



UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Consolidated Financial Statements

December 31, 2014 and 2013

(With Independent Auditors' Reports Thereon)

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

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Independent Auditors' Report

The Board of Directors
University Hospitals Health System, Inc.

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of University Hospitals Health System, Inc. and subsidiaries (the System), which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of 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 from material misstatement.

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

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



Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of University Hospitals Health System, Inc. and subsidiaries as of December 31, 2014 and 2013, and the changes in its net assets and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated March 26, 2015 on our consideration of the System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the System's internal control over financial reporting and compliance.

KPMG LLP

Cleveland, Ohio
March 26, 2015

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Consolidated Balance Sheets

December 31, 2014 and 2013

(In thousands of dollars)

Assets	2014	2013
Current assets:		
Cash and cash equivalents	\$ 175,868	193,505
Patient accounts receivable, less allowance for doubtful accounts of \$32,619 in 2014 and \$33,682 in 2013	370,771	323,877
Other receivables	81,231	63,537
Assets held for disposal	3,017	4,517
Other current assets	119,919	99,903
Total current assets	<u>750,806</u>	<u>685,339</u>
Investments	1,310,529	1,004,381
Property, plant and equipment, net	1,382,512	1,228,086
Other assets:		
Investments in affiliates	115,262	105,988
Beneficial interest in Foundations	91,300	62,956
Perpetual trusts	194,952	190,167
Other	155,019	153,809
Total other assets	<u>556,533</u>	<u>512,920</u>
Total assets	<u>\$ 4,000,380</u>	<u>3,430,726</u>

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Consolidated Balance Sheets

December 31, 2014 and 2013

(In thousands of dollars)

Liabilities and Net Assets	2014	2013
Current liabilities:		
Current installments of long-term debt	\$ 19,364	17,595
Accounts payable and accrued expenses	380,871	333,523
Other current liabilities	91,520	75,317
Estimated amounts due to third-party payors	35,862	28,979
Total current liabilities	<u>527,617</u>	<u>455,414</u>
Long-term debt, less current installments	1,148,091	1,068,719
Revolving credit borrowing	—	40,000
Other liabilities	564,410	217,321
Total liabilities	<u>2,240,118</u>	<u>1,781,454</u>
Net assets:		
Unrestricted	1,138,737	1,076,431
Temporarily restricted	265,566	234,080
Permanently restricted	355,959	338,761
Total net assets	<u>1,760,262</u>	<u>1,649,272</u>
Total liabilities and net assets	<u>\$ 4,000,380</u>	<u>3,430,726</u>

See accompanying notes to consolidated financial statements.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2014 and 2013

(In thousands of dollars)

	<u>2014</u>	<u>2013</u>
Unrestricted revenues:		
Net patient service revenue	\$ 2,808,119	2,229,084
Provision for bad debts	(61,772)	(60,418)
Net patient service revenue less provision for bad debts	<u>2,746,347</u>	<u>2,168,666</u>
Other revenue	<u>195,089</u>	<u>172,466</u>
Total unrestricted revenues	<u>2,941,436</u>	<u>2,341,132</u>
Expenses:		
Salaries, wages, and employee benefits	1,669,854	1,353,563
Purchased services	202,658	146,937
Patient care supplies	448,170	330,358
Other supplies	38,907	35,050
Insurance	34,421	25,915
Other expenses	285,196	223,573
Depreciation and amortization	121,994	101,276
Interest	47,785	39,904
Special charges	7,855	5,938
Net operating income	<u>84,596</u>	<u>78,618</u>
Nonoperating revenues (expenses):		
Investment income	59,615	80,545
Other-than-temporary decline in investments	(5,797)	(7,010)
Change in fair value of derivative instruments	(17,368)	21,999
Loss on extinguishment of debt	(961)	(833)
Member substitutions	<u>154,641</u>	<u>—</u>
Excess of revenues over expenses	<u>\$ 274,726</u>	<u>173,319</u>

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.
Consolidated Statements of Operations and Changes in Net Assets
Years ended December 31, 2014 and 2013
(In thousands of dollars)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Net assets at December 31, 2012	\$ 827,356	225,971	305,992	1,359,319
Excess of revenues over expenses	173,319	—	—	173,319
Investment income	—	4,610	—	4,610
Other support and revenue	—	33,637	9,788	43,425
Change in beneficial interest in Foundation and perpetual trusts	—	5,978	22,981	28,959
Net assets released from restrictions used for operations	—	(29,028)	—	(29,028)
Change in net unrealized gains and (losses) on other-than-trading securities	(1,868)	(71)	—	(1,939)
Change in joint venture unrestricted net assets	(8)	—	—	(8)
Pension liability adjustment	70,615	—	—	70,615
Net assets released from restrictions for acquisition of property and equipment	7,017	(7,017)	—	—
Increase in net assets	<u>249,075</u>	<u>8,109</u>	<u>32,769</u>	<u>289,953</u>
Net assets at December 31, 2013	1,076,431	234,080	338,761	1,649,272
Excess of revenues over expenses	274,726	—	—	274,726
Investment income	—	7,739	—	7,739
Other support and revenue	—	32,314	11,345	43,659
Change in beneficial interest in Foundations and perpetual trusts	—	9,082	3,378	12,460
Net assets released from restrictions used for operations	—	(24,804)	—	(24,804)
Change in net unrealized gains and (losses) on other-than-trading securities	(19,369)	99	—	(19,270)
Change in joint venture unrestricted net assets	134	—	—	134
Pension liability adjustment	(208,023)	—	—	(208,023)
Net assets released from restrictions for acquisition of property and equipment	14,604	(14,604)	—	—
Contributed capital	234	—	—	234
Member substitutions	—	21,660	2,475	24,135
Increase in net assets	<u>62,306</u>	<u>31,486</u>	<u>17,198</u>	<u>110,990</u>
Net assets at December 31, 2014	<u>\$ 1,138,737</u>	<u>265,566</u>	<u>355,959</u>	<u>1,760,262</u>

See accompanying notes to consolidated financial statements.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Consolidated Statements of Cash Flows

Years ended December 31, 2014 and 2013

(In thousands of dollars)

	<u>2014</u>	<u>2013</u>
Operating activities:		
Increase in net assets	\$ 110,990	289,953
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	121,994	101,276
Provision for bad debts	61,772	60,418
Loss on extinguishment of debt	961	833
Other than temporary decline in investments	5,797	7,010
Change in beneficial interest in Foundations and perpetual trusts	(12,460)	(28,959)
Change in net unrealized investment gains and losses	19,270	1,939
Pension liability adjustment	208,023	(70,615)
Net change attributable to investments in joint ventures	(8,381)	(8,521)
Net change in restricted net assets received	(31,722)	(20,728)
Net change in patient accounts receivable	(63,228)	(92,090)
Net change in other current assets	(17,632)	(5,686)
Net change in other current liabilities	8,649	19,423
Net change in operating assets and liabilities	70,175	(166,448)
Member substitutions	(181,276)	—
Net activity attributable to discontinued operations	—	(378)
Net cash provided by operating activities	<u>292,932</u>	<u>87,427</u>
Investing activities:		
Acquisition of property, plant and equipment	(110,901)	(76,815)
Proceeds from sales of investments	3,028,860	512,230
Purchases of investments	(3,220,793)	(708,310)
Member substitution cash contributions	19,381	—
Net cash used in investing activities	<u>(283,453)</u>	<u>(272,895)</u>
Financing activities:		
Proceeds from restricted revenue and investment income	31,722	20,728
Repayment of long-term debt	(138,712)	(147,260)
Proceeds from issuance of long-term debt	116,051	267,032
Bond issuance costs	(1,118)	(2,262)
(Repayment of) proceeds from revolving credit borrowing	(40,000)	20,000
Increase in treasury service agreement	4,941	41,579
Net cash (used in) provided by financing activities	<u>(27,116)</u>	<u>199,817</u>
(Decrease) increase in cash and cash equivalents	(17,637)	14,349
Cash and cash equivalents at beginning of year	<u>193,505</u>	<u>179,156</u>
Cash and cash equivalents at end of period	<u>\$ 175,868</u>	<u>193,505</u>

See accompanying notes to consolidated financial statements.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

(1) Organization and Principles of Consolidation

University Hospitals Health System, Inc. (the System) is the parent of various corporations involved in the delivery of healthcare services, including a network of physicians, outpatient centers, hospitals, wellness, occupational health, skilled nursing, elder health, rehabilitation, and home care services that operate in the Northeast Ohio region. University Hospitals Cleveland Medical Center d/b/a University Hospitals Case Medical Center (UHCMC) is the System's major subsidiary. The System provides certain management and planning services to its subsidiaries. The System also has investments in multiple healthcare systems (note 13), which are being accounted for under the equity method.

The consolidated financial statements include the accounts of the System and its subsidiaries. All significant intercompany transactions have been eliminated in the consolidated financial statements.

On January 1, 2014, the System became the sole corporate member of Comprehensive Health Care of Ohio, Inc. (CHCO) and The Parma Community General Hospital Association (Parma) through separate member substitution agreements. Both CHCO and Parma are Ohio not-for-profit corporations, tax-exempt under Section 501(c)(3) of the Internal Revenue Code.

CHCO consists of the parent corporation and multiple subsidiaries including EMH Regional Medical Center, Amherst Hospital Association, Inc., and Comprehensive Ventures Unlimited, Inc. CHCO also owns several physician groups, including North Ohio Heart, Inc., EMH Professional Services, Inc., and Center for Orthopedics, Inc. CHCO is a healthcare system providing a wide range of healthcare services primarily to residents of western Cuyahoga and Lorain counties in Ohio. Comprehensive Ventures Unlimited, Inc. is a for-profit wholly owned subsidiary of CHCO. After January 1, 2014, CHCO formed a separate Foundation, which is separate from this entity that will oversee implementation of the agreement.

Parma is an acute care hospital with four wholly owned subsidiaries including PRL Corporation, Powers Professional Corporation, Royalton Senior Living, Inc., and Parma Hospital Health Care Foundation. PRL Corporation is a for-profit corporation established to own and operate medical office buildings and provide certain other nonclinical services. Powers Professional Corporation is a for-profit professional corporation established to provide professional medical services at office locations in the community and at Parma.

(2) Summary of Significant Accounting Policies

(a) Cash and Cash Equivalents

The System considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. The carrying amount of cash and cash equivalents approximates fair value. Certain amounts deposited at financial institutions are in excess of the Federal Deposit Insurance Corporation limits.

(b) Concentrations of Credit Risk

Financial instruments that potentially subject the System to concentrations of credit risk consist principally of cash, cash equivalents, and patient accounts receivable. The System invests its cash equivalents in highly rated financial instruments including time deposits, U.S. Treasury bonds and

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

notes, government-backed mortgage securities, and corporate notes with original maturities of three months or less.

The System's concentration of credit risk relating to patient accounts receivable is limited by the diversity and number of the System's patients and payors. Patient accounts receivable consist of amounts due from governmental programs, commercial insurance companies, other group insurance companies, and private pay patients. Combined revenues from the Medicare and Medicaid programs accounted for approximately 47% and 42% of the System's net patient service revenue for the years ended December 31, 2014 and 2013, respectively. Excluding governmental programs, no one payor source represents more than 15% of the System's patient accounts receivable. The System maintains an allowance for doubtful accounts based on the expected collectibility of patient accounts receivable considering historical collection experience and other economic factors.

(c) ***Investments and Investment Income***

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value on the consolidated balance sheets and are classified as other-than-trading securities.

The System has alternative investments that include private equity, real estate, hedge funds, and distressed debt. Certain investments in alternative investments, where the System's ownership percentage is greater than 3%, are accounted for using the equity method of accounting. Income from these investments is recorded within the consolidated statements of operations and changes in net assets as investment income. The cost method is used for certain alternatives when the System owns less than 3% of the investment. The System has elected the fair value option on several alternative investments (note 5 and note 6). Unrealized and realized gains and losses from these investments are recorded within the consolidated statements of operations and changes in net assets as investment income.

Investment income, including realized gains and losses, is reported as investment income in nonoperating revenue on the consolidated statements of operations and changes in net assets. Unrealized gains and losses on investments recorded at fair value are reported within net assets. Interest and dividend income on temporarily and permanently restricted investments is recorded according to the donor's intentions and as restricted investment income within the consolidated statements of operations and changes in net assets.

Other-than-temporary declines result from decreases in the fair market values of debt, equity, and alternative investments below the cost basis in these securities. Other-than-temporary declines for unrestricted investments are recorded in the consolidated statements of operations and changes in net assets. Other-than-temporary losses for temporarily and permanently restricted net assets are recorded within restricted investment income in the consolidated statements of operations and changes in net assets. Other-than-temporary declines also result in a new cost basis for the investment.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

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December 31, 2014 and 2013

(In thousands of dollars)

(d) *Costs of Borrowing*

Interest costs incurred on borrowed funds during the period of construction of capital assets are capitalized as a component of the cost of acquiring those assets. Capitalized interest totaled \$923 and \$649 for the years ended December 31, 2014 and 2013, respectively. Deferred financing costs are capitalized when incurred, and then amortized on a straight-line basis during the period in which the debt is outstanding.

(e) *Property and Equipment and Other Long-Lived Assets*

Additions and improvements to property and equipment are capitalized at cost. Expenditures for maintenance and repairs are charged to expense as incurred. Depreciation on plant and equipment is computed on the straight-line basis over the estimated useful lives of the respective assets. Buildings and improvements are depreciated over estimated useful lives ranging generally from 5 to 40 years. Leasehold improvements are depreciated over the lesser of the life of the asset or the term of the lease. Estimated useful lives of equipment vary generally from 3 to 20 years.

Long-lived assets, such as property, plant and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted cash flows expected to be generated by the asset. The impairment loss recognized is measured by the amount by which the carrying value of the asset exceeds the fair value of the asset. There were no impaired assets identified in 2014 or 2013.

(f) *Gifts, Private Grants, Bequests, and Pledges*

Donors contribute cash, marketable securities, and other assets. Unrestricted contributions are included in the consolidated statements of operations and changes in net assets as unrestricted gifts and are recorded net of fundraising costs in other revenue. Contributions that are received with restrictions that limit the use of the donated asset are reported as either temporarily or permanently restricted in the consolidated statements of operations and changes in net assets as other support and revenue. These donations are recorded at fair value at the time of the contribution.

Gifts, private grants, and bequests that have been received from various corporations, foundations, and individuals for the years ended December 31, 2014 and 2013 are as follows:

	2014	2013
Unrestricted	\$ 1,077	1,334
Temporarily restricted	32,314	33,637
Permanently restricted	11,345	9,788
	\$ 44,736	44,759

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

Pledges are recorded at fair value as receivables in the year made and reported as either temporarily or permanently restricted in the consolidated statements of operations and changes in net assets as other support and revenue. Conditional donor promises to give and indications of intentions to give are not recognized until the condition is satisfied. Pledges due in less than one year are classified as other current assets. Pledges due in more than one year are classified as other long-term assets on the consolidated balance sheets.

Outstanding pledges receivable from various corporations, foundations, and individuals are recorded at their net present value using the London Interbank Offered Rate (LIBOR), which approximates 2%, as the discount rate. The balances at December 31, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Pledges due:		
In less than one year	\$ 43,610	45,256
In one year to five years	66,419	67,481
In more than five years	39,131	41,570
	<u>149,160</u>	<u>154,307</u>
Discount	(13,355)	(13,841)
Allowance for doubtful pledges	<u>(3,125)</u>	<u>(3,136)</u>
	<u>\$ 132,680</u>	<u>137,330</u>

The System has conditional donor promises to give of \$170,502 and \$145,713 at December 31, 2014 and 2013, respectively, which are not recognized as assets in the accompanying consolidated balance sheets.

The System has entered into an affiliation agreement with Case Western Reserve University School of Medicine with the primary goal of supporting innovative, high-quality programs in medical education, biomedical research, and clinical care. In order to meet this goal, the parties will collaborate on many clinical and academic programs and jointly recruit and fund clinical chairs and faculty.

In connection with the affiliation agreement with Case Western Reserve University School of Medicine, the System has estimated conditional commitments of \$28,587 at December 31, 2014 that are not recorded as liabilities as these commitments are contingent upon future performance for the year 2015.

(g) Government Grants

Amounts received from government agencies are reported in the consolidated statements of operations and changes in net assets as other revenue. Grants received totaled \$9,180 and \$11,767 for the years ended December 31, 2014 and 2013, respectively.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

(h) *Charity Care and Provision for Bad Debts*

Throughout the admission, billing, and collection processes, certain patients are identified by the System as qualifying for charity care. The System provides care to these patients without charge or at amounts less than its established rates. Charity care includes those patients required to be identified in connection with the System's participation in the State of Ohio's Care Assurance Program. Under this Program, patients who are Ohio residents without any or adequate health insurance coverage and who are at or below 100% of the federally defined poverty level are eligible to receive Medicaid covered services free of charge. The charges forgone for charity care provided by the System are not reported as net patient service revenue or as patient accounts receivable. The System accepts all patients covered by Medicare and Medicaid and treats patients requiring emergency care regardless of their ability to pay.

The uncompensated cost of charity care is estimated by applying an overall cost to charge ratio to the charges associated with patients who qualify for charity care. The estimated uncompensated costs of charity care are approximately \$61,226 and \$59,370 for the years ended December 31, 2014 and 2013, respectively.

In addition, the System provides services to other medically indigent patients under various state Medicaid programs. Such programs pay providers amounts that are less than the established charges for the services provided to the recipients. The uncompensated costs associated with these state programs is estimated as the total direct and indirect costs in excess of the payments received for the services provided. Services provided to Medicaid recipients (including Medicaid recipients who are participants in a Medicaid managed care plan) represented approximately 21% of the System's patient activity for both 2014 and 2013.

The System also provides other uncompensated care and community benefits. In furtherance of its exempt purpose to benefit the community, the System operates an inner city medical clinic to serve the healthcare needs of the community; operates emergency rooms open to the public 24 hours per day, 7 days per week; maintains research facilities for the study of disease and injuries; provides facilities for teaching and training various medical personnel; facilitates the advancement of medical and surgical education; provides community screenings for the detection of various diseases such as breast and colorectal cancer; sponsors cancer support groups; provides various community health education classes, speeches, television appearances, and articles published in newspapers and magazines; and undertakes other types of community benefit activities.

In addition to charity care and insufficient funding from the Medicaid program, there are significant losses related to self-pay patients who fail to make payment for services rendered or insured patients who fail to remit co-payments and deductibles as required under applicable health insurance arrangements. The provision for bad debts represents revenues for services provided that are deemed to be uncollectible. Provision for bad debts totaled \$61,772 and \$60,418 for the years ended December 31, 2014 and 2013, respectively.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

(i) Excess of Revenues over Expenses

The consolidated statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets, which, consistent with industry practice, are excluded from excess of revenues over expenses, include unrealized gains and losses on other-than-trading securities, certain changes in joint venture net assets, assets acquired using funds restricted by the donor for the purpose of acquiring such assets and adjustments for pension accounting (note 12).

(j) Derivative Financial Instruments

Derivative financial instruments are utilized by the System to manage: (i) interest rate risk; (ii) the fixed and floating interest rate mix of the System's total debt portfolio; and (iii) related overall cost of borrowing. The interest rate swap agreements involve the periodic exchange of payments without the exchange of the notional amount upon which the payments are based. The System does not use financial instruments for trading purposes. The related amount of payables to counterparties under swap agreements is included in other liabilities and the related amount of receivables from counterparties under swap agreements is included in other assets on the consolidated balance sheets (note 9).

Derivative financial instruments are recorded on the consolidated balance sheets at their respective fair value. Gains and losses on derivative financial instruments are recorded in the change in fair value of derivative instruments within the consolidated statements of operations and changes in net assets. The net amount paid or received under the swap agreements is recorded as interest expense in the consolidated statements of operations and changes in net assets.

The System minimizes credit risk related to derivative financial instruments by requiring high credit standards for its counterparties and periodic settlements. The counterparties to these contractual arrangements are financial institutions that carry investment-grade credit ratings with which the System also has other financial relationships. The System is exposed to credit loss in the event of nonperformance by these counterparties. To mitigate credit exposure, the swap agreements contain certain collateral provisions applicable to both the System and the counterparties.

(k) Income Taxes

The System and most of its subsidiaries, including UHCMC, are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code (Code) and are exempt from federal income taxes pursuant to Section 501(a) of the Code. The System also has certain subsidiaries that are taxable for federal income tax purposes (note 18).

(l) Costs Expected to Be Incurred in Connection with a Loss Contingency

Liabilities for asserted claims and assessments are recorded when an unfavorable outcome of a matter is deemed to be both probable and the loss contingency is reasonably estimable.

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(In thousands of dollars)

(m) Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles (GAAP) 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 and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(n) Electronic Health Record Incentive Program

The Medicaid and Medicare Electronic Health Records (EHR) Incentive Programs (the Programs) provide incentive payments to eligible hospitals and professionals as they adopt, implement, upgrade, or demonstrate meaningful use of certified EHR technology in their first year of participation and demonstrate meaningful use for up to five remaining participation years. The System accounts for the Programs using International Accounting Standards 20, *Accounting for Grants and Disclosures of Government Assistance*. The System recognizes revenue when there is reasonable assurance that the System will comply with the conditions and will receive the Programs' incentive payments. For the years ended December 31, 2014 and 2013, the System recognized approximately \$15,342 and \$17,610, respectively, as other revenue related to Medicaid and Medicare EHR incentives, which have been received or are expected to be received based on certifications prepared by management under the appropriate attestation guidelines.

(o) Treasury Service Agreement

The System included amounts due to a third party financing company for the use under a Supplemental Treasury Services Agreement (Agreement), entered into during 2013, within accounts payable in the accompanying consolidated balance sheets. Borrowings and payments on the Agreement are classified as financing activities in the consolidated statements of cash flows. The Agreement is a \$50,000 unsecured credit line that is noninterest bearing and is not collateralized. The agreement includes customary covenants as well as customary events of defaults. The amounts outstanding on the Agreement fluctuate on a daily basis, but as of December 31, 2014, the amount outstanding included within accounts payable was \$46,520. The System incurred no interest on the borrowing for the year ended December 31, 2014.

(p) The Patient Protection and Affordable Care Act

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (often referred to, collectively, as the Affordable Care Act of the healthcare reform law), was signed into law on March 23, 2010. The statute changes how healthcare services are delivered and reimbursed through a variety of mechanisms. The law contains stronger anti-fraud enforcement provisions and provides additional funding for enforcement activity.

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(In thousands of dollars)

On May 6, 2011, CMS issues a final rule establishing a value-based purchasing program for acute care hospitals under the Medicare Inpatient Prospective Payment System. Beginning in federal fiscal year 2014, incentive payments are made based on achievement of or improvement in a set of clinical and quality measures designed to foster improved clinical outcomes. There has been no significant impact as a result of this regulation.

The Budget Control Act of 2011 (BCA) mandated significant reductions and spending caps on the federal budget for fiscal year 2012 through 2021. The BCA also created a joint select committee on deficit reduction (the Super Committee) to develop a plan to further reduce the federal deficit. Since the Super Committee failed to act before the mandatory deadline, a 2% reduction in Medicare spending, among other reductions, was to take effect January 1, 2013 in a process known as Sequestration. The BCA also required a 21.2% reduction in the sustainable growth formula regarding physician reimbursement under Medicare effective April 1, 2015.

On January 2, 2013, the President signed into law the American Taxpayer Relief Act (ATRA), which delayed Sequestration until March 1, 2013 and is now in effect as of March 1, 2013 and will continue until Congress takes further action. The ATRA delays the reduction in physician reimbursement until the end of 2014. As such, only the 2% reduction for nonphysician payments was effective April 1, 2013.

(3) Net Patient Service Revenue

The System and certain of its subsidiary corporations have agreements with third party payors (e.g., Medicare, Medicaid, and commercial insurance carriers) that provide for payments and reimbursement at amounts different from the System's established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third party payors. Adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as settlements are determined. Adjustments for the Medicare, Medicaid, and Champus/Tricare program resulted in net patient service revenue increasing by approximately \$9,471 and \$5,827 for the years ended December 31, 2014 and 2013, respectively.

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. The System believes that it is in compliance, in all material respects, with all applicable laws and regulations.

Patients' accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectibility of patients' accounts receivable, the System analyzes its past history and identifies trends to estimate the appropriate allowance for doubtful accounts. Management regularly reviews data about the System's major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for doubtful accounts, if necessary (e.g., for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of

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amounts due unlikely). For receivables associated with self-pay patients, those with no third-party coverage, the System records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is written-off against the allowance for doubtful accounts.

The System's allowance for uncollectible accounts decreased to 76% of self pay accounts receivable at December 31, 2014, from 82% of self pay accounts receivable at December 31, 2013. Although the System has experienced an increase in charity care and bad debt write-offs as a result of unemployment, loss of employer-sponsored insurance plans, and rising patient responsibilities due in part to high deductible and high co-pay insurance plans; during 2014, a higher percentage of uninsured patients were able to qualify for Medicaid than in past years. The System did not change its charity care or uninsured discount policies during fiscal year 2014 or 2013. The System does not maintain a material allowance for doubtful accounts from third-party payors, nor did it have significant write-offs from third-party payors.

The System recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the System recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of the System's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the System records a significant provision for bad debts related to uninsured patients in the period the services are provided. The percentage of patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), derived from these major payor sources as of December 31, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Third party	96%	91%
Self-pay	4	9
	<u>100%</u>	<u>100%</u>

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(4) 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 System. Temporarily restricted gifts, which include unrestricted pledges, are recorded as an addition to temporarily restricted net assets in the period received. Temporarily restricted net assets are available for the following purposes at December 31, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Capital expenditures	\$ 32,928	38,991
Education	9,028	8,477
Research	90,234	77,155
Patient care	64,538	67,895
Beneficial interest in Foundations	68,838	41,562
	<u>\$ 265,566</u>	<u>234,080</u>

Permanently restricted net assets consist of amounts held in perpetuity as designated by donors, including the System's portion of beneficial interests in several perpetual trusts. Investment income on temporarily and permanently restricted investments, including realized gains and losses, is recorded according to the donor intentions. Changes in unrealized gains and losses on temporarily and permanently restricted investments are recognized directly in net assets.

Net assets are released from donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of other events specified by donors. Net assets released from restrictions used for operations totaled \$24,804 and \$29,028 during 2014 and 2013, respectively. Net assets released from restrictions are recorded in other revenue in the consolidated statements of operations and changes in net assets. In addition, \$14,604 and \$7,017 in net assets were released for the acquisition of property and equipment in 2014 and 2013, respectively.

The System's endowment consists of 378 individual funds established for a variety of purposes. Endowments include both donor-restricted funds and funds designated by the Board of Directors (the Board) to function as endowments. Net assets associated with endowment funds, including funds designated by the Board to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions. The System's permanently restricted endowment funds are donor restricted, which totaled \$121,687 and \$109,316 at December 31, 2014 and 2013, respectively. Board designated funds are unrestricted and totaled \$17,330 and \$17,654 at December 31, 2014 and 2013, and are included within unrestricted and board designated investments.

The System's investment policy establishes a limited number of investment pools with a specific purpose of aggregating various System funds' investments according to their risk tolerance. Asset allocation is reviewed quarterly with respect to: i) System tolerance for risk based on its financial condition and need for cash from investments to support operations; ii) expected asset class return, risk, and correlation characteristics; iii) changes in accounting guidance or tax law; and iv) changes in bond covenants or other restrictions.

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Management of the System is responsible to ensure the proper allocation of funds according to the specific needs, timing of cash flows, and risk tolerance of each fund.

The System's spending practices are intended to comply with the donor's wishes and meet all applicable laws and regulations including the Uniform Prudent Management of Institutional Funds Act. Spending must be for a purpose that is consistent with the documented intent of the donor. The System generally appropriates an amount not to exceed 5% of the endowment fund's fair value for annual spending subject to spending guidelines and restrictions per the System's policy. The fair value of the endowment fund is determined quarterly and averaged over a period of a rolling thirty-six months.

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, at December 31, 2012	\$ 17,654	—	106,213	123,867
Investment return:				
Investment income	—	1,385	—	1,385
Contributions	—	—	3,103	3,103
Appropriation of endowment assets for expenditure	—	(1,385)	—	(1,385)
Endowment net assets, at December 31, 2013	17,654	—	109,316	126,970
Investment return:				
Investment income	—	2,227	—	2,227
Contributions	—	—	12,371	12,371
Appropriation of endowment assets for expenditure	(324)	(2,227)	—	(2,551)
Endowment net assets, at December 31, 2014	\$ <u>17,330</u>	<u>—</u>	<u>121,687</u>	<u>139,017</u>

(5) Fair Value Measurements

The FASB establishes a hierarchy for ranking the quality and reliability of the information used to determine fair values. Assets and liabilities carried at fair value are to be disclosed according to the following three levels:

Level 1 – Unadjusted quoted prices for identical assets or liabilities in active markets. Level 1 yields the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

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Level 2 – Observable inputs other than quoted prices in Level 1. Inputs such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar liabilities that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3 – Unobservable inputs that are significant to the valuation of assets or liabilities and are supported by little or no market data. This includes discounted cash flow methodologies, pricing models, and similar techniques that use significant unobservable inputs.

The inputs used to fair value Level 1 instruments are unadjusted quoted prices derived from stock exchanges, and the Chicago Board of Trade. Level 1 instruments primarily consist of equities, exchange traded funds, and certain government securities.

Investments in Level 2 are primarily comprised of corporate bonds, bonds, asset-backed securities, and fixed income mutual funds. Level 2 inputs primarily consist of quotes from independent pricing vendors based on recent trading activity, and other relevant information including matrix pricing, market corroborated pricing, yield curves, and other indices that are used when Level 1 inputs are not available.

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Items classified as Level 3 in the fair value hierarchy include certain alternative investments, beneficial interest in Foundations, perpetual trusts, derivative financial instruments, and excludes pledges of \$135,805 and \$140,466 at December 31, 2014 and 2013, respectively.

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2014:				
Assets:				
Cash and cash equivalents	\$ 175,868	—	—	175,868
Cash and cash equivalents – pooled with investments:				
Cash equivalents	—	188,945	—	188,945
Short-term bond instruments	—	1,074	—	1,074
Total cash and cash equivalents	—	190,019	—	190,019
Fixed income securities:				
Corporate bonds	—	146,372	—	146,372
Fixed income mutual funds	194,438	71,043	—	265,481
Government securities	154,811	47,775	—	202,586
Total fixed income securities	349,249	265,190	—	614,439
Equities, mutual and exchange traded funds:				
U.S. equities	81,581	—	—	81,581
Mutual and exchange traded funds	228,563	35,512	—	264,075
Total equities, mutual and exchange traded funds	310,144	35,512	—	345,656
Alternative investments:				
Hedge funds	—	—	59,833	59,833
Real estate	—	—	6,297	6,297
Distressed debt	—	—	7,253	7,253
Total alternative investments	—	—	73,383	73,383

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	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Deferred compensation assets -				
mutual funds	\$ 20,556	—	—	20,556
Foundations	—	—	91,300	91,300
Perpetual trusts	—	—	194,952	194,952
Derivative financial instruments	—	2,345	—	2,345
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total assets	\$ 855,817	493,066	359,635	1,708,518
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
December 31, 2014:				
Liabilities:				
Deferred compensation liabilities	\$ 20,556	—	—	20,556
Derivative financial instruments	—	65,546	—	65,546
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total liabilities	\$ 20,556	65,546	—	86,102
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2013:				
Assets:				
Cash and cash equivalents	\$ 193,505	—	—	193,505
Cash and cash equivalents – pooled with investments:				
Cash equivalents	3,097	130,497	—	133,594
Short-term bond instruments	—	3,108	—	3,108
Total cash and cash equivalents	<u>3,097</u>	<u>133,605</u>	<u>—</u>	<u>136,702</u>
Fixed income securities:				
Corporate bonds	—	58,193	—	58,193
Fixed income mutual funds	110,450	102,690	—	213,140
Government securities	130,029	27,647	—	157,676
Total fixed income securities	<u>240,479</u>	<u>188,530</u>	<u>—</u>	<u>429,009</u>
Equities, mutual and exchange traded funds:				
U.S. equities	76,395	—	—	76,395
Mutual and exchange traded funds	144,958	43,305	—	188,263
Total equities, mutual and exchange traded funds	<u>221,353</u>	<u>43,305</u>	<u>—</u>	<u>264,658</u>
Alternative investments:				
Hedge funds	—	—	76,317	76,317
Real estate	—	—	6,470	6,470
Distressed debt	—	—	3,178	3,178
Total alternative investments	<u>—</u>	<u>—</u>	<u>85,965</u>	<u>85,965</u>

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	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Deferred compensation assets -				
mutual funds	\$ 19,119	—	—	19,119
Foundations	—	—	62,956	62,956
Perpetual trusts	—	—	190,167	190,167
Derivative financial instruments	—	98	—	98
	<u>—</u>	<u>98</u>	<u>—</u>	<u>98</u>
Total assets	\$ <u>677,553</u>	<u>365,538</u>	<u>339,088</u>	<u>1,382,179</u>
December 31, 2013:				
Liabilities:				
Deferred compensation liabilities	\$ 19,119	—	—	19,119
Derivative financial instruments	—	36,817	—	36,817
	<u>—</u>	<u>36,817</u>	<u>—</u>	<u>36,817</u>
Total liabilities	\$ <u>19,119</u>	<u>36,817</u>	<u>—</u>	<u>55,936</u>

The System evaluated transfers between levels based upon the nature of the financial instrument and size of the transfer relative to the total net assets available for benefits. For the years ended December 31, 2014 and 2013, there were no transfers into or out of Level 1, 2, or 3.

The System has various interest rate swaps as of December 31, 2014 and 2013, consisting of fixed-payor and fixed spread basis swaps. Fair values for the System's interest rate swaps are provided on a monthly basis by the System's independent financial advisor and counterparties. Monthly valuations are derived by pricing models, which use market inputs such as LIBOR, Securities Industry and Financial Markets Association (SIFMA) Swap Index, and bond coupon rates provided by various inter-broker sources. The resulting combination of market data feeds, specific structuring characteristics such as the amortization of notional amounts, effective dates, payment frequencies, day counts, credit risk, and indices, are factored into the pricing model to determine the fair market value of the System's interest rate swaps.

The System elected the fair value option on several of its alternative investments. The fair value option election was made in order to take advantage of fair market value increases expected to occur over the life of the investment. The System holds several alternative investments that are recorded under the cost or equity methods of accounting. The System will continue to record previously entered into alternative investments under the cost or equity methods as appropriate. The System uses net asset value to approximate fair value for alternative investments.

Foundations operate for the exclusive benefit of the System, and variance power was not explicitly given to the Foundations by the donors. Therefore, the System is required to record its beneficial interest in the net assets of the Foundations. The investment in the Foundations is categorized as a Level 3 item. The primary input utilized in calculating the Foundations' fair value is its net assets, which represents fair market valuation of certain equity, debt, and other instruments held by the Foundations. The System records 100% of the Foundations' net assets at approximate fair market value.

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Permanently restricted net assets consist of amounts held in perpetuity as designated by donors, including the System's portion of beneficial interests in several perpetual trusts held and administered by others in which the System is an income beneficiary. Perpetual trusts are measured at fair market value by the external trustee, which approximates the present value of expected future cash flows. Perpetual trusts utilize significant unobservable inputs determined by the external trustees in estimating fair market value.

	Fair value measurements using significant unobservable inputs (Level 3)					
	Foundations	Perpetual trusts	Alternative investments			Total
			Hedge funds	Real estate	Distressed debt	
Balance at December 31, 2012	\$ 55,322	168,842	81,458	6,029	3,280	314,931
Additions	—	—	36	2,459	800	3,295
Total gains or losses included in:						
Realized gains (losses)	—	—	(391)	1,780	113	1,502
Unrealized gains	—	—	8,475	974	178	9,627
Total change included in:						
Temporarily restricted net assets	5,978	—	—	—	—	5,978
Permanently restricted net assets	1,656	21,325	—	—	—	22,981
Dispositions	—	—	(13,261)	(4,772)	(1,193)	(19,226)
Balance at December 31, 2013	62,956	190,167	76,317	6,470	3,178	339,088
Additions	—	—	560	745	5,289	6,594
Member substitutions	18,194	2,475	—	—	—	20,669
Total gains or losses included in:						
Realized gains	—	—	1,113	1,728	369	3,210
Unrealized gains (losses)	—	—	1,217	(355)	(230)	632
Total change included in:						
Temporarily restricted net assets	9,082	—	—	—	—	9,082
Permanently restricted net assets	1,068	2,310	—	—	—	3,378
Dispositions	—	—	(19,374)	(2,291)	(1,353)	(23,018)
Balance at December 31, 2014	\$ 91,300	194,952	59,833	6,297	7,253	359,635

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(6) Investments

The fair value and the cost of investments at December 31, 2014 and 2013 are as follows:

	2014		2013	
	Carrying value	Cost	Carrying value	Cost
Cash and cash equivalents – pooled with investments	\$ 190,019	190,027	136,702	136,729
Fixed income securities	614,439	610,184	429,009	423,936
Equities, mutual and exchange traded funds	345,656	307,496	264,658	221,247
Alternative investments*	73,383	60,413	85,965	72,765
Total investments at fair value	1,223,497	\$ 1,168,120	916,334	\$ 854,677
Alternative investments**	79,913		86,152	
Other	7,119		1,895	
Total investments	\$ 1,310,529		1,004,381	

* Fair value option elected on several alternative investments, see note 5.

** See note 2(c) for the accounting treatment of these alternative investments.

The System holds certain investments in fixed income securities including domestic and international corporate bonds; U.S. Treasuries, government, and agency bonds; non-U.S. sovereign debt; and emerging market debt. The System holds common and preferred stock including investments in small cap, mid cap, and large cap companies as well as in non-U.S. equities in developed and emerging markets.

Alternative investments include private equity, real estate, hedge funds, and distressed debt. These investments are made either directly or through various Fund-of-Funds, both of which are typically Limited Partnership structures. For the Fund-of-Funds investments, the System is invested in a Limited Partnership, which in turn utilizes its expertise to invest in underlying Limited Partnership Funds and make certain other investments. These investments are not readily marketable and are valued utilizing the most current information provided by the general partner, subject to assessments that the value is representative of fair value.

The General Partner of each direct Limited Partnership determines the fair market valuation of its underlying holdings based on i) the nature and terms of each underlying investment, ii) market inputs, and iii) certain other relevant information. The General Partner of each Fund-of-Funds Limited Partnership determines the fair market valuation of its underlying Limited Partnership investments. These valuations are based primarily on the quarterly internal and annual audited consolidated financial statements of the underlying Limited Partnership Funds, which report net asset value based on i) the nature and terms of each underlying investment, ii) market inputs, and iii) certain other relevant information. The System performs various measures to validate that the reported net asset value approximates the fair market value. The determination

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of fair market values for the alternative investments requires the General Partners and System management to make estimates and assumptions about certain inputs and other factors that are inherently uncertain. These estimates are subjective and require judgment regarding significant matters such as the amount and timing of future cash flows and the selection of discount rates that appropriately reflect market and credit risks.

Assets categorized as alternative investments may be subject to liquidity restrictions such as gates. These gates prevent short-term liquidation of assets. Hedge funds may be redeemed at quarter-end requiring advanced notice ranging from 45 to 65 days, prior written notice subject to certain limitations that may be imposed by the General Partner of the fund without notice. Private equity and private real estate funds generally have contractual terms of 10 years or greater from the time the commitment to the fund is made. While distributions of capital during this term typically occur, many of these funds have provisions that allow the General Partner to extend the final term and suspend distributions. Distressed debt funds are typically 1-year to 5-year or 6-year to 10-year term structures, and although some of the funds offer liquidity, the fund documents allow the General Partner to suspend redemptions if they deem necessary. Resulting from these contractual limitations on liquidity, these alternative assets are generally considered illiquid. Contractual liquidity terms of alternative investments at December 31, 2014 are as follows:

	<u>Carrying amount</u>	<u>Unfunded commitments</u>
Less than 1 year, no contractual restrictions have been imposed	\$ 69,161	—
Subject to existing gates or restrictions	21,327	—
Limited Partnership Fund expiring in 1 – 5 years	44,886	6,807
Limited Partnership Fund expiring in 6 – 10 years	17,439	15,459
Limited Partnership Fund expiring in 11 – 12 years	483	5,469
Total alternative investments	<u>\$ 153,296</u>	<u>27,735</u>

The fair value of alternative investments totaled approximately \$161,758 and \$183,391 compared to a carrying value of \$153,296 and \$172,117 as of December 31, 2014 and 2013, respectively.

The components and related restrictions of investments shown above are as follows:

	<u>2014</u>	<u>2013</u>
Unrestricted and board designated	\$ 1,102,831	812,811
Held by bond trustee	2,232	4,805
Swap collateral	4,881	5,551
Temporarily restricted	78,898	71,898
Permanently restricted	121,687	109,316
Total investments	<u>\$ 1,310,529</u>	<u>1,004,381</u>

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Investment income is comprised of the following for the years ended December 31, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Interest and dividend income:		
Unrestricted	\$ 35,036	14,685
Temporarily restricted	3,448	2,467
	<u>38,484</u>	<u>17,152</u>
Net realized gains on sales of securities:		
Unrestricted	22,892	50,788
Temporarily restricted	4,291	2,143
	<u>27,183</u>	<u>52,931</u>
Unrestricted – Gains from alternative investments	<u>1,687</u>	<u>15,072</u>
	<u>\$ 67,354</u>	<u>85,155</u>

(7) Property, Plant, and Equipment

Property, plant, and equipment, at cost, at December 31, 2014 and 2013, are summarized below:

	<u>2014</u>	<u>2013</u>
Land and land improvements	\$ 137,752	105,860
Buildings and fixed equipment	1,799,445	1,478,613
Movable equipment and furnishings	1,230,260	962,783
Construction in progress	57,174	50,183
	<u>3,224,631</u>	<u>2,597,439</u>
Less accumulated depreciation	<u>1,842,119</u>	<u>1,369,353</u>
Net property, plant, and equipment	<u>\$ 1,382,512</u>	<u>1,228,086</u>

As of December 31, 2014, the commitment on construction contracts, including Information Technology projects is \$23,052.

(8) Short-Term Borrowings and Long-Term Debt

Effective March 29, 2012, the System amended a \$100,000 revolving credit commitment (the Credit Commitment) in a syndicated transaction. The Credit Commitment bears interest at various rates for short-term periods with final maturity at September 29, 2016. There were no borrowings under the Credit Commitment and the remaining available credit line was \$100,000 at December 31, 2014. The average interest rate for borrowings under this credit line was 0.97% for the year ended December 31, 2014. At December 31, 2013, borrowings under the Credit Commitment totaled \$40,000 providing for remaining available credit of \$60,000 at December 31, 2013. The \$40,000 borrowing is classified as a long-term

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liability within the consolidated balance sheet as of December 31, 2013. The average interest rate for borrowings under this credit line was 1.00% for the year ended December 31, 2013.

Effective October 4, 2011, the System renewed a \$130,000 revolving credit facility (the Facility) in a syndicated transaction. The Facility bears interest at various rates for short-term periods with final maturity at October 3, 2015. There were no borrowings under the Facility and the remaining available credit line was \$130,000 at both December 31, 2014 and 2013. The average interest rate for the borrowings under this credit line for the years ended December 31, 2014 and 2013 was 0.97% and 3.25%, respectively.

A summary of long-term debt at December 31, 2014 and 2013 is as follows:

Series	Type	Average interest rate% for	Final maturity	Amount outstanding	
		the year ended December 31, 2014		December 31	2014
2014A	Fixed	3.69	2044	\$ 56,145	—
2014B	Variable	0.39	2045	30,000	—
2014C	Variable	0.80	2035	15,000	—
2013A	Fixed	4.65	2029	90,735	90,735
2013B	Variable	0.49	2033	30,000	30,000
2013C	Variable	0.11	2050	75,000	75,000
2013D	Variable	1.11	2040	25,000	25,000
2013E	Variable	1.11	2038	29,500	30,000
2012A	Fixed	4.72	2041	180,120	182,380
2012B	Variable	0.91	2019	27,225	34,105
2012C	Fixed	3.71	2042	55,825	55,825
2012D	Variable	0.86	2021	23,775	8,085
2010A	Fixed	4.71	2027	69,160	75,665
2010B	Variable	0.96	2035	71,125	71,125
2009B	Fixed	4.84	2039	—	18,195
2009C	Fixed	4.88	2039	20,000	20,000
2007A	Fixed	4.85	2046	289,460	289,460
2001	Variable	0.78	2033	10,000	10,000
Note payable	Fixed	1.90	2036	60,000	60,000
Other long-term debt				962	235
				<u>1,159,032</u>	<u>1,075,810</u>
Add unamortized premium				10,597	12,067
Less:					
Unamortized discount				2,174	1,563
Current installments				<u>19,364</u>	<u>17,595</u>
Long-term debt, less current installments				<u>\$ 1,148,091</u>	<u>1,068,719</u>

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In November 2014, the System issued tax-exempt bonds totaling \$101,145. The debt is comprised of the 2014A, 2014B and 2014C bonds in respective amounts of \$56,145, \$30,000 and \$15,000. The 2014A Series contains \$46,145 of 4% fixed rate bonds issued with a discount of \$784 and \$10,000 of step coupon bonds with an initial fixed rate of 2.25% issued at par. The 2.25% rate steps to 4.0% in 2019 and is callable at par on the step date. The 2014B and the 2014C Bonds both have a variable rate. The rate for 2014B Bonds is determined by a remarketing agent while the rate for the 2014C Bonds is based on a set spread over LIBOR. The System used proceeds of \$89,139 to pay off taxable revolving lines of credit related to the member substitutions of the University Hospitals Parma Medical Center and University Hospitals Elyria Medical Center. The System used \$10,000 of proceeds for new capital projects and the remainder paid for the cost of issuance.

In December 2013, the System issued the 2013A and 2013B Bonds totaling \$90,735 and \$30,000, respectively. These bonds are tax-exempt and the proceeds from these bonds were used to refund \$122,700 of the 2008B, 2008D, and 2008E floating-rate tax-exempt bonds. The 2013A Bonds were issued in a fixed rate mode to reduce exposure to rising interest rates and bank renewal risk. The 2013A Bonds were issued with a premium of \$3,724 and discount of \$317 and incurred a loss of \$833 on the extinguishment of debt. The 2013B Bonds are variable rate debt determined weekly by a remarketing agent and were issued to reduce bank renewal risk, remarketing fees, and credit fees.

In December 2013, the System issued the 2013C, 2013D, and 2013E Bonds totaling \$75,000, \$25,000, and \$30,000, respectively. The proceeds from these bonds are taxable and were used to fund the System's pension obligation. The 2013C, 2013D, and 2013E Bonds are privately placed and were all issued in a variable rate mode.

In June 2012, the System issued the 2012A Bonds totaling \$182,380, the proceeds of which were used in conjunction with the 2009A debt service reserve fund to defease \$172,000 in 2009A Bonds. The 2012A Bonds are fixed rate debt and were issued to take advantage of favorable interest rates. The 2012A Bonds were issued with a premium of \$8,134 and discount of \$732.

In September 2012, the System issued the 2012B Bonds totaling \$40,710 in a variable rate mode to extinguish \$14,800 and \$25,740 in 1996A and B Bonds, respectively. The 2012B Bonds are privately placed and were issued to take advantage of favorable interest rates.

In October 2012, the System issued the 2012C Bonds totaling \$55,825, the proceeds of which were used in conjunction with the 2009B and C debt service reserve fund to extinguish \$41,470 and \$13,000 of the 2009B and C Bonds, respectively. The 2012C Bonds were issued in a fixed rate mode to take advantage of favorable interest rates. The 2012C Bonds were issued with premium of \$58 and a discount of \$512.

In October 2012, the System had available draw down bonds. The 2012D Bonds total \$23,775, which are at a variable rate and privately placed. Proceeds totaling \$7,890 were received in January 2013 and used with the 2009B and C debt service funds to extinguish \$8,400 of the 2009C Bonds. The remaining \$15,690 was received in January 2014 and were used with the 2009B and C debt service funds to extinguish \$17,730 of the 2009B Bonds.

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Effective April 15, 2011, the System entered into a note payable agreement with a regional center designated by the U.S. Citizenship and Immigration Services EB-5 Program for \$50,000. The note payable bears a 2.00% interest rate. On September 23, 2011, the System increased the borrowing capacity on the note by an additional \$10,000. The increased commitment bears a 1.50% interest rate. Borrowings under this agreement were \$60,000 at both December 31, 2014 and 2013, respectively. The note payable's principal payments begin in 2017 and its final maturity is December 2036.

A total of \$20,714 of bonds could become due in 2015. This amount represents i) variable rate bonds totaling \$10,714, which are backed by bank letters of credit, could become due in 2015 based on the repayment schedule of the bank letters of credit upon the failure to remarket these bonds and ii) \$10,000 of variable rate bonds for which the System provides self-liquidity and which is not backed by a letter of credit. The total that could become due in 2015 is offset by the remaining available borrowing capacity of \$100,000 on the revolving credit commitment with PNC Bank, which is not due until September 29, 2016.

The System is party to a Master Trust Indenture, amended and restated as of June 15, 1989 (the Indenture), pursuant to which the 2012A, B, C, and D were issued. The Series 2001, 2007A, 2009 C, 2010A and B, 2013 A, B, C, D, and E, and 2014 A, B, and C Bonds (collectively, the Revenue Bonds) are secured by the Indenture. The Revenue Bonds are general obligations of the Obligated Group. The Obligated Group consists of the System, UHCMC, University Hospitals Geauga Medical Center, University Hospitals Ahuja Medical Center, Inc., University Hospitals Parma Medical Center, and University Hospitals Elyria Medical Center.

In connection with the issuance of the Series 2014 A and B, 2013A and B, 2012A, B, C and D, 2010A and B, 2009C, and 2007A tax-exempt bonds by the Ohio Higher Educational Facility Commission (the Commission) for the benefit of the System, the System has leased to the Commission, and the Commission has subleased to the System the certain bond-financed assets. The System does not receive rental payments under its lease to the Commission and is required only to make rental payments to the Commission at the times and in the amounts sufficient to pay principal and interest on the outstanding tax-exempt bonds under its lease from the Commission. The lease agreements expire upon repayment of all indebtedness secured by the leases.

In connection with the issuance of the Series 2001 tax-exempt bonds by Cuyahoga County (the County) for the benefit of the System, the System has leased to the County, and the County has subleased to the System, certain healthcare facilities of the System. The System does not receive rental payments under its lease to the County and is required only to make rental payments to the County at the times and in the amounts sufficient to pay principal and interest on the outstanding tax-exempt bonds under its lease from the County. The lease agreements expire upon repayment of all indebtedness secured by the leases.

During the term of the various agreements and leases, the System is required to make specified deposits with trustees to fund principal and interest payments due. The System is subject to certain restrictive covenants, including provisions relating to certain debt ratios, days cash on hand, and other matters. The System was in compliance with these debt covenants at December 31, 2014.

Combined current aggregate scheduled maturities of long-term debt for the five years subsequent to December 31, 2014, excluding bonds that could come due in 2015, are as follows: 2015 – \$19,364; 2016 – \$21,683; 2017 – \$21,127; 2018 – \$22,595; 2019 – \$23,565; and 2020 and thereafter – \$1,050,698.

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The average interest rate included in the table above is the weighted average interest cost for the year ended December 31, 2014 for the 2001, 2010B, 2012B and D, 2013 B, C, D, and E, and 2014 B and C Bonds. The carrying value of the variable rate debt approximates their fair value. The fair value of the fixed rate debt totaled \$860,279 compared to a carrying value of \$821,445 as of December 31, 2014. The fair value of fixed rate debt was determined using observable inputs other than quoted market prices, which are considered Level 2 inputs (note 5).

Cash paid for operating interest totaled \$45,364 and \$40,176 in 2014 and 2013, respectively.

(9) Interest Rate Swap Agreements

The System utilizes interest rate swaps to manage the overall cost of debt and risk profile related to its long-term debt. The swaps utilized include i) fixed-payor swaps, whereby the System receives a floating rate and pays a fixed rate designed to either hedge against rising interest rates or achieve a lower overall cost of debt relative to traditional fixed-rate structures and ii) basis swaps whereby the System receives a floating rate based on a taxable index (LIBOR) and pays a floating rate based on a tax-exempt index (SIFMA) designed to reduce interest costs associated with its traditional fixed rate debt. A summary of the System's interest rate swap agreements is as follows:

Swap type	Maturity date	Year ended December 31, 2014		Notional value at December 31	
		System pays	System receives	2014	2013
Fixed-payor	2034	3.49%/3.46%	67% of 1-month LIBOR	\$ 75,000	75,000
Basis	2028	SIFMA Index	67% of 1-month LIBOR + 0.47%	25,000	25,000
Basis	2028	SIFMA Index	67% of 1-month LIBOR + 0.53%	25,000	25,000
Basis	2027	SIFMA Index	61.7% of 1-month LIBOR +0.67%	25,000	25,000
Basis	2027	SIFMA Index	61.7% of 1-month LIBOR +0.62%	25,000	25,000
Fixed-payor	2034	3.42%/3.36%	67% of 1-month LIBOR	75,000	75,000
Basis	2027	SIFMA Index	62.3% of 1-month LIBOR + 0.79%	42,500	42,500
Basis	2027	SIFMA Index	86.2% of 1-month LIBOR	50,000	50,000
Fixed-payor	2044	3.25%/3.5%	65% of 1-month LIBOR + 0.12%	100,000	100,000
Fixed-payor	2042	3.64%	70% of 1-month LIBOR	26,590	26,590
Basis	2032	SIFMA Index	85.3% of 3-month LIBOR	50,000	50,000
Fixed-payor	2029	3.606%	64.11% of 5-year LIBOR	28,755	—
Fixed-payor	2030	5.091%	91.03% of 5-year LIBOR	10,525	—
Fixed-payor	2030	3.623%	64.09% of 5-year LIBOR	9,490	—
Fixed-payor	2022	3.68%	70% of 1-month LIBOR	4,500	—
Fixed-payor	2026	3.78%	70% of 1-month LIBOR	9,545	—
Fixed-payor	2021	3.308%	70% of 1-month LIBOR	14,935	—
				<u>\$ 596,840</u>	<u>519,090</u>

SIFMA is an index of high-grade, tax-exempt variable rate demand obligations. SIFMA ranged from 0.03% to 0.12% (average rate of 0.05%) for the year ended December 31, 2014 and 0.05% to 0.23% (average rate of 0.09%) for the year ended December 31, 2013.

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In 2011, the System entered into a basis swap whereby the System pays the SIFMA Index and receives 67% of 3-month LIBOR plus 100 basis points through December 31, 2014. The System will pay the SIFMA Index and receive 85.3% of 3-month LIBOR on this basis swap beginning January 1, 2014 and thereafter. This transaction is expected to produce interest savings over its term.

The net fair value of interest rate swap agreements totaled \$(63,201) as of December 31, 2014. The net fair value for swap agreements in 2014 consisted of \$2,345 recorded in other assets and \$(65,546) recorded in other liabilities within the 2014 consolidated balance sheet. The net fair value for swap agreements in 2013 consisted of \$98 recorded in other assets and \$(36,817) recorded in other liabilities within the 2013 consolidated balance sheet.

Changes in fair value of derivative instruments in the consolidated statements of operations and changes in net assets totaled \$(17,368) and \$21,999 for the years ended December 31, 2014 and 2013, respectively. The net amount paid or received under the swap agreements is recorded as interest expense in the consolidated statements of operations and changes in net assets. Cash paid totaled \$10,166 and \$8,434 for the years ended December 31, 2014 and 2013, respectively. Cash received totaled \$1,551 and \$2,030 for the years ended December 31, 2014 and 2013, respectively.

The System posted collateral due to the decrease in swap valuations of \$4,881 and \$5,551 as of December 31, 2014 and 2013, respectively. The collateral is comprised of U.S. Treasury and government securities, is limited as to use, and is recorded as an investment within the consolidated balance sheets.

(10) Operating Leases

The System leases various facilities and equipment under operating lease agreements, which extend to 2050. Lease expense in 2014 and 2013 totaled \$35,626 and \$25,935, respectively. Minimum operating lease payments over the next five years and thereafter are as follows:

2015	\$	33,116
2016		27,585
2017		16,861
2018		9,889
2019		7,707
2020 and thereafter		26,439
	\$	<u>121,597</u>

(11) Insurance

Prior to July 1, 2002, the System provided coverage for professional and general liability and workers' compensation claims through a combination of self-insured retentions and commercial and excess insurance policies. Western Reserve Assurance Company, Ltd. (Western Reserve), a wholly owned subsidiary of the System, commenced operations on July 1, 2002 providing professional and general liability insurance coverage on a claims-made basis for substantially all of the System. Effective July 1, 2004, Western Reserve was restructured from a single parent company to a segregated portfolio company (SPC), Western Reserve Assurance Company, Ltd., SPC (Western Reserve SPC). SPC is an insurance company that operates as a

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single legal entity, which allows for assets and liabilities to be segregated between different protected portfolios of the company. The individual segregated portfolios do not, by law, have access or rights to the assets of any of the other segregated portfolios within SPC. At December 31, 2014, the Western Reserve SPC consists of several individual segregated portfolios. Each segregated portfolio provides coverage for its respective entity's insurance programs and is consolidated into each respective entity's consolidated financial statements. Western Reserve SPC has reinsurance agreements with unrelated commercial carriers in place relative to a portion of the risks.

Various claimants have asserted professional and general liability and workers' compensation claims against the System. These claims are in various stages of processing or are in litigation. In addition, there are known incidents, and there also may be unknown incidents, which may result in the assertion of additional claims. The System has accrued the actuarial estimate of both asserted and unasserted losses primarily based on actuarially determined amounts. The System's reserves for professional, general, and workers' compensation liabilities (including incurred but not reported claims) approximated \$146,551 and \$127,375 at December 31, 2014 and 2013, respectively. The current portion of the reserves, which approximates \$10,000 in both years, is recorded in other current liabilities and the remaining portion is recorded in other long-term liabilities. The retention limits per occurrence for the various policies written by Western Reserve SPC range from \$500 to \$10,000.

(12) Pension Plans

The System maintains noncontributory defined benefit pension plans (the plans) for the benefit of eligible employees. The benefits are based upon years of service and the employees' compensation, as defined by the respective plans. It is the System's policy to contribute annually to the defined benefit plans amounts that are actuarially determined to provide the plans with sufficient assets to meet future benefit payment requirements.

The System recognizes the funded status (difference between the fair value of plan assets and the projected benefit obligation) of defined benefit pension plans on its consolidated balance sheets. Gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit costs are recognized as a component of unrestricted net assets. The System uses December 31 as the measurement date for plan assets and benefit obligations.

The amounts recognized in changes in unrestricted net assets at December 31, 2014 and 2013 consisted of the following:

	<u>2014</u>	<u>2013</u>
Amount recognized in unrestricted net assets at end of year:		
Unrecognized actuarial loss	\$ 489,621	281,592
Unrecognized prior service costs	12	18
Net amount recognized	<u>\$ 489,633</u>	<u>281,610</u>

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The accumulated benefit obligation for the plans was \$1,047,465 and \$644,150 as of December 31, 2014 and 2013, respectively. The following represents selected information about the plans for 2014 and 2013 as of December 31, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Change in benefit obligation:		
Projected benefit obligation (PBO) at beginning of year	\$ 656,952	652,820
Member substitutions	170,075	—
Service cost	41,705	41,194
Interest cost	40,624	27,388
Actuarial loss (gain)	208,996	(33,666)
Benefits paid	<u>(43,579)</u>	<u>(30,784)</u>
Projected benefit obligation at end of year	<u>1,074,773</u>	<u>656,952</u>
Change in plan assets:		
Fair value of assets at beginning of year	646,789	432,608
Member substitutions	128,047	—
Actual return on assets	34,353	46,010
Employer contribution	10,548	198,955
Benefits paid	<u>(43,579)</u>	<u>(30,784)</u>
Fair value of assets at end of year	<u>776,158</u>	<u>646,789</u>
Funded status (PBO in excess of plan assets)	(298,615)	(10,163)
Unrecognized actuarial loss	489,621	281,592
Unrecognized prior service costs	<u>12</u>	<u>18</u>
Net amount recognized	\$ <u>191,018</u>	\$ <u>271,447</u>
	<u>2014</u>	<u>2013</u>
The components of periodic pension costs included the following:		
Service cost	\$ 41,705	41,194
Interest cost	40,624	27,388
Expected return on plan assets	(56,791)	(37,425)
Amortization of prior service costs	6	8
Recognized net actuarial loss	<u>23,390</u>	<u>28,356</u>
Net periodic pension cost	\$ <u>48,934</u>	\$ <u>59,521</u>

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The amounts in unrestricted net assets expected to be recognized as components of net periodic pension costs in 2015 are as follows:

Amortization of prior service costs	\$	(2,393)
Recognized actuarial losses		<u>42,547</u>
Total	\$	<u><u>40,154</u></u>

The weighted average assumptions used to determine benefit obligations and net benefit cost for the years ended December 31, 2014 and 2013 were as follows:

	<u>2014</u>	<u>2013</u>
Weighted average assumptions:		
Discount rate	4.22%	5.05%
Expected return on plan assets	7.25	7.25
Rate of compensation increase (*)	3.00/3.75	2.00/3.75

(*) 3.00% in 2015 and age graded scale thereafter

Pension assets are invested in various asset classes as follows:

	<u>2014</u>	<u>2013</u>
Asset class:		
Equities, mutual and exchange traded funds	43%	35%
Fixed income	25	27
Alternative investments	25	25
Cash and cash equivalents	7	13

The Investment Committee of the Board of Directors has responsibility for establishing and monitoring compliance with the investment policy governing the investment of pension assets. The investment policy is utilized as the basis for determining the long-term return assumption for the assets. Historical data, combined with future expected returns of each asset class, are the primary components utilized in developing this assumption. Additional information, such as specific manager performance and risk characteristics, is also included in the assessment of the long-term rate of return assumption.

The System expects to contribute \$800 to the plans in 2015. The estimated benefit payments, which reflect expected future service, as appropriate, are expected to be paid by the System as follows: 2015 – \$49,708; 2016 – \$54,215; 2017 – \$59,435; 2018 – \$63,582; 2019 – \$67,117; and 2020 to 2024 – \$379,113.

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The FASB requires that the fair value hierarchy disclosures be applied to assets held within the plans. Refer to note 5 for level definitions.

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2014:				
Assets:				
Cash and cash equivalents	\$ 41,537	14,057	—	55,594
Fixed income securities:				
Corporate bonds	7	181,286	—	181,293
Government securities	7,305	6,746	—	14,051
Total fixed income securities	<u>7,312</u>	<u>188,032</u>	<u>—</u>	<u>195,344</u>
Equities, mutual and exchange traded funds:				
U.S. equities	76,846	—	—	76,846
International equities	1,961	—	—	1,961
Mutual and exchange traded funds	241,176	14,189	—	255,365
Total equities, mutual and exchange traded funds	<u>319,983</u>	<u>14,189</u>	<u>—</u>	<u>334,172</u>
Alternative investments:				
Hedge funds	—	—	130,812	130,812
Real estate	—	—	28,766	28,766
Distressed debt	—	—	31,470	31,470
Total alternative investments	<u>—</u>	<u>—</u>	<u>191,048</u>	<u>191,048</u>
Total assets	\$ <u>368,832</u>	<u>216,278</u>	<u>191,048</u>	<u>776,158</u>

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	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2013:				
Assets:				
Cash and cash equivalents	\$ 20,609	64,265	—	84,874
Fixed income securities:				
Corporate bonds	—	170,876	—	170,876
Government securities	—	535	—	535
Total fixed income securities	—	171,411	—	171,411
Equities, mutual and exchange traded funds:				
U.S. equities	21,421	—	—	21,421
International equities	1,182	—	—	1,182
Mutual and exchange traded funds	191,680	10,872	—	202,552
Total equities, mutual and exchange traded funds	214,283	10,872	—	225,155
Alternative investments:				
Hedge funds	—	—	123,169	123,169
Real estate	—	—	12,723	12,723
Distressed debt	—	—	29,457	29,457
Total alternative investments	—	—	165,349	165,349
Total assets	\$ 234,892	246,548	165,349	646,789

The plans held certain investments in cash and cash equivalents consisting of short-term money market instruments including commercial paper, asset backed securities, treasury bonds and bills, and short-term corporate bonds. The plans also hold certain alternative investments including hedge funds, real estate, and distressed debt. Refer to note 6 for asset valuation and liquidity restriction information. Liquidity information is included in the below chart.

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The table below classifies the market value at December 31, 2014 of the alternative investment portion of the plan assets into categories based on the stated contractual liquidity terms of the underlying investments:

	<u>Fair market value</u>	<u>Unfunded commitments</u>
Less than 1 year, no contractual restrictions have been imposed	\$ 77,356	—
Subject to existing gates or restrictions	23,772	—
Limited partnership fund expiring in 1–5 years	34,753	750
Limited partnership fund expiring in 6–10 years	39,392	20,396
Limited partnership fund expiring in 11–15 years	<u>15,775</u>	<u>27,574</u>
Total alternative investments	\$ <u>191,048</u>	<u>48,720</u>

**Fair value measurements of alternative investments
using significant unobservable inputs (Level 3)**

	<u>Hedge funds</u>	<u>Real estate</u>	<u>Distressed debt</u>	<u>Total</u>
Balance at December 31, 2012	\$ 124,513	7,752	29,244	161,509
Unrealized gains (losses)	8,367	(848)	2,674	10,193
Realized gains	5,105	331	426	5,862
Disbursements and transfers out	(35,128)	(4,716)	(5,427)	(45,271)
Contributions and cash receipts	<u>20,312</u>	<u>10,204</u>	<u>2,540</u>	<u>33,056</u>
Balance at December 31, 2013	123,169	12,723	29,457	165,349
Unrealized gains (losses)	7,223	295	(892)	6,626
Realized gains	3,798	2,423	2,254	8,475
Disbursements and transfers out	(34,753)	(5,366)	(4,315)	(44,434)
Contributions and cash receipts	<u>31,375</u>	<u>18,691</u>	<u>4,966</u>	<u>55,032</u>
Balance at December 31, 2014	\$ <u>130,812</u>	<u>28,766</u>	<u>31,470</u>	<u>191,048</u>

The System sponsors various defined contribution plans. The System contributed \$23,745 and \$15,614 to the defined contribution plans for the years ended December 31, 2014 and 2013, respectively.

The System also has nonqualified deferred compensation plans for certain employees. The System contributed and expensed \$4,708 and \$3,198 to the deferred compensation plans for the years ended December 31, 2014 and 2013, respectively.

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(13) Investments in Joint Ventures

The System and Sisters of Charity of St. Augustine Health System, Inc. (SCHS) each has a 50% membership in St. John Medical Center (SJMC). The System entered into a management agreement with SCHS for the System to manage the operations of SJMC for a minimum of 5 years. The System committed \$50,000 in capital contributions to SJMC.

During 1997, the System entered into an agreement with Southwest Community Health System and certain of its affiliated entities, including Southwest General Health Center (Southwest). The agreement also provides that 50% of the voting members of Southwest's board of trustees shall be selected for appointment by the System and that the System is entitled to 50% of the annual net income as defined in the agreement. The agreement has been amended and restated as of January 1, 2011 and is effective for 10 years. The System retained its voting and income rights of 50% within the new agreement.

Details of the System's investments in these joint ventures are as follows:

	<u>SJMC 50%</u>	<u>Southwest 50%</u>	<u>Total</u>
Investment at December 31, 2012	\$ 28,024	52,325	80,349
Excess of revenues over expenses	2,535	10,865	13,400
Other unrestricted net asset activity	(8)	—	(8)
Distributions	—	(6,376)	(6,376)
Investment at December 31, 2013	30,551	56,814	87,365
Excess of revenues over expenses	2,835	9,883	12,718
Other unrestricted net asset activity	134	—	134
Distributions	—	(5,171)	(5,171)
Investment at December 31, 2014	\$ 33,520	61,526	95,046

The summary below illustrates the condensed combined financial data for SJMC and Southwest as of December 31, 2014 and 2013.

	<u>(Unaudited)</u>	
	<u>2014</u>	<u>2013</u>
Total assets	\$ 622,161	622,959
Total net assets	262,988	277,667
Total net revenues	510,848	484,790
Total excess of revenues over expenses	26,792	27,211

The System records its pro-rata portion of operating results as other revenue in the accompanying consolidated statements of operations and changes in net assets and records its pro-rata portion of changes in unrestricted net assets in the accompanying consolidated statements of operations and changes in net assets.

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(14) Care Assurance

Various subsidiaries of the System participate in the State of Ohio's Care Assurance Program, which was established in 1988 to assist Ohio hospitals that had a disproportionate amount of uncompensated care. Under the program, Ohio hospitals, including the System's hospitals, are assessed an amount which forms a pool of funds to be matched with federal Medicaid funds for payments to hospitals. Total net revenues to the System under the Care Assurance Program totaled \$14,240 and \$11,189 in 2014 and 2013, respectively. The System records the net proceeds in net patient service revenue.

(15) Litigation and Contingencies

The System is involved in litigation arising in the ordinary course of business. Claims have been asserted against the System and are currently in various stages of litigation. It is the opinion of management that estimated costs accrued are adequate to provide for potential losses resulting from pending or threatened litigation.

(16) Special Charges

The System incurred \$7,855 and \$5,938 in special charges during 2014 and 2013, respectively. The special charges related primarily to severance and restructuring costs.

(17) Purchase Commitments

The System has commitments to purchase goods and services with the following minimum contractual obligations as follows: 2015 – \$33,281; 2016 – \$28,183; 2017 – \$17,957; 2018 – \$14,550; 2019 – \$10,113; and 2020; and thereafter – \$12,087. Purchases under these contracts totaled \$140,564 and \$122,880 in 2014 and 2013, respectively, and met the provisions of the agreement. In 2001, the System entered into a thirty-year agreement with a utilities company, a related party, which provides utilities to certain buildings at UHCMC. The amounts purchased were \$22,063 and \$19,137 in 2014 and 2013, respectively.

(18) Income Taxes

The System has certain taxable subsidiaries that have incurred net losses for federal income tax purposes. The System acquired two new hospitals and their respective entities on January 1, 2014 that increased these net losses. Cumulative losses available totaled approximately \$378,263 and \$274,794 at December 31, 2014 and 2013, respectively. The losses are available to offset future taxable income and expire in varying amounts through the year 2034. A potential tax benefit has not been recorded in the financial statements at December 31, 2014 and 2013 due to the uncertainty of realizing those benefits in the future.

The System must recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the consolidated financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. As of December 31, 2014 and 2013, the System does not have any uncertain tax positions.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

(19) Functional Expenses

The System provides healthcare services, medical education, and performs medical research. Expenses related to these functions were as follows:

	<u>2014</u>	<u>2013</u>
Healthcare services	\$ 2,023,919	1,802,536
Medical education	172,079	96,526
Medical research	131,053	67,765
General and administrative	521,934	289,749
Special charges	7,855	5,938
Total expenses	<u>\$ 2,856,840</u>	<u>2,262,514</u>

(20) Related Parties

Certain members of the System's Board of Directors serve as management of companies that provide services to the System, including certain banking, investment management, and supplier relationships. Also, certain members of the System's Board of Directors are physicians who serve as medical directors or provide other services in the System. The System's management believes that transactions with related parties are entered into only upon terms comparable to those that would be available from unaffiliated third parties.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

(21) Member Substitutions (Unaudited)

On January 1, 2014, identifiable assets and liabilities assumed by the System as a result of the member substitution agreements with CHCO and Parma were recorded at fair value. The following table summarizes the fair values identified:

	Initial fair value
Current assets	\$ 87,897
Investments	141,757
Property, plant and equipment, net	165,519
Long-term assets	<u>19,609</u>
Total assets	414,782
Current liabilities	64,730
Long-term debt	96,131
Other liabilities	<u>69,645</u>
Total liabilities	<u>230,506</u>
Net assets	184,276
Cash paid	<u>(5,500)</u>
Net assets less cash paid	\$ <u><u>178,776</u></u>
Allocation of member substitutions:	
Temporarily restricted net assets	\$ 21,660
Permanently restricted net assets	2,475
Unrestricted net assets	<u>154,641</u>
	\$ <u><u>178,776</u></u>

The following unaudited pro forma financial information presents the combined historical results of operations of the System, Parma and CHCO as if the member substitutions had occurred on the first day of 2013. The unaudited pro forma financial information includes certain adjustments related to the acquisition, such as the reduction in depreciation expense from the fair value of property, plant and equipment and amortization of pension expense as part of the purchase accounting.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

December 31, 2014 and 2013

(In thousands of dollars)

Unaudited pro forma consolidated results of operations as of December 31, 2013 are as follows:

	Year ended December 31, 2013
Pro forma revenues	\$ 2,778,355
Pro forma excess revenues over expenses	183,193

The unaudited pro forma financial information is not intended to represent or be indicative of what would have occurred if the transactions had taken place on the dates presented and is not indicative of what the System's actual results of operations would have been had the member substitutions been completed at the beginning of the periods indicated above. Further, the pro forma combined results do not reflect one-time costs to fully merge and operate the combined organization more efficiently, or anticipated synergies expected to result from the member substitutions and should not be relied upon as being indicative of future results that the System will experience.

(22) Subsequent Events

Management evaluated all activity of the System through March 26, 2015. There have been no events subsequent to the date of these consolidated financial statements that would require additional disclosure.



UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Report of Federal Award Expenditures in
Accordance with OMB Circular A-133

Federal Entity Identification Number: 34-0714775

Year ended December 31, 2014

(With Independent Auditors' Reports Thereon)

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Report on Federal Award Expenditures in
Accordance with OMB Circular A-133

Year ended December 31, 2014

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UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Schedule of Expenditures of Federal Awards

Year ended December 31, 2014

<u>Federal Grantor/Program/Grant</u>	<u>Pass-through grantor</u>	<u>CFDA Number</u>	<u>Expenditures</u>
RESEARCH & DEVELOPMENT CLUSTER			
U.S. Department of Defense Risk and Resilience Project		12.420	\$ 755,406
Total Research & Development Cluster			<u>755,406</u>
HIGHWAY SAFETY CLUSTER			
U.S. Department of Transportation			
Safe Communities Program – Cuyahoga County	Ohio Department of Public Safety	20.600	121,181
Safe Communities Program – Geneva	Ohio Department of Public Safety	20.600	22,031
Ohio Buckles Buckeyes	Ohio Department of Health	20.600	63,432
OVI Task Force – Countywide OVI Task Force Program	Ohio Department of Public Safety	20.601	195,718
Total Highway Safety Cluster			<u>402,362</u>
OTHER PROGRAMS			
U.S. Department of Health and Human Services:			
Ryan White Title III Grant	Health Resources and Services Administration	93.918	477,675
Ryan White Title IV Grant	Health Resources and Services Administration	93.153	386,533
Poison Control Center	Health Resources and Services Administration	93.253	17,659
Achaogen Clinical Trial - BARDA	Health Resources and Services Administration	93.360	4,040
Transforming Pediatric Ambulatory Care: The Physician Extension Team (PET)	Centers for Medicare & Medicaid Services (CMS)	93.610	3,744,578
Evidence-Conformant Oncology Care	Centers for Medicare & Medicaid Services (CMS)	93.610	105,714
Total CFDA # 93.610			<u>3,850,292</u>
Disaster Preparedness Grant – Geauga	Center for Health Affairs	93.889	11,844
Disaster Preparedness Grant – Richmond	Center for Health Affairs	93.889	12,500
Disaster Preparedness Grant – Geneva	Center for Health Affairs	93.889	12,052
Disaster Preparedness Grant – Conneaut	Center for Health Affairs	93.889	11,395
Disaster Preparedness Grant – Rainbow Babies and Children's Hospital	Center for Health Affairs	93.889	11,794
Disaster Preparedness Grant – UHCMC	Center for Health Affairs	93.889	12,284
Total CFDA # 93.889			<u>71,869</u>
Poison Control Bioterrorism Preparedness Grant	Ohio Department of Health	93.074	113,871
Maternal and Child Health Services Block Grant (Perinatal Grant)	Ohio Department of Health	93.994	95,606
Help Me Grow	Ohio Department of Health	93.558	36,233
MedTapp Quality Program	Ohio Department of Health	93.778	75,904
Ryan White Title I Grant	Cuyahoga County Board of Commissioners	93.914	522,841
Moms First	Office of Criminal Justice Service	93.926	18,661
Total U.S. Department of Health and Human Services			<u>5,743,054</u>
Total Federal Award Expenditures			\$ <u>6,828,952</u>

See accompanying independent auditors' report and notes to schedule of expenditures of federal awards.

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Notes to Schedule of Expenditures of Federal Awards

Year ended December 31, 2014

(1) General

The accompanying schedule of expenditures of federal awards presents the activity of all federal financial assistance programs of University Hospitals Health System, Inc. (System) for the year ended December 31, 2014. Federal awards received directly from federal agencies as well as federal awards passed through other government agencies are included in the accompanying schedule.

(2) Basis of Presentation

The accompanying schedule of expenditures of federal awards is presented using the accrual basis of accounting. Funds received under various government grant programs are recognized as support over the grant period as expenditures are incurred.

(3) Relationship to Financial Statements

All federal financial assistance receipts are reported as grants and contracts from governmental agencies in the System's consolidated financial statements.

During the year ended December 31, 2014, the System passed through \$172,667 and \$491,475 to subrecipients of federal funding for the OVI Task Force – Countywide OVI Task Force Program and Risk and Resilience Project, respectively.



KPMG LLP
One Cleveland Center
Suite 2600
1375 East Ninth Street
Cleveland, OH 44114-1796

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Board of Directors
University Hospitals Health System, Inc.:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the consolidated financial statements of University Hospitals Health System, Inc. and subsidiaries (the System), which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related statements of operations and change in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements, and have issued our report thereon dated March 26, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements, we considered the System's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we do not express an opinion on the effectiveness of the System's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's consolidated financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.



Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the System's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the System's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Cleveland, Ohio
March 26, 2015



KPMG LLP
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Suite 2600
1375 East Ninth Street
Cleveland, OH 44114-1796

Independent Auditors' Report on Compliance for Each Major Federal Program; Report on Internal Control Over Compliance; and Report on Schedule of Expenditures of Federal Awards Required by OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

The Board of Directors
University Hospitals Health System, Inc.:

Report on Compliance for Each Major Federal Program

We have audited University Hospitals Health System, Inc. and subsidiaries' (the System) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the System's major federal programs for the year ended December 31, 2014. The System's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditors' Responsibility

Our responsibility is to express an opinion on compliance for each of the System's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the System's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of the System's compliance.

Opinion on Each Major Federal Program

In our opinion, the System complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended December 31, 2014.

Report on Internal Control Over Compliance

Management of the System's is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the System's internal control over compliance with the types of



requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of Federal Awards Required by OMB Circular A-133

We have audited the consolidated financial statements of the System as of and for the year ended December 31, 2014, and have issued our report thereon dated March 26, 2015, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

Cleveland, Ohio
September 30, 2015

UNIVERSITY HOSPITALS HEALTH SYSTEM, INC.

Schedule of Findings and Questioned Costs

Year ended December 31, 2014

(1) Summary of Auditor's Results

(a)	The type of report issued on the consolidated financial statements:	Unmodified opinion
(b)	Significant deficiencies in internal control were disclosed by the audit of the consolidated financial statements:	None reported
	Material weaknesses:	No
(c)	Noncompliance which is material to the consolidated financial statements:	No
(d)	Significant deficiencies in internal control over major programs:	None reported
	Material weaknesses:	No
(e)	The type of report issued on compliance for major programs:	Unmodified opinions
(f)	Any audit findings which are required to be reported under Section 510(a) of OMB Circular A-133:	No
(g)	Major programs:	
	U.S. Department of Defense	
	Risk and Resilience Project - Research and Development Cluster - CFDA No. 12.420	
	U.S. Department of Health and Human Services	
	Ryan White Title III Grant - CFDA No. 93.918	
	Pass through Cuyahoga County Board of Commissioners:	
	Ryan White Title I Grant - CFDA No. 93.914	
(h)	Dollar threshold used to distinguish between Type A and Type B programs:	\$ 300,000
(i)	Auditee qualified as low-risk auditee under Section 530 of OMB Circular A-133:	Yes

(2) Findings Related to the Financial Statements Reported in Accordance with Government Auditing Standards

None.

(3) Findings and Questioned Costs Relating to Federal Awards

None.