

CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Beacon Health System, Inc. and Affiliated Corporations
Years Ended December 31, 2017 and 2016
With Reports of Independent Auditors

Ernst & Young LLP



Beacon Health System, Inc. and Affiliated Corporations

Consolidated Financial Statements
and Supplementary Information

Years Ended December 31, 2017 and 2016

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Ernst & Young LLP
155 North Wacker Drive
Chicago, IL 60606-1787

Tel: +1 312 879 2000
Fax: +1 312 879 4000
ey.com

Report of Independent Auditors

The Board of Directors
Beacon Health System, Inc. and Affiliated Corporations

We have audited the accompanying consolidated financial statements of Beacon Health System, Inc. and Affiliated Corporations (the Corporation), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, 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 financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

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



Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Beacon Health System, Inc. and Affiliated Corporations at December 31, 2017 and 2016, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

March 8, 2018

Beacon Health System, Inc. and Affiliated Corporations

Consolidated Balance Sheets
(In Thousands)

	December 31	
	2017	2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 44,812	\$ 43,032
Short-term investments	3,388	53,501
Patient accounts receivable, less allowances for doubtful accounts (2017 – \$33,086; 2016 – \$30,657)	151,791	160,873
Due from third-party payors	27,064	40,376
Other receivables	5,055	9,072
Inventories	23,942	25,437
Prepaid expenses	15,954	15,757
Total current assets	<u>272,006</u>	<u>348,048</u>
Assets limited as to use:		
Internally designated investments	705,511	590,890
Restricted cash	2,758	4,526
Externally designated investments – insurance trust	2,710	2,680
Designated cash	20,315	19,769
Board-designated endowment	27,316	24,961
Endowment and temporarily restricted investments	7,930	6,514
	<u>766,540</u>	<u>649,340</u>
Property and equipment:		
Land	45,101	44,897
Buildings and improvements	795,115	730,503
Furniture and equipment	490,299	466,023
Construction-in-progress	16,037	55,372
	<u>1,346,552</u>	<u>1,296,795</u>
Less allowances for depreciation and amortization	<u>687,048</u>	<u>641,882</u>
	659,504	654,913
Deferred charges and other assets	38,911	32,938
Interest rate swap	625	–
Total assets	<u><u>\$ 1,737,586</u></u>	<u><u>\$ 1,685,239</u></u>

Beacon Health System, Inc. and Affiliated Corporations

Consolidated Balance Sheets
(In Thousands)

	December 31	
	2017	2016
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 47,085	\$ 46,991
Accrued salaries and benefits	36,831	35,928
Accrued expenses	4,836	4,809
Due to third-party payors	6,159	4,452
Current maturities of long-term debt	8,745	8,824
Total current liabilities	<u>103,656</u>	101,004
Non-current liabilities:		
Long-term debt, less current maturities	270,680	279,909
Pension and other liabilities	27,111	92,159
Interest rate and basis swaps	16,305	22,779
	<u>314,096</u>	<u>394,847</u>
Total liabilities	417,752	495,851
Net assets:		
Unrestricted:		
Undesignated	1,278,461	1,154,359
Board-designated endowment	27,316	19,621
Total unrestricted	<u>1,305,777</u>	<u>1,173,980</u>
Temporarily restricted	13,582	14,742
Permanently restricted	475	666
Total net assets	<u>1,319,834</u>	<u>1,189,388</u>
Total liabilities and net assets	<u><u>\$ 1,737,586</u></u>	<u><u>\$ 1,685,239</u></u>

See accompanying notes.

Beacon Health System, Inc. and Affiliated Corporations

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

	Year Ended December 31	
	2017	2016
Unrestricted revenue, gains, and other support		
Net patient service revenue	\$ 960,770	\$ 945,600
Provision for bad debts	(59,669)	(59,658)
Net patient service revenue less provision for bad debts	901,101	885,942
Other revenue	40,439	36,274
Net assets released from restrictions used for operations	1,810	980
	943,350	923,196
Expenses		
Salaries and wages	394,191	391,882
Employee benefits	101,922	102,234
Supplies and other	232,358	222,224
Professional fees and purchased services	117,039	119,129
Depreciation and amortization	59,496	55,987
Interest	7,052	6,637
	912,058	898,093
Income from operations	31,292	25,103
Non-operating income (expenses)		
Investment income, net	82,462	42,741
Unrealized gains (losses) on swap transactions, net	7,099	(1,246)
Gain on swap termination	–	158
Loss on sale of assets	–	(1,362)
Loss on bond refunding	(534)	–
Fair value of net assets combined	–	5,157
Revenue and gains in excess of expenses	120,319	70,551

Beacon Health System, Inc. and Affiliated Corporations

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

	Year Ended December 31	
	2017	2016
Unrestricted net assets		
Revenue and gains in excess of expenses	\$ 120,319	\$ 70,551
Net assets released from restrictions used for capital purposes	2,473	1,664
Postretirement benefit adjustments other than periodic costs	9,005	2,286
Increase in unrestricted net assets	<u>131,797</u>	<u>74,501</u>
Temporarily restricted net assets		
Contributions temporarily restricted for use	2,156	3,857
Investment income	776	308
Fair value of net assets combined	–	515
Reclassification of contribution restriction by donor	191	–
Net assets released from restrictions used for operating and capital purposes	<u>(4,283)</u>	<u>(2,644)</u>
Increase in temporarily restricted net assets	<u>(1,160)</u>	<u>2,036</u>
Permanently restricted net assets		
Fair value of net assets combined	–	75
Reclassification of contribution restriction by donor	<u>(191)</u>	<u>–</u>
(Decrease) increase in permanently restricted net assets	<u>(191)</u>	<u>75</u>
Change in net assets	130,446	76,612
Net assets at beginning of year	<u>1,189,388</u>	<u>1,112,776</u>
Net assets at end of year	<u>\$ 1,319,834</u>	<u>\$ 1,189,388</u>

See accompanying notes.

Beacon Health System, Inc. and Affiliated Corporations

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended December 31	
	2017	2016
Operating activities		
Change in net assets	\$ 130,446	\$ 76,612
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation and amortization	59,496	55,987
Provision for bad debts	59,669	59,658
Unrealized (gains) losses on swap transactions, net	(7,099)	1,246
Loss on bond refunding	534	-
Gain on swap termination	-	(158)
Loss on sale of assets	-	1,362
Postretirement benefit adjustments other than periodic costs	(9,005)	(2,286)
Unrealized gains on investments	(67,030)	(7,133)
Restricted contributions and investment income	(2,932)	(4,165)
Changes in operating assets and liabilities:		
Patient accounts receivable	(50,587)	(57,275)
Other receivables, inventories, and prepaid expenses	5,315	(6,790)
Other assets	(20,876)	(23,158)
Restricted cash	1,768	(1,514)
Designated cash	(546)	(821)
Investments – trading	(1,279)	(52,984)
Accounts payable, accrued salaries and benefits, and accrued expenses	1,024	(1,074)
Due to/from third-party payors, net	15,019	(34,702)
Other long-term liabilities	(56,189)	(4,368)
Net cash provided by (used in) operating activities	57,728	(1,563)
Investing activities		
Net additions to property and equipment	(49,757)	(64,823)
Net cash used in investing activities	(49,757)	(64,823)
Financing activities		
Principal payments on long-term debt and other debt obligations	(86,338)	(8,303)
Net proceeds from issuance of long-term debt and other debt obligations	77,450	50,000
Payment of bond issue costs	(235)	(282)
Restricted contributions and investment income	2,932	4,165
Net cash (used in) provided by financing activities	(6,191)	45,580
Increase (decrease) in cash and cash equivalents	1,780	(20,806)
Cash and cash equivalents at beginning of year	43,032	63,838
Cash and cash equivalents at end of year	\$ 44,812	\$ 43,032
Supplemental disclosure of cash flow information		
Interest paid	\$ 7,173	\$ 6,671
<i>See accompanying notes.</i>		

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements

(In Thousands)

December 31, 2017

1. Organization and Basis of Consolidation

The accompanying consolidated financial statements represent the accounts of Beacon Health System, Inc. (the Corporation) and its various affiliated corporations under the control of the Corporation (collectively, BHS). The Corporation is an Indiana not-for-profit corporation exempt from federal income tax under Internal Revenue Code (the Code) Section 501(a) as an organization described in Section 501(c)(3) and a public charity as described in Section 509(a)(3). The Corporation is the sole corporate member of the following entities:

- Elkhart General Hospital, Inc. (EGH)
- Memorial Hospital of South Bend, Inc. (MHSB)
- Beacon Health Foundation, Inc. (BHF), formerly Memorial Health Foundation, Inc.
- Beacon Medical Group, Inc. (BMG), formerly Memorial Health System, Inc.
- Beacon Health Ventures, Inc. (BHV)
- Community Occupational Medicine, Inc. (COM)
- CHA ACO, LLC (CHA ACO)
- Beacon Health, LLC (BH)

EGH, MHSB, BMG, and BHF are also exempt from federal income tax under Section 501(a) as organizations described in Section 501(c)(3) and as public charities described in Sections 509(a)(1) and 509(a)(2). BHV and COM are Indiana for-profit corporations. EGH is a 365-licensed-bed (254 available) acute care community hospital located in Elkhart, Indiana. MHSB is a 657-licensed-bed (409 available) acute care trauma center located in South Bend, Indiana. EGH and MHSB (collectively, the Hospitals) provide inpatient, outpatient, and 24-hour emergency care services for residents of Elkhart and South Bend, Indiana, and the surrounding communities.

In October 2016, Elkhart General Hospital Foundation (EGHF), a third party, was combined into the Memorial Hospital Foundation, Inc. (MHF) The combined operations were renamed Beacon Health Foundation, Inc. (BHF) All assets and liabilities of EGHF were assumed by BHF.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

1. Organization and Basis of Consolidation (continued)

Aggregate financial information of EGHF merged into BHF was as follows:

	<u>2016</u>
Assets	\$ 5,821
Liabilities	74
Net assets	5,747

BHF is organized primarily to promote and encourage philanthropic activities for the support of the Corporation and its affiliates. EGHF was organized primarily to support EGH. EGHF combined with MHF as it had a common purpose and alignment with MHF. MHF and EGHF combined into BHF with no impact to income from operations.

BHV manages the taxable operations of the Corporation, including home care and other non-acute health care services.

COM primarily promotes population health management.

CHA ACO coordinates high-quality care for Medicare beneficiaries participating in the Medicare Shared Savings Programs.

BMG operates the physician enterprise of the Corporation.

BH improves and expands delivery and quality of health care services for the Corporation.

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

The Corporation owns a less than majority ownership or controlling interest in the following:

- 50% interest in Community Health Alliance LLC, an Indiana physician hospital organization
- 75% interest in Memorial Spine and Neuroscience Center, LLC, an outpatient surgery center specializing in neurologic, spine, and pain control procedures

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

1. Organization and Basis of Consolidation (continued)

- 42% interest in LaPorte Medical Group Surgery Center, LLP, an outpatient surgery center
- 50% interest in Valparaiso Medical Development, LLC, a professional medical building venture
- 25% interest in Magnetic Resonance Imaging, LLC, an imaging and radiology center
- 33% interest in Michiana Information Health Network, Inc., a health information exchange
- 40% interest in in Elkhart Health, Fitness & Aquatics, Inc., a health fitness and aquatics center

Aggregate financial information relating to these investments is as follows:

	<u>2017</u>	<u>2016</u>
Assets	\$ 51,377	\$ 33,473
Liabilities	17,016	15,162
Net income	8,199	3,995

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Although estimates are considered to be fairly stated at the time the estimates are made, actual results could differ from those estimates.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Cash Equivalents

All investments that are not limited as to use with a maturity of three months or less at the time of acquisition are reflected as cash equivalents. Cash equivalents include checking accounts, money market accounts, corporate credit card accounts, and petty cash. The carrying value of cash equivalents approximates fair value.

Short-Term Investments

Short-term investments include cash reinvested on a daily basis, accrued interest on investments, and money expected to be used in less than a year. Also included in short-term investments are restricted and unrestricted investment donations that are in the process of being liquidated.

Patient Accounts Receivable

The Corporation evaluates the collectibility of its accounts receivable based on the length of time the receivable is outstanding, payor class, and the anticipated future uncollectible amounts based on historical experience. Accounts receivable are charged to the allowance for doubtful accounts when they are deemed uncollectible.

Assets Limited as to Use

Assets limited as to use include assets set aside by the Board of Directors (the Board) for future capital improvements and community health enhancement initiatives that the Board, at its discretion, may subsequently use for other purposes. In addition, assets limited as to use also include assets held by trustees under self-funded insurance agreements, investments externally designated under indenture or donor restriction and money expected to be used as part of BHS' community benefit.

Investments

The Corporation classifies its investments as trading. Under a trading classification, all unrestricted realized and unrealized gains and losses are included in revenue and gains in excess of expenses.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

2. Summary of Significant Accounting Policies (continued)

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices for those or similar investments. Dividend and interest income, realized gains and losses, and changes to fair values of investments are reported as non-operating investment income in the consolidated statements of operations and changes in net assets.

Investments in alternative investments, primarily hedge fund of funds, that invest in marketable securities and derivative products are reported using the equity method. The estimated fair values are provided by the respective fund managers and are based on historical costs, appraisals, and other estimates that require varying degrees of judgment. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and may differ from the value that would have been used had a ready market for such investments existed. Resulting differences could be material. The financial statements of the hedge funds are audited annually. Equity earnings related to these alternative investments are included in non-operating investment income. The Corporation's holding reflects net contributions to the hedge fund and an allocated share of realized and unrealized investment income and expense.

Inventories

Inventories are stated at the lower of cost (average cost method) or market.

Unamortized Bond Issuance Costs

Costs incurred in connection with the issuance of long-term debt are deferred and amortized over the term of the related financing, which approximates the effective interest method.

Fair Value of Financial Instruments

The Corporation's carrying amount for its financial instruments, which include cash and cash equivalents, investments and assets limited as to use, accounts receivable, debt and interest rate and basis swaps, at December 31, 2017 and 2016, approximates fair value. The estimated fair value amounts have been determined by the Corporation using available market information and appropriate valuation methodologies.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment are carried at cost, except for donated assets, which are recorded at fair value at the date of donation. Allowances for depreciation and amortization are computed primarily utilizing the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years.

Asset Impairment

The Corporation considers whether indicators of impairment are present and performs the necessary tests to determine whether the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating expenses at the time the impairment is identified. There was \$0 and \$681 of impairment of long-lived assets in 2017 and 2016, respectively.

The carrying value of goodwill amounted to approximately \$10,409 at December 31, 2017 and 2016, respectively, and is included in deferred charges and other assets in the consolidated balance sheets. Goodwill is assessed for impairment on an annual basis at the reporting unit level. If the fair value of the reporting unit is less than the carrying value, an impairment loss equal to the difference between the implied fair value of the reporting unit goodwill and the carrying value of the reporting unit goodwill is recognized. There was no impairment of goodwill in 2017 or 2016.

Deferred Charges and Other Assets

Included in deferred charges and other assets are intangible assets, goodwill, and investments in unconsolidated affiliates.

The acquisition of a business entity can result in the recording of intangible assets. Acquired definite-lived intangible assets (excluding goodwill) are amortized over the useful life of the assets. Goodwill is carried at acquisition value, less any impairment reductions.

The Corporation accounts for its investments in less than majority owned and controlled affiliates using either the equity method of accounting. Income from these investments is reflected in other revenue in the consolidated statements of operations and changes in net assets.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Endowment Investments

Income is received directly by BHF from BHF board-designated endowment investments and is included in investment income within temporarily restricted net assets. EGH receives a portion of the income from investments in endowments directly as they are released from restriction. These endowment investments have perpetual existence.

Contributions

Unconditional pledges to give cash and other assets are reported at fair value at the date the pledge is received to the extent estimated to be collectible by the Corporation. Pledges received with donor restrictions that limit the use of the donated assets are reported as either temporarily or permanently restricted support. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions.

Temporarily Restricted Net Assets

Temporarily restricted net assets are used to differentiate resources, the use of which is restricted by donors or grantors to a specific time period or purpose, from resources on which no restrictions have been placed or that arise from the general operations of the Corporation. Temporarily restricted gifts and bequests are recorded as an addition to temporarily restricted net assets in the period received. Assets released from restrictions that are used for the purchase of property and equipment or capital purposes are reported in the consolidated statements of operations and changes in net assets as additions to unrestricted net assets. Resources restricted by donors for specific operating purposes are reported in unrestricted revenue, gains, and other support to the extent expended within the period.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Permanently Restricted Net Assets

Permanently restricted net assets have been restricted by donors to be maintained by the Corporation in perpetuity. In accordance with the restriction, a majority of the investment income and investment gains or losses from permanently restricted net assets are restricted by the donor for a specific purpose and are therefore temporarily restricted. A specified portion of income earned by the temporarily restricted net assets is released from restriction and used for operations each year and, therefore, is included in the consolidated statements of operations and changes in net assets as other revenue.

Net Patient Service Revenue

Net patient service revenue is recorded in the period in which services are rendered, based upon estimated amounts due from patients and third-party payors. Third parties include Medicare, Medicaid, managed health care plans, and other commercial plans. BHS has agreements with various third-party payors that provide for payments to BHS at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts received or due from patients, third-party payors, and others for services rendered. These amounts include estimated adjustments under certain reimbursement agreements with third-party payors, which are subject to audit by the applicable administering agency. These adjustments are accrued on an estimated basis and are adjusted in future periods as final settlements are determined (see Note 3). MHSB and EGH (the Hospitals) provide care to all patients regardless of their ability to pay. Charity care provided is excluded from net patient service revenue (see Note 4).

Performance Indicator

The consolidated statements of operations and changes in net assets include a performance indicator, revenue and gains in excess of expenses. Changes in unrestricted net assets, which are excluded from revenue and gains in excess of expenses, consistent with industry practice, include contributions of long-lived assets, including assets acquired using contributions, which, by donor restrictions, were to be used for the purpose of acquiring such assets, and pension-related changes other than net periodic costs.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

2. Summary of Significant Accounting Policies (continued)

Allocation of Costs

The Corporation's ability to exercise control over consolidated entities could result in the entities having a financial position or operating results that are significantly different from those that would have been obtained if the entities were autonomous. The manner of allocating certain shared and centralized costs, such as accounts payable processing, information technology support, and other Corporation-managed administration costs, is determined by the Corporation utilizing Internal Revenue Service transfer pricing guidance and is not audited. Alternate methods of accounting for these cost allocations may produce significantly different operating results for each of the consolidated entities.

Interest Rate and Basis Swaps

All interest rate and basis swaps are measured at fair value based on techniques consistent with the market approach. None of the swaps are designated as hedging instruments; therefore, the unrealized gains or losses on the fair value of the swaps are included in revenue and gains in excess of expenses in the consolidated statements of operations and changes in net assets.

Asset Retirement Obligations

The Corporation accounts for the fair value of legal obligations associated with long-lived asset retirements by recognizing an expense and accreting a liability over the life of the asset to cover potential legal obligations at the end of the asset's useful life. The asset retirement obligation primarily relates to future asbestos remediation related to buildings on MHSB's campus, as well as ground/soil remediation associated with the removal of underground fuel tanks. The carrying value of the obligation amounted to approximately \$4,590 and \$4,444 at December 31, 2017 and 2016, respectively, and is reflected in pension and other liabilities on the consolidated balance sheets.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

2. Summary of Significant Accounting Policies (continued)

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and subsequently issued amendments ASU 2016-08, 2016-10 and 2016-12 further clarifying key guidance related to revenue recognition. The core principle of the new accounting guidance is to require an entity to recognize as revenue the amount that reflects the consideration to which it expects to be entitled in exchange for goods or services as it transfers control to its customers. The new standard converged and replaced most current revenue recognition guidance, including industry-specific guidance, and may be applied retrospectively to each period presented (full retrospective method) or retrospectively with the cumulative effect recognized in beginning retained earnings as of the date of adoption (modified retrospective method).

BHS adopted the standard effective January 1, 2018 using the full retrospective method. BHS's process for implementation began with a preliminary evaluation of the standard and considered subsequent interpretations by the FASB Transition Resource Group for Revenue Recognition and the AICPA. BHS performed an analysis of revenue streams and transactions under the new standard. In particular, for net patient service revenue, BHS performed an analysis into the application of the portfolio approach as a practical expedient to group patient contracts with similar characteristics, such that revenue for a given portfolio would not be materially different than if it were evaluated on a contract-by-contract basis. Additionally, BHS evaluated any variable consideration and potential constraints on the estimate of variable consideration, in particular as it related to third-party settlements.

The impact to the consolidated financial statements upon adoption is not material. Upon adoption, the majority of what is currently classified as bad debt expense (and presented as a reduction to net patient service revenue on the consolidated statements of operations and changes in net assets) will be treated as an implicit price concession that reduces the transaction price (net patient service revenue). The new standard also requires enhanced disclosures related to the disaggregation of revenue and significant judgments made in measurement and recognition. BHS is still evaluating the presentation of supplemental Medicaid payments and their related assessment on the consolidated statements of operations and changes in net assets under the new standard.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

2. Summary of Significant Accounting Policies (continued)

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. The amendments in this update replace the three classes of net assets (unrestricted, temporary, and permanent) with two classes (with and without donor restrictions). The ASU also requires additional disclosures relating to net assets and expenses. BHS is required to adopt the new guidance for the year ended December 31, 2018 (and interim periods within the annual period beginning January 1, 2019), and does not expect the guidance to have a material impact to the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. The amendments in this update clarify the classification of eight types of transactions, including proceeds from the settlement of insurance claims and distributions received from equity method investees, in the statement of cash flows to reduce diversity in practices. BHS is required to adopt the new guidance for the year ended December 31, 2018 (and interim periods within the annual period beginning January 1, 2019), and does not expect the guidance to have a material impact to the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases*. Under the new guidance, lessees are required to capitalize leases with greater than 12 months term on the balance sheet. Leases will be classified as operating or financing. Both types of leases will be recorded on the balance sheet. Operating leases will reflect lease expense on a straight-line basis, whereas financing leases will accelerate lease expense in the early period of the lease term and decline with passage of time, similar to current accounting for capital leases. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. BHS is required to adopt the new guidance for the fiscal year beginning on January 1, 2019, and is currently evaluating the impact this guidance will have on its consolidated financial statements.

Reclassifications

Certain reclassifications were made to the 2016 consolidated financial statements to conform with classifications made in 2017. The reclassifications had no effect on the changes in net assets or on net assets previously reported.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts

The Medicare and Medicaid programs reimburse the Corporation for inpatient and outpatient services at predetermined rates based on diagnosis and treatment. Changes in the Medicare and Medicaid programs or reduction in funding of the programs could have an adverse effect on future amounts recognized as net patient service revenue.

The laws and regulations governing the Medicare and Medicaid programs are extremely 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.

Managed care reimbursement agreements provide for payment of patient services at a fixed percentage of covered charges. The Corporation has also entered into contractual arrangements with various health maintenance and preferred provider organizations, the terms of which call for the Corporation to be paid for covered services at predetermined rates, including percentage of charges, per diem, and case rate.

Estimated amounts due are calculated from contractually obligated terms of payment for each payor, as well as uninsured discounts applied for patients with no insurance coverage. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the years ended December 31 from these major payor sources is as follows:

Payor	2017	2016
Anthem	\$ 190,908	\$ 195,495
Commercial	298,374	289,665
Medicare	271,731	267,045
Medicaid	145,280	131,663
Self-pay	54,477	61,732
Net patient service revenue	960,770	945,600
Provision for bad debts	(59,669)	(59,658)
Net patient service revenue less provision for bad debt	<u>\$ 901,101</u>	<u>\$ 885,942</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts (continued)

Net patient service revenues related to the Medicare program are 28% for the years ended December 31, 2017 and 2016. Net patient service revenues related to the Medicaid program are 15% and 14% for the years ended December 31, 2017 and 2016, respectively. Amounts reported under the Anthem payor contract account for 20% and 21% of net patient service revenue for the years ended December 31, 2017 and 2016, respectively. Credit is granted without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Major components of net patient accounts receivable include 26% from Medicare and 21% from Anthem at December 31, 2017, and 32% from Medicare and 23% from Anthem at December 31, 2016.

The provision for bad debts is based upon management's assessment of historical and expected net collections taking into consideration the trends in health care coverage, historical economic trends, and other collection indicators. Management assesses the adequacy of the allowances periodically throughout the year based upon historical write-off experience by major payor category. The results of the review are then utilized to make modifications, as necessary, to the provision for bad debts to provide for an appropriate allowance for uncollectible accounts. A significant portion of the Corporation's uninsured patients will be unable to pay for the services provided. Thus, the Corporation records a significant provision for bad debts related to uninsured patients in the period the services are provided. The allowance for doubtful accounts recognized at December 31 by major payor source is as follows:

<u>Payor</u>	<u>2017</u>	<u>2016</u>
Third-party payors	\$ 17,414	\$ 18,341
Self-pay	15,672	12,316
	<u>\$ 33,086</u>	<u>\$ 30,657</u>

Adjustments arising from reimbursement arrangements with third-party payors are accrued for on an estimated basis in the period in which the services are rendered, with the exception of Indiana Medicaid Disproportionate Share (DSH) reimbursement. DSH payments by the state of Indiana, if eligible, are paid according to the fiscal year of the state, which ends on June 30 of each year, and are based on the cost of uncompensated care provided by the DSH providers during their respective fiscal year ended during the state fiscal year. DSH payments are recorded after

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

**3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts
(continued)**

eligibility is determined, and payments are probable and reasonably estimable. In 2016, MHSB qualified for the State DSH program for State Fiscal Years (SFY) 2016 and 2017. In 2015, MHSB qualified for SFYs 2014 and 2015. MHSB recorded net patient service revenue of \$27,960 for the year ended December 31, 2017, related to SFY 2017 and 2016 DSH payments. MHSB recorded net patient service revenue of \$22,923 for the year ended December 31, 2016, related to SFY 2016 and 2015 DSH payments.

In April 2014, the Indiana Hospital Assessment Fee program (HAF) was approved by the Centers for Medicare & Medicaid Services (CMS) retroactively for the period July 1, 2013 to June 30, 2017. The state budget extended HAF through June 30, 2019. Under HAF, Indiana hospitals receive additional federal Medicaid funds for the state's health care system, administered by the Indiana Family and Social Services Administration. HAF includes both a payment to the Hospitals from the state (included in net patient service revenue) and an assessment (included in supplies and other expenses) against the Hospitals, which is paid to the state the same year. BHS recognized revenues and assessments as follows:

	Year Recognized		
	2017	2016	Total
Year ended December 31, 2017 HAF:			
Revenue	\$ 46,507	\$ —	\$ 46,507
Year ended December 31, 2017 HAF:			
Assessments	(29,435)	—	(29,435)
Year ended December 31, 2016 HAF:			
Revenue	—	47,799	47,799
Year ended December 31, 2016 HAF:			
Assessments	(855)	(24,961)	(25,816)
Year ended December 31, 2015 HAF:			
Revenue	—	(138)	(138)
	<u>\$ 16,217</u>	<u>\$ 22,700</u>	<u>\$ 38,917</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts (continued)

HAF revenue is included in net patient service revenue and HAF assessments are included in supplies and other expenses in the consolidated statements of operations and changes in net assets.

Estimates for DSH, cost report settlements, and contractual allowances can differ from actual reimbursement based on the results of subsequent reviews, government regulatory changes, and cost report audits. For the years ended December 31, 2017 and 2016, net patient service revenue has been increased by approximately \$3,468 and \$9,618, respectively, for changes in estimates of third-party payor settlements related to prior years.

4. Charity Care

Charity care represents unreimbursed costs for services rendered at a reduced fee, or no fee, due to the inability of the patient to pay for services. The amount of the charity care provided was approximately \$5,203 and \$5,908 for the years ended December 31, 2017 and 2016, respectively, at estimated cost. The Corporation utilized a cost to charge ratio methodology for the cost analysis. The only reimbursement for financial assistance care received by the Corporation is determined through a settlement process in the Hospitals' annual Medicare cost report filing. Financial assistance care reimbursement was approximately \$815 and \$827 for the years ended December 31, 2017 and 2016, respectively.

5. Retirement Plans

The Corporation maintains a defined-contribution employee retirement and savings plan for all employees who have attained 21 years of age and have completed 12 months of continuous service. The Corporation's contributions are based on 100% of the employee's contributions, up to 4% of the employee's salary. Both employee and corporation contributions are subject to certain limitations. Included in employee benefits on the consolidated statements of operations and changes in net assets are contributions of approximately \$11,911 and \$11,487 for the years ended December 31, 2017 and 2016, respectively.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The Corporation also has a noncontributory, defined-benefit pension plan (the MEM Plan), which includes MHSB, BMG, BHF, and BHV with a final average pay plan and a cash balance plan. The cash balance plan was frozen for new participants and accrual of benefits as of December 31, 2007, and the much smaller grandfathered final average pay plan, with fewer participants, remains frozen and has not been altered. The assets in the cash balance plan will continue to earn interest, but service credits are frozen.

The Corporation also has a noncontributory, defined-benefit pension plan (the EGH Plan) for EGH. As of December 31, 2007, the EGH Plan was frozen for all participants who had not attained the age of 50 and accumulated 15 years of vesting service as of December 31, 2007. No new participants are allowed into the plan as of December 31, 2007. Participants who were at least 50 years old and had accumulated 15 years of service at December 31, 2007, continued to accrue benefits under the terms of the EGH Plan until it was frozen effective January 1, 2013. Additionally, a lump-sum payout option was effective for all participants on July 1, 2012.

In October 2017, the Corporation provided notice of intent to terminate the MEM and EGH plans, effective December 31, 2017. The Corporation intends to distribute assets to the participants by October 1, 2018.

The Corporation's defined-benefit plan expense included on the consolidated statements of operations and changes in net assets was as follows:

	<u>EGH</u>	<u>MEM</u>	<u>Total</u>
December 31, 2017	\$ 3,573	\$ 2,237	\$ 5,810
December 31, 2016	4,136	3,814	7,950

The Corporation's expected plan expense for the year ending December 31, 2018 is as follows:

	<u>EGH</u>	<u>MEM</u>	<u>Total</u>
Plan expense	\$ 2,649	\$ 474	\$ 3,123

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The measurement date of December 31 is utilized for both plans. The summary of the changes in the benefit obligation and plan assets and the resulting funded status of the plans are as follows:

	December 31, 2017		
	EGH	MEM	Total
Accumulated benefit obligation	\$ 156,308	\$ 139,120	\$ 295,428
Change in projected benefit obligation:			
Projected benefit obligation at beginning of year	\$ 151,129	\$ 138,800	\$ 289,929
Service cost	285	901	1,186
Interest cost	5,451	5,035	10,486
Actuarial loss	9,125	4,870	13,995
Benefits and administrative expenses paid	(6,044)	(4,801)	(10,845)
Lump-sum benefits paid	(3,638)	(3,570)	(7,208)
Effect of settlement/curtailment	–	(2,115)	(2,115)
Projected benefit obligation at end of year	\$ 156,308	\$ 139,120	\$ 295,428
Change in plan assets:			
Fair value of plan assets at beginning of year	\$ 109,142	\$ 101,267	\$ 210,409
Actual return on plan assets	14,874	11,869	26,743
Employer contributions	31,000	31,000	62,000
Benefits and administrative fees paid	(6,044)	(4,801)	(10,845)
Lump-sum benefits paid	(3,638)	(3,570)	(7,208)
Fair value of plan assets at end of year	\$ 145,334	\$ 135,765	\$ 281,099
Funded status:			
Funded status of the plan and amounts recognized as pension and other liabilities in the consolidated balance sheets	\$ (10,974)	\$ (3,355)	\$ (14,329)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

	December 31, 2016		
	EGH	MEM	Total
Accumulated benefit obligation	\$ 151,129	\$ 138,800	\$ 289,929
Change in projected benefit obligation:			
Projected benefit obligation at beginning of year	\$ 150,727	\$ 139,494	\$ 290,221
Service cost	910	1,662	2,572
Interest cost	5,661	5,271	10,932
Actuarial loss	4,862	530	5,392
Benefits and administrative expenses paid	(6,742)	(5,369)	(12,111)
Lump-sum benefits paid	(4,289)	(2,788)	(7,077)
Projected benefit obligation at end of year	\$ 151,129	\$ 138,800	\$ 289,929
Change in plan assets:			
Fair value of plan assets at beginning of year	\$ 105,371	\$ 95,992	\$ 201,363
Actual return on plan assets	7,302	5,932	13,234
Employer contributions	7,500	7,500	15,000
Benefits and administrative fees paid	(6,742)	(5,369)	(12,111)
Lump-sum benefits paid	(4,289)	(2,788)	(7,077)
Fair value of plan assets at end of year	\$ 109,142	\$ 101,267	\$ 210,409
Funded status:			
Funded status of the plan and amounts recognized as pension and other liabilities in the consolidated balance sheets	\$ (41,987)	\$ (37,533)	\$ (79,520)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

Included in unrestricted net assets are the following amounts that have not been recognized in net periodic pension cost:

	At December 31, 2017		
	EGH	MEM	Total
Prior service cost	\$ —	\$ —	\$ —
Actuarial net loss	59,086	41,273	100,359
	\$ 59,086	\$ 41,273	\$ 100,359

	At December 31, 2016		
	EGH	MEM	Total
Prior service cost	\$ —	\$ 5	\$ 5
Actuarial net loss	62,672	46,687	109,359
	\$ 62,672	\$ 46,692	\$ 109,364

The estimated prior service cost and actuarial net losses that will be amortized into expense over the next fiscal year are as follows:

	At December 31, 2017		
	EGH	MEM	Total
Prior service cost	\$ —	\$ —	\$ —
Actuarial net loss	(4,817)	(2,725)	(7,542)
Estimated benefit cost amortizations in the next fiscal year	\$ (4,817)	\$ (2,725)	\$ (7,542)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

Changes in the plan's assets and benefit obligations recognized in unrestricted net assets include the following:

	Year Ended December 31, 2017		
	EGH	MEM	Total
Current year actuarial gain	\$ 3,586	\$ 5,419	\$ 9,005
Current year amortization prior service cost	–	–	–
	<u>\$ 3,586</u>	<u>\$ 5,419</u>	<u>\$ 9,005</u>
	Year Ended December 31, 2016		
	EGH	MEM	Total
Current year actuarial loss	\$ (905)	\$ (3,743)	\$ (4,648)
Current year amortization prior service cost	–	5	5
	<u>\$ (905)</u>	<u>\$ (3,738)</u>	<u>\$ (4,643)</u>

The components of net periodic benefit cost for the defined-benefit pension plans were as follows:

	Year Ended December 31, 2017		
	EGH	MEM	Total
Service cost	\$ 285	\$ 901	\$ 1,186
Interest cost	5,451	5,035	10,486
Expected return on plan assets	(7,447)	(6,982)	(14,429)
Prior service credit recognized	–	2	2
Amortization of recognized losses	5,284	3,281	8,565
Benefit cost	<u>\$ 3,573</u>	<u>\$ 2,237</u>	<u>\$ 5,810</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

	Year Ended December 31, 2016		
	EGH	MEM	Total
Service cost	\$ 910	\$ 1,662	\$ 2,572
Interest cost	5,661	5,271	10,932
Expected return on plan assets	(7,196)	(6,626)	(13,822)
Prior service credit recognized	–	2	2
Amortization of recognized losses	4,760	3,502	8,262
Benefit cost	<u>\$ 4,135</u>	<u>\$ 3,811</u>	<u>\$ 7,946</u>

Assumptions used to determine benefit obligations at the measurement date are as follows:

	December 31, 2017	
	EGH	MEM
Discount rates	3.35%	3.35%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	N/A

	December 31, 2016	
	EGH	MEM
Discount rates	3.75%	3.75%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00

In 2017, mortality assumptions for the plans utilizing the RP-2014 mortality tables were updated with the 2017 projection scale.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

Assumptions used to determine net pension expense for the fiscal years are as follows:

	December 31, 2017	
	EGH	MEM
Discount rates	3.75%	3.75%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00

	December 31, 2016	
	EGH	MEM
Discount rates	3.90%	3.90%
Expected return on plan assets	7.00	7.00
Rate of compensation increase	N/A	3.00

The following is a summary of the pension plan asset actual allocations:

Asset Category	EGH/MEM	2017		2016	
	Target	EGH	MEM	EGH	MEM
Equity securities	38%	1%	1%	39%	39%
Debt securities	33	74	74	23	21
Other	29	25	25	38	40
Total	100%	100%	100%	100%	100%

The Corporation has liquidated and transferred existing investments to bond funds with the intent to maintain the current asset value for the future termination of the plans. Assets are being held in highly liquid bond funds. Investments not currently held in bond funds are in the process of liquidation or are held in short-term investments.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The following table sets forth by level, within the fair value hierarchy (see Note 11), the combined MEM and EGH plan assets carried at fair value as of December 31, 2017:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Fair Value</u>
Cash and cash equivalents	\$ 15,931	\$ —	\$ —	\$ 15,931
Short-term investment funds ^(a)	26,710	—	—	26,710
Fixed income funds ^(b)	—	206,511	—	206,511
Total assets measured on a recurring basis at fair value	<u>\$ 42,641</u>	<u>\$ 206,511</u>	<u>\$ —</u>	<u>249,152</u>
Investments recorded at fair value based on NAV				<u>31,947</u>
Total assets measured at fair value				<u>\$ 281,099</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

The following table sets forth by level, within the fair value hierarchy (see Note 11), the combined MEM and EGH plan assets carried at fair value as of December 31, 2016:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Fair Value</u>
Short-term investment funds ^(a)	\$ 7,546	\$ —	\$ —	\$ 7,546
Mutual funds ^(a) :				
Large cap equity	24,543	—	—	24,543
International equity	35,642	—	—	35,642
Blended fund	21,537	—	—	21,537
Total mutual funds	<u>81,722</u>	<u>—</u>	<u>—</u>	<u>81,722</u>
Total assets measured on a recurring basis at fair value	<u>\$ 89,268</u>	<u>\$ —</u>	<u>\$ —</u>	<u>89,268</u>
Investments recorded at fair value based on NAV				<u>121,141</u>
Total assets measured at fair value				<u>\$ 210,409</u>

^(a) Pricing for common stocks, mutual funds, and short-term investments is based on the open market and is valued on a daily basis.

^(b) Pricing is based on the fair value of the underlying securities and is valued on a daily basis.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

5. Retirement Plans (continued)

In addition to understanding fair value methodologies, long/short funds, master limited partnership (MLP), Real Estate Investment Trust (REIT), fund of funds, hedge funds, and other funds may be subject to redemption and/or liquidity restrictions. Those funds that have restrictions are summarized below (values shown may include cash positions subject to the stated redemption restrictions), as follows:

Type of Fund	Fair Value at December 31		Redemption Restrictions	Liquidity Time Frame
	2017	2016		
Mutual funds				
International equities	\$ 1,414	\$ 1,948	None	Under 95 days
Long/short funds				
Commingled	–	3,133	None	Under 95 days
Master limited partnership	267	11,745	1 year lock redemption fee	Under 95 days
REIT	8,685	11,926	None	Under 95 days
Hedge funds				
Multi-strategy hedge funds	9,285	13,511	1 year lock varying redemption fees	Under 95 days
Multi-strategy hedge funds	817	1,027	None	Under 95 days
Long/short hedge funds	5,103	4,087	None	Under 95 days
Long/short hedge funds	2,432	4,571	1 year lock redemption fee	Under 95 days
International	3,026	2,765	1 year lock redemption fee	Under 95 days
International	2,011	1,958	None	Under 95 days
Other hedge funds	–	5,102	None	Under 95 days
Other hedge funds	5,639	3,124	1 year lock redemption fee	Under 95 days
Other hedge funds	2,730	2,467	18 month year lock redemption fee	Under 95 days
Fund of funds				
Fund of funds	–	450	1 year redemption restriction	Under 95 days
Fund of funds	2,513	1,864	None	Under 95 days

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

6. Lease Obligations

The Corporation leases certain office space and equipment under non-cancelable operating leases. At December 31, 2017, the minimum future rental payments under these leases are as follows:

2018	\$	4,798
2019		1,994
2020		1,632
2021		1,408
2022		1,315
Thereafter		7,043
	\$	<u>18,190</u>

Rental expense for the years ended December 31, 2017 and 2016 was approximately \$7,489 and \$7,622, respectively, which is included in supplies and other expenses.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

7. Long-Term Debt

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

	2017	2016
Tax-exempt bonds issued on behalf of BHS by the Indiana Finance Authority:		
BHS Revenue Refunding Bonds, Series 2017A, bearing interest at variable rates with a floating fixed interest rate swap of 3.52% at December 31, 2017, due in varying annual installments on August 15 of each year through 2033, with a mandatory tender date of September 8, 2022	\$ 37,240	\$ —
BHS Revenue Refunding Bonds, Series 2017B, bearing interest at a variable rate of 1.38% at December 31, 2017, due annually on May 1 of each year through 2033	40,210	—
BHS Revenue Bonds, Series 2013A, bearing interest at fixed rates between 2.00% and 5.00%, due in varying annual installments on August 15 of each year through 2034	90,525	95,830
BHS Revenue Note, Series 2013B, bearing interest at a fixed rate of 1.17%, at December 31, 2017, due in monthly installments through 2020	2,566	3,644
Tax-exempt bonds issued on behalf of BHS by the Hospital Authority of St. Joseph County:		
BHS Revenue Bonds, Series 2016, bearing interest at fixed rate of 1.39%, due in varying annual installments through 2046	49,800	50,000
BHS Revenue Bonds, Series 2013C, bearing interest at fixed rates between 3.75% and 5.00%, due in varying annual installments on August 15 of each year through 2044	46,130	46,130
Tax-exempt bonds issued on behalf of MHSB by the Hospital Authority of St. Joseph County:		
MHSB Revenue Bonds, Series 2008A, bore interest at a variable rate retaining the hedge from Series 2006 with a floating fixed interest rate swap of 3.52% at December 31,2016	—	37,450

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

7. Long-Term Debt (continued)

	<u>2017</u>	<u>2016</u>
Tax-exempt bonds issued on behalf of EGH by the Hospital Authority of Elkhart County:		
EGH Revenue Bonds, Series 2008, bore interest at a variable rates of 0.74% at December 31, 2016	\$ –	\$ 41,180
Mortgage – bearing interest at variable rates of 2.99% and 2.22% at December 31, 2017 and 2016, respectively, London Interbank Offered Rate (LIBOR) plus 1.50%, due in varying annual installments on the last day of every month through 2020	484	671
Capital leases	790	1,727
	267,745	276,632
Bond issuance costs	(1,833)	(2,247)
Unamortized premium	13,513	14,348
	279,425	288,733
Less current portion	8,745	8,824
	\$ 270,680	\$ 279,909

In September 2017, the Indiana Finance Authority, on behalf of BHS, issued revenue refunding bonds Series 2017A (2017A) in the principal amount of \$37,240. The 2017A Bonds are private placement bonds, bearing interest at a variable monthly interest rate. The proceeds from 2017A were utilized to refund the MHSB Revenue Bonds, Series 2008A.

In September 2017, the Indiana Finance Authority, on behalf of BHS, issued revenue refunding bonds Series 2017B (2017B) in the principal amount of \$40,210. The 2017B Bonds are private placement bonds, bearing interest at a variable monthly interest rate. The proceeds from 2017B were utilized to refund the EGH Revenue Bonds, Series 2008.

In August 2016, the Hospital Authority of St. Joseph County issued Hospital Revenue Bonds, Series 2016 (Series 2016 Bonds), on behalf of the Obligated Group. The Series 2016 Bonds are \$50,000 private placement bonds bearing interest at a fixed rate of 1.39%, due in varying annual installments through 2046. Proceeds from the bonds were utilized to fund existing and future capital projects.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

7. Long-Term Debt (continued)

In May 2013, the Indiana Finance Authority, on behalf of BHS, issued revenue refunding bonds Series 2013A (2013A) in the principal amount of \$116,705. The interest rate for 2013A is a fixed rate varying between 2.00% and 5.00%. The proceeds from 2013A were utilized to refund the MHSB Revenue Bonds, Series 2008B; MHSB Revenue Bonds, Series 1998A; and the EGH Revenue Bonds, Series 1998.

In May 2013, the Indiana Finance Authority, on behalf of BHS, issued a revenue note Series 2013B (2013B) in the principal amount of \$7,492. The interest rate for 2013B is a fixed rate of 1.17%. Proceeds from the bond were utilized for the purchase of a helicopter.

In May 2013, the Hospital Authority of St. Joseph County, on behalf of BHS, issued revenue bonds Series 2013C (2013C) in the principal amount of \$46,130. The interest rate for 2013C is a fixed rate varying between 3.75% and 5.00%. The proceeds from 2013C were utilized to refund the MHSB Revenue Bonds, Series 2007. The remaining proceeds are set aside in externally designated investments for future projects.

The Corporation is the Obligated Group Agent for the Obligated Group under the Master Trust Indentures. The Obligated Group includes the Corporation, MHSB, EGH, and BMG. MHF and BHV constitute designated affiliates under the terms of the Master Trust Indentures. The bonds are secured by pledged revenues of the Obligated Group and contain various covenants, including achievement of specified financial ratios and limitations on additional debt.

The loan agreements require maintenance of certain debt service coverage ratios, limit additional borrowings, and require compliance with various other restrictive covenants. The Corporation was in compliance with all covenants during 2017 and 2016.

Interest capitalized for the years ended December 31, 2017 and 2016 was approximately \$897 and \$1,311.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

7. Long-Term Debt (continued)

Maturities of long-term debt and capital lease obligations for each of the next five years are as follows:

2018	\$	8,745
2019		8,932
2020		8,078
2021		8,925
2022		9,310

8. Line of Credit

The Corporation has a \$2,000 revolving line of credit with 1st Source Bank. The line of credit was renewed and extended through May 31, 2018. Of the \$2,000 revolving line of credit, \$50 for the years ended December 31, 2017 and 2016 was segregated for the beneficiary of a self-insurance trust. Conversely, \$1,950 was available to be drawn upon at December 31, 2017 and 2016. No draws were taken by MHSB in either 2017 or 2016. The interest rate on the line of credit is the prime rate minus 0.5%. No amounts were outstanding on the line of credit as of December 31, 2017 or 2016.

9. Interest Rate and Basis Swaps

MHSB has various derivative instruments related to long-term debt obligations to manage the exposure on interest rates and MHSB's interest expense. Through the use of derivative financial instruments, MHSB is exposed to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of the derivative contract is positive, the counterparty owes MHSB, which creates credit risk to MHSB. When the fair value of the derivative contract is negative, MHSB owes the counterparty, and there is no credit risk to MHSB at that point in time. MHSB minimizes the credit risk in derivative instruments by entering into transactions that require the counterparty to post collateral for the benefit of the fair value of the derivative contract. Market risk is the adverse effect on the value of the financial instrument that results from a change in interest rates. The management of market risk associated with interest rate changes is defined in MHSB's Swap Management Policy (the Policy). The Policy includes continuous monitoring of market conditions, emergent opportunities, and risks. Swap management is meant to be long term in nature, and any modifications to the program are reviewed for the long-term costs and benefits. Management also mitigates risk through periodic reviews of its derivative position in the context of its total blended cost of capital.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

9. Interest Rate and Basis Swaps (continued)

In February 2016, MHSB terminated one Deutsche bank swap with a notional amount of \$54,000. MHSB realized a net gain of \$158, which is included in the nonoperating income on the consolidated statements of operations and changes in net assets.

The derivative instruments require adherence to collateral posting thresholds. For the years ended December 31, 2017 and 2016, the mark-to-market valuation on the swap portfolio was below the required collateral posting threshold of \$30,000 with PNC Bank, \$25,000 with Morgan Stanley, \$25,000 with Wells Fargo, and \$25,000 with Deutsche Bank.

The following is a summary of the outstanding fixed payer rate swaps as of December 31, 2017:

Origination Date	Notional Amounts	MHSB Receives	MHSB Pays	Maturity Date
March 2006	\$ 37,240	61.9% of 30-day LIBOR plus 0.31%	3.5150%	August 2033
March 2003	7,600	65% of 30-day LIBOR plus 0.45%	3.8100	August 2034

The following is a summary of the outstanding fixed payer rate swaps as of December 31, 2016:

Origination Date	Notional Amounts	MHSB Receives	MHSB Pays	Maturity Date
March 2006	\$ 37,450	61.9% of 30-day LIBOR plus 0.31%	3.5150%	August 2033
March 2003	7,850	65% of 30-day LIBOR plus 0.45%	3.8100	August 2034

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

9. Interest Rate and Basis Swaps (continued)

The following is a summary of the outstanding basis rate swaps as of December 31, 2017:

Origination Date	Notional Amounts	MHSB Receives	MHSB Pays	Maturity Date
January 2007	\$ 42,000	74.6% of 1M LIBOR	SIFMA tax-exempt index + 0.0715%	January 2041
March 2001	140,000	75.125% of 3M LIBOR	SIFMA tax-exempt index	March 2031
July 2009	63,000	74.6% of 1M LIBOR	SIFMA tax-exempt index + 0.17%	January 2041
August 2009	81,000	61.7% of 1M LIBOR + 0.76%	SIFMA tax-exempt index + 0.17%	August 2041

The following swap agreement was terminated in February 2016 and is not included in the table above:

Origination Date	Notional Amounts	Corporation Receives	Corporation Pays	Maturity Date
August 2007	\$ 54,000	61.7% of 1M LIBOR + 0.76%	SIFMA tax-exempt index +.0715%	August 2041

Net interest paid or received under the above swap agreements is included in interest expense. The net differential for MHSB as a result of the swap agreements amounted to payments of approximately \$760 and \$1,318 for the years ended December 31, 2017 and 2016, respectively, and is reflected as an increase to interest expense. The swap agreements do not qualify for hedge accounting; therefore, the change in the fair value of the swap agreements is recorded as an unrealized non-operating gain (loss) of approximately \$7,099 and (\$1,246) for the years ended December 31, 2017 and 2016, respectively.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

9. Interest Rate and Basis Swaps (continued)

The fair value of derivative instruments at December 31 is as follows:

	<u>Balance Sheet Location</u>	<u>2017</u>	<u>2016</u>
Derivatives not designated as hedging instruments:			
Interest rate contracts	Interest rate and basis swap receivable	\$ 625	\$ —
	Interest rate and basis swaps payable	(16,305)	(22,779)
		<u>\$ (15,680)</u>	<u>\$ (22,779)</u>

10. Investments

Total investment return for the years ended December 31 is summarized as follows:

	<u>2017</u>	<u>2016</u>
Investment return:		
Net unrealized gains on investments	\$ 60,391	\$ 4,370
Net realized gains on investments	16,208	35,916
Net equity earnings on alternative investments	6,639	2,763
	<u>\$ 83,238</u>	<u>\$ 43,049</u>
Reported as:		
Investment income, net (non-operating)	\$ 82,462	\$ 42,741
Investment income (temporarily restricted net assets)	776	308
	<u>\$ 83,238</u>	<u>\$ 43,049</u>

The Corporation's investments are exposed to various kinds and levels of risk. Equity mutual funds expose the Corporation to market risk, performance risk, and liquidity risk. Market risk is the risk associated with major movements of the equity markets. Performance risk is the risk associated with a company's operating performance. Fixed-income securities expose the Corporation to interest rate risk, credit risk, and liquidity risk. As interest rates change, the value of many fixed-income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

10. Investments (continued)

of market participants to buy and sell given securities. Liquidity risk tends to be higher for equities related to small capitalization companies. Due to the volatility of the capital markets, there is a reasonable possibility of changes in fair value, resulting in additional gains and losses in the near term.

11. Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable and accrued expenses are reasonable estimates of their fair values due to the short-term nature of these financial instruments.

The fair value of the Corporation's long-term debt, excluding capital leases and the mortgage, is approximately \$279,277 and \$284,707 at December 31, 2017 and 2016, respectively. The valuation for the estimated fair value of long-term debt is completed by a third-party service and takes into account a number of factors, including, but not limited to, any one or more of the following: (i) general interest rate and market conditions; (ii) macroeconomic and/or deal-specific credit fundamentals; (iii) valuations of other financial instruments that may be comparable in terms of rating, structure, maturity, and/or covenant protection; (iv) investor opinions about the respective deal parties; (v) size of the transaction; (vi) cash flow projections, which, in turn, are based on assumptions about certain parameters that include, but are not limited to, default, recovery, prepayment, and reinvestment rates; (vii) administrator reports, asset manager estimates, broker quotations, and/or trustee reports; and (viii) comparable trades, where observable. Based on the inputs in determining the estimated fair value of debt, this fair value measurement would be considered Level 2.

Accounting Standards Codification Topic (ASC) 820-10-50-2 establishes a three-level valuation hierarchy. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in an active market and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables present the financial instruments carried as of December 31, 2017 and 2016, by caption, on the consolidated balance sheets by the valuation hierarchy defined above for those instruments carried at fair value, as well as the alternative investments that are reported on the equity method of accounting. Deferred compensation investments are included in other assets on the consolidated balance sheets.

	December 31, 2017					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets						
Short-term investments ^(a)	\$ 3,388	\$ –	\$ –	\$ 3,388	\$ –	\$ 3,388
Internally designated investments:						
Mutual funds ^(a)	–	–	–	–	–	–
Blended fund	421,268	–	–	421,268	–	421,268
Total mutual funds	421,268	–	–	421,268	–	421,268
Common stock ^(a)	5,961	–	–	5,961	–	5,961
Alternatives:						
Fund of hedge funds	–	–	–	–	2,884	2,884
International equity	–	–	–	–	2,772	2,772
MLP	–	–	–	–	38,208	38,208
Private equity	–	–	–	–	33,006	33,006
REIT	–	–	–	–	31,050	31,050
International	–	–	–	–	14,969	14,969
Commingled funds	–	–	–	–	94,174	94,174
Other	–	–	–	–	16,656	16,656
Long/short hedge	–	–	–	–	14,144	14,144
Global	–	–	–	–	4,946	4,946
Multi-strategy	–	–	–	–	25,473	25,473
Total alternatives	–	–	–	–	278,282	278,282
Total internally designated investments	427,229	–	–	427,229	278,242	705,511

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

	December 31, 2017					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets (continued)						
Restricted cash ^(a)	\$ 2,758	\$ –	\$ –	\$ 2,758	\$ –	\$ 2,758
Ext. designated investment – insurance trust:						
Fixed income ^(a)	2,710	–	–	2,710	–	2,710
Designated cash ^(a)	20,315	–	–	20,315	–	20,315
Board-designated endowment:						
Mutual funds: ^(a)						
Equities	1,378	–	–	1,378	–	1,378
Blended fund	16,812	–	–	16,812	–	16,812
Fixed income ^{(a), (b)}	197	146	–	343	–	343
Equities ^(a)	1,576	–	–	1,576	–	1,576
Alternatives	–	–	–	–	7,207	7,207
Total board-designated endowment	19,963	146	–	20,109	7,207	27,316
Endowment:						
Mutual funds: ^(a)						
Fixed income	1	–	–	1	–	1
Blended fund	4,914	–	–	4,914	–	4,914
Money market ^(a)	3	–	–	3	–	3
Equities ^(a)	460	–	–	460	–	460
Alternatives	–	–	–	–	2,552	2,552
Total endowment	5,378	–	–	5,378	2,552	7,930
Swap ^(c)	–	–	625	625	–	625
Total	\$ 481,741	\$ 146	\$ 625	\$ 482,512	\$ 288,041	\$ 770,553
Liabilities						
Swaps ^(c)	\$ –	\$ –	\$ (16,305)	\$ (16,305)	\$ –	\$ (16,305)
Total	\$ –	\$ –	\$ (16,305)	\$ (16,305)	\$ –	\$ (16,305)

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

	December 31, 2016					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets						
Short-term investments ^(a)	\$ 53,501	\$ —	\$ —	\$ 53,501	\$ —	\$ 53,501
Internally designated investments:						
Mutual funds ^(a)						
Blended fund	330,982	—	—	330,982	—	330,982
Total mutual funds	330,982	—	—	330,982	—	330,982
Common stock ^(a)	5,742	—	—	5,742	—	5,742
Alternatives:						
Fund of hedge funds	—	—	—	—	2,654	2,654
International equity	—	—	—	—	3,818	3,818
MLP	—	—	—	—	41,577	41,577
Private equity	—	—	—	—	21,710	21,710
REIT	—	—	—	—	29,054	29,054
International	—	—	—	—	16,321	16,321
Commingled funds	—	—	—	—	83,565	83,565
Other	—	—	—	—	15,075	15,075
Long/short hedge	—	—	—	—	12,089	12,089
Global	—	—	—	—	4,212	4,212
Multi-strategy	—	—	—	—	24,091	24,091
Total alternatives	—	—	—	—	254,166	254,166
Total internally designated investments	336,724	—	—	336,724	254,166	590,890

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

	December 31, 2016					
	Level 1	Level 2	Level 3	Fair Value	Equity Method	Carrying Value
Assets (continued)						
Restricted cash ^(a)	\$ 4,526	\$ –	\$ –	\$ 4,526	\$ –	\$ 4,526
Ext. designated investment – insurance trust:						
Fixed income ^(a)	2,680	–	–	2,680	–	2,680
Designated cash ^(a)	19,769	–	–	19,769	–	19,769
Board-designated endowment:						
Mutual funds ^(a) :						
Equities	2,733	–	–	2,733	–	2,733
Blended fund	9,168	417	–	9,585	–	9,585
Fixed income ^{(a), (b)}	371	277	–	648	–	648
Equities ^(a)	953	–	–	953	–	953
Common collective trust funds ^(d)	–	2,904	–	2,904	–	2,904
Alternatives	–	–	–	–	8,138	8,138
Total board-designated endowment	13,225	3,598	–	16,823	8,138	24,961
Endowment:						
Mutual funds ^(a) :						
Fixed income	379	–	–	379	–	379
Equities	1,071	–	–	1,071	–	1,071
Blended fund	1,317	–	–	1,317	–	1,317
Money market ^(a)	200	–	–	200	–	200
Hedge funds	–	–	–	–	414	414
Common collective trust funds ^(d)	–	3,133	–	3,133	–	3,133
Total endowment	2,967	3,133	–	6,100	414	6,514
Total	\$ 433,392	\$ 6,731	\$ –	\$ 440,123	\$ 262,718	\$ 702,841
Liabilities						
Swaps ^(c)	\$ –	\$ –	\$ (22,779)	\$ (22,779)	\$ –	\$ (22,779)
Total	\$ –	\$ –	\$ (22,779)	\$ (22,779)	\$ –	\$ (22,779)

^(a) Pricing for mutual funds, short-term investments, equities, and government obligations is based on the open market and is valued on a daily basis.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

11. Fair Value of Financial Instruments (continued)

- (b) Pricing is based on the fair value of the securities and is valued on a monthly basis. Information used to value this account is provided by International Data Corp. (IDC). In the event that a security is not actively traded in the open market, the characteristics are matched to a comparable issue from the IDC data to appropriately value the holding.
- (c) Pricing is based on discounted cash flows to reflect a credit spread adjustment to the LIBOR discount curve in order to reflect “nonperformance” risk. The credit spread adjustment is derived from how other comparable entities’ bonds price and trade in the market. As the credit spread adjustment is a significant component of the swap valuation and is an unobservable input, the swaps have been classified as Level 3.
- (d) Pricing is based on the market value of the securities and is valued on a monthly basis.

The table below sets forth a summary of changes in the fair value of the Corporation’s Level 3 swaps for the years ended December 31:

	<u>2017</u>	<u>2016</u>
Balance, beginning of the year	\$ (22,779)	\$ (19,925)
Unrealized gains, net	7,099	(1,246)
Realized gains, net	–	158
Sales of swaps	–	(1,766)
Balance, end of the year	<u>\$ (15,680)</u>	<u>\$ (22,779)</u>

For the year ended December 31, 2017, the Corporation recorded approximately \$7,099 in non-operating gains, which relates to gains of \$7,775 due to the change in the swaps’ value and loss of \$676 to reflect the fair value of the uncollateralized portion of the swap balance. For the year ended December 31, 2016, the Corporation recorded approximately \$1,246 in non-operating losses, which relates to losses of \$2,325 due to the change in the swaps’ value and loss of \$528 to reflect the fair value of the uncollateralized portion of the swap balance.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued) (In Thousands)

12. Functional Expenses

The Corporation provides general health care services to residents within its geographic location. Expenses related to this and general and administrative functions for the years ended December 31 are as follows:

	<u>2017</u>	<u>2016</u>
Health care services	\$ 566,202	\$ 564,601
Affiliated health services	182,243	178,321
General and administrative	163,613	155,171
	<u>\$ 912,058</u>	<u>\$ 898,093</u>

13. Commitments

BMG is a guarantor for a portion of a loan of an unconsolidated joint venture, Valparaiso Medical Development, LLC, in which BMG records an equity interest. The portion of debt guaranteed by BMG is a maximum of \$4,814 and \$5,052 at December 31, 2017 and 2016, respectively. No amounts have been paid or accrued pursuant to this guarantee as of December 31, 2017 or 2016. The loan is collateralized by the assets, including the facility and land, held by Valparaiso Medical Development, LLC.

The Corporation has total commitments to invest \$148,300 in certain hedge funds and alternative investments. During the years ended December 31, 2017 and 2016, the Corporation invested approximately \$17,348 and \$11,210, respectively. The Corporation had a remaining unfunded commitment of approximately \$82,885 at December 31, 2017.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

14. Professional Liability Insurance

The Corporation is involved in lawsuits and various governmental investigations, audits, reviews, and administrative proceedings arising in the ordinary course of business. Additionally, the Corporation may be subject to additional claims alleging professional liability for medical malpractice. The Corporation has a claims made policy that covers all entities and has a \$25,000 deductible per claim. Historically, MHSB and EGH have obtained separate professional liability insurance coverage under claims-made policies. The claims made policy covers all years other than years that were self-funded. MHSB was self-funded of its professional and general liability coverage for the period of December 1, 2003 to November 30, 2009. EGH was self-funded for its professional and general liability coverage for the period of March 1, 2010 to April 1, 2012. The Indiana Medical Malpractice Act has provided recovery up to \$1,250, per occurrence, with the first \$250 covered by the respective entity, for claims prior to July 1, 2017. Effective July 1, 2017, the coverage limit was increased to \$1,650, per occurrence, with the first \$400 covered by the respective entity. MHSB maintains a trust fund for its self-insurance program, which it will continue to maintain until all claims have been settled. The fair value of the trust fund at December 31, 2017 and 2016 was approximately \$2,711 and \$2,680, respectively. The amount of malpractice and general liability claims, including a component for incurred but not reported claims, was approximately \$5,227 and \$5,400, gross of an insurance recoverable at December 31, 2017 and 2016, respectively, which is included in pension and other liabilities. The interest rate used to discount these claims was 3.0% at December 31, 2017. In addition, at December 31, 2017 and 2016, the Corporation recognized a recoverable insurance asset of approximately \$4,287, which is included in deferred charges and other assets.

15. Income Taxes

The Corporation and its related affiliates, except for BHV, have been determined to qualify as exempt from federal income tax under Section 501(a) as organizations described in Section 501(c)(3) of the Code.

Most of the income received by the Corporation and its related affiliates, except for BHV, is exempt from taxation, as the income is related to the mission of the organization. Accordingly, there is no material provision for income tax for these entities. However, some of the income received by exempt entities is subject to taxation as unrelated business income. The Corporation and its subsidiaries file federal and various state income tax returns in the United States.

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)
(In Thousands)

15. Income Taxes (continued)

ASC 740, *Income Taxes*, requires that realization of an uncertain income tax position is more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it is recognized in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. This interpretation also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. No amount was recorded for the years ended December 31, 2017 or 2016.

16. Restricted Net Assets

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

	<u>2017</u>	<u>2016</u>
Net assets currently available for:		
General – health care	\$ 9,280	\$ 10,012
Capital	2,128	3,210
Programs	312	178
Education	684	285
Other	1,178	1,057
	<u>\$ 13,582</u>	<u>\$ 14,742</u>

Permanently restricted net assets generate investment income, which is used to benefit the following purposes at December 31:

	<u>2017</u>	<u>2016</u>
Endowment investments providing income for health care educational purposes	\$ 75	\$ 266
Endowment for charity care at EGH	400	400
	<u>\$ 475</u>	<u>\$ 666</u>

Beacon Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

(In Thousands)

17. Subsequent Events

The Corporation evaluated events and transactions occurring subsequent to December 31, 2017 through March 8, 2018, the date of issuance of the accompanying consolidated financial statements. During this period, there were no subsequent events requiring recognition or disclosure in the consolidated financial statements.

Supplementary Information



Ernst & Young LLP
155 North Wacker Drive
Chicago, IL 60606-1787
Tel: +1 312 879 2000
Fax: +1 312 879 4000
ey.com

Report of Independent Auditors on Supplementary Information

The Board of Directors
Beacon Health System, Inc. and Affiliated Corporations

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

Ernst & Young LLP

March 8, 2018

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet

(In Thousands)

December 31, 2017

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Assets								
Current assets:								
Cash and cash equivalents	\$ 44,812	\$ –	\$ (141)	\$ 7,007	\$ 56	\$ 1,686	\$ 14,515	\$ 21,689
Short-term investments	3,388	–	12	–	1,178	–	–	2,198
Patient accounts receivable, net	151,791	(5,018)	89,329	16,804	–	3,478	45,898	1,300
Due from third-party payors	27,064	–	26,303	–	–	–	761	–
Other receivables	5,055	–	1,795	1,027	793	176	1,044	220
Inventories	23,942	–	16,813	–	–	53	7,076	–
Prepaid expenses	15,954	–	1,075	1,133	–	124	968	12,654
Due from affiliates	–	(4,098)	–	449	–	–	–	3,649
Total current assets	272,006	(9,116)	135,186	26,420	2,027	5,517	70,262	41,710
Assets limited as to use:								
Internally designated investments	705,511	–	–	–	–	–	–	705,511
Restricted cash	2,758	–	–	–	2,758	–	–	–
Externally designated investments – insurance trust	2,710	–	2,681	19	–	10	–	–
Designated cash	20,315	–	–	–	–	–	–	20,315
Board-designated endowment	27,316	–	–	–	27,316	–	–	–
Endowment and temporarily restricted investments	7,930	–	–	–	762	–	7,168	–
	766,540	–	2,681	19	30,836	10	7,168	725,826
Property and equipment:								
Land	45,101	–	21,318	3,883	–	–	4,147	15,753
Buildings and improvements	795,115	–	492,306	46,260	19	1,441	250,819	4,270
Furniture and equipment	490,299	–	293,352	33,318	162	6,338	113,851	43,278
Construction-in-progress	16,037	–	3,183	785	–	17	2,267	9,785
	1,346,552	–	810,159	84,246	181	7,796	371,084	73,086
Less allowances for depreciation and amortization	687,048	–	437,839	35,104	150	5,415	177,550	30,990
	659,504	–	372,320	49,142	31	2,381	193,534	42,096
Deferred charges and other assets	38,911	(12,367)	4,562	17,253	1,323	6,493	3,719	17,928
Interest in net assets of recipient organization	–	(6,814)	6,814	–	–	–	–	–
Interest rate swap	625	–	625	–	–	–	–	–
Total assets	\$ 1,737,586	\$ (28,297)	\$ 522,188	\$ 92,834	\$ 34,217	\$ 14,401	\$ 274,683	\$ 827,560

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet (continued)

(In Thousands)

December 31, 2017

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Liabilities and net assets								
Current liabilities:								
Accounts payable	\$ 47,085	\$ –	\$ 19,657	\$ 9,046	\$ 6	\$ 417	\$ 11,387	\$ 6,572
Accrued salaries and benefits	36,831	(5,018)	17,155	7,517	–	1,855	8,646	6,676
Accrued expenses	4,836	–	2,357	–	–	164	821	1,494
Due to third-party payors	6,159	–	5,056	–	–	–	1,103	–
Due to affiliates	–	(4,098)	63	–	452	3,551	32	–
Current maturities of long-term debt	8,745	–	5,564	68	–	–	2,953	160
Total current liabilities	103,656	(9,116)	49,852	16,631	458	5,987	24,942	14,902
Non-current liabilities:								
Long-term debt, less current maturities	270,680	–	149,966	57	–	–	71,288	49,369
Pension and other liabilities	27,111	–	8,264	3,361	–	14	12,883	2,589
Interest rate and basis swaps	16,305	–	16,305	–	–	–	–	–
Total liabilities	417,752	(9,116)	224,387	20,049	458	6,001	109,113	66,860
Net assets:								
Unrestricted:								
Undesignated	1,278,461	(12,367)	290,987	72,785	(446)	8,400	158,402	760,700
Board-designated endowment	27,316	–	–	–	27,316	–	–	–
Total unrestricted	1,305,777	(12,367)	290,987	72,785	26,870	8,400	158,402	760,700
Temporarily restricted	13,582	(6,814)	6,814	–	6,814	–	6,768	–
Permanently restricted	475	–	–	–	75	–	400	–
Total net assets	1,319,834	(19,181)	297,801	72,785	33,759	8,400	165,570	760,700
Total liabilities and net assets	\$ 1,737,586	\$ (28,297)	\$ 522,188	\$ 92,834	\$ 34,217	\$ 14,401	\$ 274,683	\$ 827,560

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet

(In Thousands)

December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Assets								
Current assets:								
Cash and cash equivalents	\$ 43,032	\$ –	\$ 25,091	\$ 4,451	\$ 451	\$ 1,709	\$ 11,458	\$ (128)
Short-term investments	53,501	–	34,652	–	1,057	–	–	17,792
Patient accounts receivable, net	160,873	(4,615)	89,958	14,453	–	4,351	55,354	1,372
Due from third-party payors	40,376	–	37,855	–	–	–	2,521	–
Other receivables	9,072	–	4,353	998	1,267	300	1,770	384
Inventories	25,437	–	17,028	–	–	443	7,966	–
Prepaid expenses	15,757	–	1,016	398	–	128	1,528	12,687
Due from affiliates	–	(1)	1	–	–	–	–	–
Total current assets	348,048	(4,616)	209,954	20,300	2,775	6,931	80,597	32,107
Assets limited as to use:								
Internally designated investments	590,890	–	–	–	–	–	–	590,890
Restricted cash	4,526	–	–	–	4,526	–	–	–
Externally designated investments – insurance trust	2,680	–	2,650	20	–	10	–	–
Designated cash	19,769	–	–	–	–	–	–	19,769
Board-designated endowment	24,961	–	–	–	24,961	–	–	–
Endowment and temporarily restricted investments	6,514	–	–	–	–	–	6,514	–
	649,340	–	2,650	20	29,487	10	6,514	610,659
Property and equipment:								
Land	44,897	–	21,318	3,883	–	–	3,943	15,753
Buildings and improvements	730,503	–	434,250	43,559	19	1,448	246,861	4,366
Furniture and equipment	466,023	–	284,146	32,456	159	8,059	101,998	39,205
Construction-in-progress	55,372	–	43,438	308	–	–	6,459	5,167
	1,296,795	–	783,152	80,206	178	9,507	359,261	64,491
Less allowances for depreciation and amortization	641,882	–	417,901	30,825	141	5,850	160,503	26,662
	654,913	–	365,251	49,381	37	3,657	198,758	37,829
Deferred charges and other assets	32,938	(12,367)	4,583	16,728	1,607	7,046	4,181	11,160
Interest in net assets of recipient organization	–	(8,628)	8,628	–	–	–	–	–
Total assets	\$ 1,685,239	\$ (25,611)	\$ 591,066	\$ 86,429	\$ 33,906	\$ 17,644	\$ 290,050	\$ 691,755

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet (continued)

(In Thousands)

December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Liabilities and net assets								
Current liabilities:								
Accounts payable	\$ 46,991	\$ –	\$ 23,193	\$ 8,585	\$ 3	\$ 664	\$ 10,924	\$ 3,622
Accrued salaries and benefits	35,928	(4,615)	16,946	6,801	–	2,022	8,514	6,260
Accrued expenses	4,809	–	2,454	–	–	123	937	1,295
Due to third-party payors	4,452	–	3,582	–	–	–	870	–
Due to affiliates	–	(1)	–	–	–	–	–	1
Current maturities of long-term debt	8,824	–	5,757	66	–	–	2,801	200
Total current liabilities	101,004	(4,616)	51,932	15,452	3	2,809	24,046	11,378
Non-current liabilities:								
Long-term debt, less current maturities	279,909	–	155,995	131	–	–	74,264	49,519
Pension and other liabilities	92,159	–	8,467	37,558	–	14	43,980	2,140
Interest rate and basis swaps	22,779	–	22,779	–	–	–	–	–
Total liabilities	495,851	(4,616)	239,173	53,141	3	2,823	142,290	63,037
Net assets:								
Unrestricted:								
Undesignated	1,154,359	(12,367)	343,265	33,288	5,388	14,821	141,246	628,718
Board-designated endowment	19,621	–	–	–	19,621	–	–	–
Total unrestricted	1,173,980	(12,367)	343,265	33,288	25,009	14,821	141,246	628,718
Temporarily restricted	14,742	(8,628)	8,628	–	8,628	–	6,114	–
Permanently restricted	666	–	–	–	266	–	400	–
Total net assets	1,189,388	(20,995)	351,893	33,288	33,903	14,821	147,760	628,718
Total liabilities and net assets	\$ 1,685,239	\$ (25,611)	\$ 591,066	\$ 86,429	\$ 33,906	\$ 17,644	\$ 290,050	\$ 691,755

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets
(In Thousands)

Year Ended December 31, 2017

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted revenue, gains, and other support								
Net patient service revenue	\$ 960,770	\$ –	\$ 522,579	\$ 116,225	\$ –	\$ 25,356	\$ 289,207	\$ 7,403
Provision for bad debts	(59,669)	–	(28,872)	(5,246)	–	(447)	(25,104)	–
Net patient service revenue less provision for bad debts	901,101	–	493,707	110,979	–	24,909	264,103	7,403
Other revenue	40,439	(8,399)	18,719	9,849	1,236	2,456	10,516	6,062
Net assets released from restrictions used for operations	1,810	–	647	9	26	–	76	1,052
	943,350	(8,399)	513,073	120,837	1,262	27,365	274,695	14,517
Expenses								
Salaries and wages	394,191	–	143,361	122,872	–	19,514	78,734	29,710
Employee benefits	101,922	–	39,168	22,455	–	4,526	24,023	11,750
Supplies and other	232,358	(8,323)	124,676	22,103	491	5,726	75,092	12,593
Management fees	–	–	34,474	11,013	160	1,929	22,519	(70,095)
Professional fees and purchased services	117,039	(76)	45,556	3,929	1,145	688	36,129	29,668
Depreciation and amortization	59,496	–	30,464	5,451	9	1,409	17,879	4,284
Interest	7,052	–	5,521	4	–	–	1,527	–
	912,058	(8,399)	423,220	187,827	1,805	33,792	255,903	17,910
Income (loss) from operations	31,292	–	89,853	(66,990)	(543)	(6,427)	18,792	(3,393)
Non-operating income (expenses)								
Investment income, net	82,462	–	785	40	2,405	4	(41)	79,269
Unrealized gains on swap transactions, net	7,099	–	7,099	–	–	–	–	–
Loss on bond refunding	(534)	–	(204)	–	–	–	(330)	–
Revenue and gains in excess of (less than) expenses	120,319	–	97,533	(66,950)	1,862	(6,423)	18,421	75,876

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (continued)
(In Thousands)

Year Ended December 31, 2017

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted net assets								
Revenue and gains in excess of (less than) expenses	\$ 120,319	\$ –	\$ 97,533	\$ (66,950)	\$ 1,862	\$ (6,423)	\$ 18,421	\$ 75,876
Net assets released from restrictions used for capital purposes	2,473	–	2,335	–	–	–	138	–
Other	–	–	(152,146)	101,028	–	2	(4,990)	56,106
Postretirement benefit adjustments other than periodic costs	9,005	–	–	5,419	–	–	3,586	–
Increase (decrease) in unrestricted net assets	131,797	–	(52,278)	39,497	1,862	(6,421)	17,155	131,982
Temporarily restricted net assets								
Contributions temporarily restricted for use	2,156	–	–	–	2,156	–	–	–
Investment income	776	–	–	–	121	–	655	–
Reclassification of contribution restriction by donor	191	–	–	–	191	–	–	–
Net assets released from restrictions used for operating and capital purposes	(4,283)	–	–	–	(4,283)	–	–	–
Change in interest in recipient organization	–	1,814	(1,814)	–	–	–	–	–
(Decrease) increase in temporarily restricted net assets	(1,160)	1,814	(1,814)	–	(1,815)	–	655	–
Permanently restricted net assets								
Reclassification of contribution restriction by donor	(191)	–	–	–	(191)	–	–	–
Decrease in permanently restricted net assets	(191)	–	–	–	(191)	–	–	–
Increase (decrease) in net assets	130,446	1,814	(54,092)	39,497	(144)	(6,421)	17,810	131,982
Net assets at beginning of year	1,189,388	(20,995)	351,893	33,288	33,903	14,821	147,760	628,718
Net assets at end of year	\$ 1,319,834	\$ (19,181)	\$ 297,801	\$ 72,785	\$ 33,759	\$ 8,400	\$ 165,570	\$ 760,700

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (In Thousands)

Year Ended December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted revenue, gains, and other support								
Net patient service revenue	\$ 945,600	\$ –	\$ 505,241	\$ 111,648	\$ –	\$ 31,438	\$ 290,795	\$ 6,478
Provision for bad debts	(59,658)	–	(29,577)	(5,814)	–	(2,280)	(21,983)	(4)
Net patient service revenue less provision for bad debts	885,942	–	475,664	105,834	–	29,158	268,812	6,474
Other revenue	36,274	(10,606)	16,647	8,411	864	2,562	12,821	5,575
Net assets released from restrictions used for operations	980	–	338	12	–	(1)	11	620
	923,196	(10,606)	492,649	114,257	864	31,719	281,644	12,669
Expenses								
Salaries and wages	391,882	–	143,776	118,031	–	22,102	78,875	29,098
Employee benefits	102,234	–	39,695	21,660	–	4,968	25,010	10,901
Supplies and other	222,224	(10,150)	119,883	20,402	545	7,374	72,059	12,111
Management fees	–	–	30,071	10,880	200	2,750	19,325	(63,226)
Professional fees and purchased services	119,129	(456)	47,275	4,287	830	1,272	41,312	24,609
Depreciation and amortization	55,987	–	29,522	5,239	10	1,258	16,086	3,872
Interest	6,637	–	5,322	6	–	1	1,308	–
	898,093	(10,606)	415,544	180,505	1,585	39,725	253,975	17,365
Income (loss) from operations	25,103	–	77,105	(66,248)	(721)	(8,006)	27,669	(4,696)
Non-operating income (expenses)								
Investment income, net	42,741	–	674	53	382	4	16	41,612
Unrealized losses on swap transactions, net	(1,246)	–	(1,246)	–	–	–	–	–
Gain on swap termination	158	–	158	–	–	–	–	–
Loss on sale of assets	(1,362)	–	(1,362)	–	–	–	–	–
Fair value of net assets combined	5,157	–	–	–	5,157	–	–	–
Revenue and gains in excess of (less than) expenses	70,551	–	75,329	(66,195)	4,818	(8,002)	27,685	36,916

Beacon Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (continued) (In Thousands)

Year Ended December 31, 2016

	Consolidated	Eliminations	Memorial Hospital of South Bend, Inc.	Beacon Medical Group, Inc.	Beacon Health Foundation, Inc.	Beacon Health Ventures, Inc.	Elkhart General Hospital, Inc.	Beacon Health System, Inc.
Unrestricted net assets								
Revenue and gains in excess of (less than) expenses	\$ 70,551	\$ –	\$ 75,329	\$ (66,195)	\$ 4,818	\$ (8,002)	\$ 27,685	\$ 36,916
Net assets released from restrictions used for capital purposes	1,664	–	1,557	50	–	–	57	–
Other	–	–	(37,066)	70,297	417	5,076	(7,134)	(31,590)
Postretirement benefit adjustments other than periodic costs	2,286	–	–	2,281	–	–	5	–
Increase (decrease) in unrestricted net assets	74,501	–	39,820	6,433	5,235	(2,926)	20,613	5,326
Temporarily restricted net assets								
Contributions temporarily restricted for use	3,857	–	–	–	3,857	–	–	–
Investment income	308	–	–	–	11	–	297	–
Contributions of net assets from Elkhart General Hospital Foundation	515	–	–	–	515	–	–	–
Net assets released from restrictions used for operating and capital purposes	(2,644)	–	–	–	(2,644)	–	–	–
Change in interest in recipient organization	–	(1,739)	1,739	–	–	–	–	–
Increase in temporarily restricted net assets	2,036	(1,739)	1,739	–	1,739	–	297	–
Permanently restricted net assets								
Fair value of net assets combined	75	–	–	–	75	–	–	–
Increase in permanently restricted net assets	75	–	–	–	75	–	–	–
Increase (decrease) in net assets	76,612	(1,739)	41,559	6,433	7,049	(2,926)	20,910	5,326
Net assets at beginning of year	1,112,776	(19,256)	310,334	26,855	26,854	17,747	126,850	623,392
Net assets at end of year	\$ 1,189,388	\$ (20,995)	\$ 351,893	\$ 33,288	\$ 33,903	\$ 14,821	\$ 147,760	\$ 628,718

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