		28,313
2021		26,198
2022		23,597
2023		19,527
Thereafter		100,411
	\$	<u>228,580</u>

Approximately 41% of employees are represented by various collective bargaining arrangements, of whom approximately 55% are represented by arrangements that are pending or expire within one year.

Laws and regulations governing the Medicare program are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The System believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material effect on its consolidated financial statements. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare program.

The System is subject to various legal proceedings and claims that are incidental to its normal business activities. With respect to these actions, established reserves are fairly stated, though actual results could vary from the estimates and assumptions that were used.

ALLINA HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Dollars in thousands)

(19) Functional Expenses

The System provides health care services to residents within its geographic location. Expenses related to providing these services included in the consolidated statements of operations and changes in net assets as of December 31, 2018 with 2017 corresponding totals are as follows:

	Healthcare services	General and administration	Total
2018:			
Salaries and benefits	\$ 2,377,077	324,147	2,701,224
Supplies and services	813,075	166,534	979,609
Depreciation and amortization	141,685	39,962	181,647
Financing costs	43,893	—	43,893
State assessments and taxes	79,693	(3,901)	75,792
Utilities and maintenance other operating expenses	65,439	13,403	78,842
	<u>185,234</u>	<u>37,940</u>	<u>223,174</u>
	<u>\$ 3,706,096</u>	<u>578,085</u>	<u>4,284,181</u>
2017	\$ 3,479,374	553,748	4,033,122

(20) Subsequent Events

The System has evaluated subsequent events from the consolidated balance sheet date through March 12, 2019, the date at which the consolidated financial statements were issued, and determined that other than the impact of adopting ASC 842 there are no other items to disclose



KPMG LLP
4200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402

Independent Auditors' Report on Supplementary Information

The Board of Directors
Allina Health System:

We have audited the consolidated financial statements of Allina Health System and its subsidiaries as of and for the years ended December 31, 2018 and 2017, and have issued our report thereon dated March 12, 2019 which contained an unmodified opinion on those consolidated financial statements. Our audits were performed for the purpose of forming an opinion on the consolidated financial statements as a whole. The 2018 and 2017 consolidating balance sheets and statements of operations and changes in net asset information are presented for the purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

Minneapolis, Minnesota
March 12, 2019

ALLINA HEALTH SYSTEM

Consolidating Balance Sheet

December 31, 2018

(Dollars in thousands)

Assets	Obligated Group	Other nonobligated	Eliminations	Allina Health System
Current assets:				
Cash and cash equivalents	\$ 126,359	9,221	—	135,580
Short-term investments	278,587	—	—	278,587
Patient accounts receivable, net	491,915	19,747	—	511,662
Inventories	72,055	497	—	72,552
Other current assets	108,458	4,270	—	112,728
	<u>1,077,374</u>	<u>33,735</u>	<u>—</u>	<u>1,111,109</u>
Investments	1,778,940	45,179	—	1,824,119
Investments with limited uses	9,739	144,074	—	153,813
Beneficial interests in net assets of Allina Foundations	183,529	—	(183,529)	—
Land, buildings, and equipment, net	1,218,454	5,374	—	1,223,828
Other assets	224,080	101,068	—	325,148
	<u>4,492,116</u>	<u>329,430</u>	<u>(183,529)</u>	<u>4,638,017</u>
Total assets	\$ 4,492,116	329,430	(183,529)	4,638,017
Liabilities and Net Assets				
Current liabilities:				
Accounts payable and accrued expenses	\$ 419,012	34,610	—	453,622
Current portion of long-term debt	26,639	852	—	27,491
Other current liabilities	110,174	—	—	110,174
	<u>555,825</u>	<u>35,462</u>	<u>—</u>	<u>591,287</u>
Long-term debt	918,643	2,242	—	920,885
Other liabilities	334,753	70,496	—	405,249
	<u>1,809,221</u>	<u>108,200</u>	<u>—</u>	<u>1,917,421</u>
Total liabilities	1,809,221	108,200	—	1,917,421
Net assets:				
Without donor restriction	2,490,989	74,558	—	2,565,547
With donor restriction	191,906	146,672	(183,529)	155,049
	<u>2,682,895</u>	<u>221,230</u>	<u>(183,529)</u>	<u>2,720,596</u>
Total net assets	2,682,895	221,230	(183,529)	2,720,596
Total liabilities and net assets	\$ 4,492,116	329,430	(183,529)	4,638,017

See accompanying independent auditors' report.

ALLINA HEALTH SYSTEM

Consolidating Statement of Operations and Changes in Net Assets

Year ended December 31, 2018

(Dollars in thousands)

	<u>Obligated Group</u>	<u>Other nonobligated</u>	<u>Eliminations</u>	<u>Allina Health System</u>
Revenues:				
Net patient service revenue	\$ 4,041,023	30,691	—	4,071,714
Other operating revenue	<u>255,938</u>	<u>22,817</u>	<u>19,970</u>	<u>298,725</u>
Total revenues	<u>4,296,961</u>	<u>53,508</u>	<u>19,970</u>	<u>4,370,439</u>
Expenses:				
Salaries and benefits	2,687,350	13,874	—	2,701,224
Supplies and services	913,973	65,636	—	979,609
Depreciation and amortization	179,733	1,914	—	181,647
Financing costs	43,423	470	—	43,893
Services provided by (to) related divisions	5,783	(25,753)	19,970	—
State assessments and taxes	89,618	(13,826)	—	75,792
Utilities and maintenance	78,017	825	—	78,842
Other operating expenses	<u>210,827</u>	<u>12,347</u>	<u>—</u>	<u>223,174</u>
Total expenses	<u>4,208,724</u>	<u>55,487</u>	<u>19,970</u>	<u>4,284,181</u>
Operating income (loss)	88,237	(1,979)	—	86,258
Nonoperating gains (losses):				
Investment return	(57,907)	(1,740)	—	(59,647)
Gain on interest rate swap agreements	2,653	—	—	2,653
Nonservice periodic pension costs	921	—	—	921
Other	<u>(6,367)</u>	<u>(1,434)</u>	<u>—</u>	<u>(7,801)</u>
Excess (deficit) of revenues over expenses	\$ <u>27,537</u>	<u>(5,153)</u>	<u>—</u>	<u>22,384</u>

ALLINA HEALTH SYSTEM

Consolidating Statement of Operations and Changes in Net Assets

Year ended December 31, 2018

(Dollars in thousands)

	<u>Obligated Group</u>	<u>Other nonobligated</u>	<u>Eliminations</u>	<u>Allina Health System</u>
Net assets without donor restrictions:				
Excess (deficit) of revenues over expenses	\$ 27,537	(5,153)	—	22,384
Net assets released from restrictions for capital purposes	265	13,772	—	14,037
Transfer net assets released to Obligated Group	15,728	(15,728)	—	—
Amortization of unrealized loss on interest rate swap agreement	874	—	—	874
Capital contributions to nonobligated group affiliates, net	(24,741)	24,741	—	—
Other	(253)	(2,056)	—	(2,309)
	<u>19,410</u>	<u>15,576</u>	<u>—</u>	<u>34,986</u>
Net assets with donor restrictions				
Contributions	326	16,636	—	16,962
Investment return	(152)	(5,107)	—	(5,259)
Net assets released from restrictions	(265)	(25,453)	—	(25,718)
Change in beneficial interests in net assets of Allina Foundations	(20,736)	—	20,736	—
Other	(1,776)	(490)	—	(2,266)
	<u>(22,603)</u>	<u>(14,414)</u>	<u>20,736</u>	<u>(16,281)</u>
(Decrease) increase in net assets with donor restrictions	<u>(22,603)</u>	<u>(14,414)</u>	<u>20,736</u>	<u>(16,281)</u>
(Decrease) increase in net assets	(3,193)	1,162	20,736	18,705
Net assets at beginning of year	<u>2,686,116</u>	<u>220,068</u>	<u>(204,265)</u>	<u>2,701,919</u>
Net assets at end of year	\$ <u><u>2,682,923</u></u>	<u><u>221,230</u></u>	<u><u>(183,529)</u></u>	<u><u>2,720,624</u></u>

See accompanying independent auditors' report.

ALLINA HEALTH SYSTEM

Consolidating Balance Sheet

December 31, 2017

(Dollars in thousands)

Assets	Obligated Group	Other nonobligated	Eliminations	Allina Health System
Current assets:				
Cash and cash equivalents	\$ 138,154	9,366	—	147,520
Short-term investments	404,934	—	—	404,934
Patient accounts receivable, net	485,475	20,569	—	506,044
Inventories	65,606	145	—	65,751
Other current assets	96,268	3,191	—	99,459
	<u>1,190,437</u>	<u>33,271</u>	<u>—</u>	<u>1,223,708</u>
Investments	1,658,637	42,603	—	1,701,240
Investments with limited uses	16,181	142,753	—	158,934
Beneficial interests in net assets of Allina Foundations	204,265	—	(204,265)	—
Land, buildings, and equipment, net	1,213,609	8,083	—	1,221,692
Other assets	256,215	80,973	—	337,188
	<u>4,539,344</u>	<u>307,683</u>	<u>(204,265)</u>	<u>4,642,762</u>
Total assets	\$ 4,539,344	307,683	(204,265)	4,642,762
Liabilities and Net Assets				
Current liabilities:				
Accounts payable and accrued expenses	\$ 423,873	15,500	—	439,373
Current portion of long-term debt	25,442	793	—	26,235
Other current liabilities	104,330	—	—	104,330
	<u>553,645</u>	<u>16,293</u>	<u>—</u>	<u>569,938</u>
Long-term debt	945,953	3,095	—	949,048
Other liabilities	353,630	68,227	—	421,857
	<u>1,853,228</u>	<u>87,615</u>	<u>—</u>	<u>1,940,843</u>
Total liabilities	1,853,228	87,615	—	1,940,843
Net assets:				
Without donor restriction	2,471,579	58,982	—	2,530,561
With donor restriction	214,537	161,086	(204,265)	171,358
	<u>2,686,116</u>	<u>220,068</u>	<u>(204,265)</u>	<u>2,701,919</u>
Total net assets	2,686,116	220,068	(204,265)	2,701,919
Total liabilities and net assets	\$ 4,539,344	307,683	(204,265)	4,642,762

See accompanying independent auditors' report.

ALLINA HEALTH SYSTEM

Consolidating Statement of Operations and Changes in Net Assets

Year ended December 31, 2017

(Dollars in thousands)

	<u>Obligated Group</u>	<u>Other nonobligated</u>	<u>Eliminations</u>	<u>Allina Health System</u>
Revenues:				
Net patient service revenue	\$ 3,832,121	19,582	—	3,851,703
Other operating revenue	292,113	20,022	17,494	329,629
Total revenues	<u>4,124,234</u>	<u>39,604</u>	<u>17,494</u>	<u>4,181,332</u>
Expenses:				
Salaries and benefits	2,559,642	12,884	—	2,572,526
Supplies and services	871,302	45,375	—	916,677
Depreciation and amortization	173,582	1,796	—	175,378
Financing costs	38,759	445	—	39,204
Services provided by (to) related divisions	3,980	(21,474)	17,494	—
State assessments and taxes	86,571	(414)	—	86,157
Utilities and maintenance	75,889	761	—	76,650
Other operating expenses	159,313	7,217	—	166,530
Total expenses	<u>3,969,038</u>	<u>46,590</u>	<u>17,494</u>	<u>4,033,122</u>
Operating income (loss)	155,196	(6,986)	—	148,210
Nonoperating gains (losses):				
Investment return	163,533	3,261	—	166,794
Losses on interest rate swap agreements	(6,656)	—	—	(6,656)
Loss on debt refinancing	(6,767)	—	—	(6,767)
Nonservice periodic pension costs	(2,343)	—	—	(2,343)
Other	(2,398)	(1,438)	—	(3,836)
Excess (deficit) of revenues over expenses	<u>\$ 300,565</u>	<u>(5,163)</u>	<u>—</u>	<u>295,402</u>

ALLINA HEALTH SYSTEM

Consolidating Statement of Operations and Changes in Net Assets

Year ended December 31, 2017

(Dollars in thousands)

	Obligated Group	Other nonobligated	Eliminations	Allina Health System
Net assets without donor restrictions:				
Excess (deficit) of revenues over expenses	\$ 300,565	(5,163)	—	295,402
Net assets released from restrictions for capital purposes	2,370	12,279	—	14,649
Transfer net assets released to Obligated Group	13,704	(13,704)	—	—
Amortization of unrealized loss on interest rate swap agreement	874	—	—	874
Capital contributions to nonobligated group affiliates, net	(6,112)	6,112	—	—
Other	(2,113)	(492)	—	(2,605)
Increase (decrease) in net assets without donor restrictions	309,288	(968)	—	308,320
Net assets with donor restrictions				
Contributions	2,370	17,122	—	19,492
Investment return	(506)	13,328	—	12,822
Net assets released from restrictions	(2,370)	(24,448)	—	(26,818)
Change in beneficial interests in net assets of Allina Foundations	3,320	—	(3,320)	—
Other	1,613	(1,646)	—	(33)
Increase (decrease) in net assets with donor restrictions	4,427	4,356	(3,320)	5,463
Increase (decrease) in net assets	313,715	3,388	(3,320)	313,783
Net assets at beginning of year	2,372,401	216,680	(200,945)	2,388,136
Net assets at end of year	\$ 2,686,116	220,068	(204,265)	2,701,919

See accompanying independent auditors' report.