

CONSOLIDATED FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION

Vanderbilt University Medical Center
Years Ended June 30, 2018 and 2017
With Report of Independent Auditors

Ernst & Young LLP



Building a better
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Vanderbilt University Medical Center
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June 30, 2018 and 2017

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Report of Independent Auditors

The Board of Directors Vanderbilt University Medical Center

We have audited the accompanying consolidated financial statements of Vanderbilt University Medical Center, which comprise the consolidated balance sheet as of June 30, 2018, and the related consolidated statements of operations, changes in net assets, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Vanderbilt University Medical Center as of June 30, 2018, and the consolidated results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Report of Other Auditors on 2017 Financial Statements

The consolidated financial statements of Vanderbilt University Medical Center for the year ended June 30, 2017, were audited by other auditors who expressed an unmodified opinion on those statements on October 19, 2017.

Ernst & Young LLP

October 26, 2018

Vanderbilt University Medical Center
Consolidated Balance Sheets
June 30, 2018 and 2017

(\$ in thousands)	<u>2018</u>	<u>2017</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 500,908	\$ 520,857
Current investments	134,467	133,977
Patient accounts receivable, net of allowance for bad debts of \$179.1 million and \$130.5 million as of June 30, 2018 and 2017, respectively	474,385	374,686
Estimated receivables under third-party programs	-	12,642
Grants and contracts receivable, net	57,748	67,249
Inventories	72,636	67,478
Other current assets	85,843	73,076
Total current assets	<u>1,325,987</u>	<u>1,249,965</u>
Noncurrent investments	262,846	94,412
Noncurrent investments limited as to use	260,842	202,592
Property, plant, and equipment, net	1,306,639	1,219,768
Other noncurrent assets	35,877	34,593
Total assets	<u>\$ 3,192,191</u>	<u>\$ 2,801,330</u>
Liabilities and Net Assets		
Current liabilities:		
Current installments of long-term debt	\$ 5,774	\$ 5,753
Accounts payable and other accrued expenses	268,087	266,665
Estimated payables under third-party programs	72,947	37,072
Accrued compensation and benefits	197,945	194,739
Current portion of deferred revenue	37,303	39,353
Current portion of medical malpractice self-insurance reserves	16,558	17,161
Total current liabilities	<u>598,614</u>	<u>560,743</u>
Long-term debt, net of current installments	1,512,698	1,288,346
Fair value of interest rate exchange agreements	54,206	65,203
Noncurrent portion of medical malpractice self-insurance reserves	57,520	54,373
Noncurrent portion of deferred revenue	18,719	10,694
Other noncurrent liabilities	22,804	21,069
Total liabilities	<u>2,264,561</u>	<u>2,000,428</u>
Net assets:		
Unrestricted net assets controlled by Vanderbilt University Medical Center	807,481	708,088
Unrestricted net assets related to noncontrolling interests	5,724	5,891
Total unrestricted net assets	<u>813,205</u>	<u>713,979</u>
Temporarily restricted net assets	79,496	69,058
Permanently restricted net assets	34,929	17,865
Total net assets	<u>927,630</u>	<u>800,902</u>
Total liabilities and net assets	<u>\$ 3,192,191</u>	<u>\$ 2,801,330</u>

The accompanying notes are an integral part of these consolidated financial statements.

Vanderbilt University Medical Center
Consolidated Statements of Operations
Years Ended June 30, 2018 and 2017

(\$ in thousands)	2018	2017
Operating revenues		
Patient service revenue, net of contractual adjustments and discounts	\$ 3,578,525	\$ 3,444,438
Provision for bad debts	(135,748)	(109,119)
Patient service revenue, net	3,442,777	3,335,319
Academic and research revenue	495,306	421,776
Other operating revenue	148,316	146,473
Total operating revenues	4,086,399	3,903,568
Operating expenses		
Salaries, wages, and benefits	2,179,647	2,035,263
Supplies and drugs	770,459	699,200
Facilities and equipment	256,938	245,416
Services and other	659,455	605,302
Depreciation and amortization	105,654	91,443
Interest	58,078	48,482
Total operating expenses	4,030,231	3,725,106
Income from operations	56,168	178,462
Nonoperating revenues and expenses		
Income from investments	24,021	21,250
Gift income	11,945	9,770
Earnings of unconsolidated organizations	3,696	3,910
Unrealized gain on interest rate exchange agreements, net of cash settlements	6,379	18,845
Other nonoperating losses, net	-	(861)
Total nonoperating revenues and expenses	46,041	52,914
Excess of revenues over expenses	102,209	231,376
Excess of revenues over expenses attributable to noncontrolling interests	(4,068)	(4,883)
Excess of revenues over expenses attributable to VUMC	98,141	226,493
Other changes in unrestricted net assets		
Change in noncontrolling interest's net assets	(167)	364
Net asset reclassification	(89)	(22,234)
Plant contributions placed into service	1,292	-
Other changes	49	(65)
Total changes in unrestricted net assets	\$ 99,226	\$ 204,558

The accompanying notes are an integral part of these consolidated financial statements.

Vanderbilt University Medical Center
Consolidated Statements of Changes in Net Assets
Years Ended June 30, 2018 and 2017

(\$ in thousands)

	2018	2017
Unrestricted net assets		
Unrestricted net assets at the beginning of the period	\$ 713,979	\$ 509,421
Excess of revenues over expenses	98,141	226,493
Change in noncontrolling interest's net assets	(167)	364
Net asset reclassification	(89)	(22,234)
Plant contributions placed into service	1,292	-
Other changes	49	(65)
Change in unrestricted net assets	99,226	204,558
Unrestricted net assets at the end of the period	\$ 813,205	\$ 713,979
Temporarily restricted net assets		
Temporarily restricted net assets at the beginning of the period	\$ 69,058	\$ 26,985
Contributions	17,817	27,681
Endowment appreciation	759	749
Net assets released from restrictions	(7,042)	(6,114)
Net asset reclassification	195	19,757
Plant contributions released from restrictions	(1,292)	-
Other changes	1	-
Change in temporarily restricted net assets	10,438	42,073
Temporarily restricted net assets at the end of the period	\$ 79,496	\$ 69,058
Permanently restricted net assets		
Permanently restricted net assets at the beginning of the period	\$ 17,865	\$ 6,769
Contributions	17,170	8,619
Net asset reclassification	(106)	2,477
Change in permanently restricted net assets	17,064	11,096
Permanently restricted net assets at the end of the period	\$ 34,929	\$ 17,865
Total net assets		
Beginning of the period	\$ 800,902	\$ 543,175
Change in total net assets	126,728	257,727
End of the period	\$ 927,630	\$ 800,902

The accompanying notes are an integral part of these consolidated financial statements.

Vanderbilt University Medical Center
Consolidated Statements of Cash Flows
Years Ended June 30, 2018 and 2017

<i>(\$ in thousands)</i>	2018	2017
Cash flows from operating activities		
Change in total net assets	\$ 126,728	\$ 257,727
Adjustments to reconcile change in total net assets to net cash provided by operating activities:		
Depreciation and amortization	105,654	91,443
Amortization of debt issuance costs, and original issue premium and discount	518	(902)
Provision for bad debts	135,748	109,119
(Gain) loss on disposal of assets	(7,686)	3,409
Undistributed equity in earnings of equity method affiliates	(1,807)	(1,156)
Net realized and unrealized gain on investments	(10,954)	(16,371)
Purchases of trading securities	(348,124)	(312,072)
Sales of trading securities	332,330	112,056
Change in split-interest trusts	(230)	(963)
Unrealized gain on interest rate exchange agreements	(10,997)	(24,333)
Restricted contributions for endowments and property, plant, and equipment	(24,326)	(17,991)
(Decrease) increase in cash due to changes in:		
Patient accounts receivable	(235,447)	(144,582)
Accounts payable and other accrued expenses	477	49,352
Other assets and other liabilities, net	58,538	539
Net cash provided by operating activities	<u>120,422</u>	<u>105,275</u>
Cash flows from investing activities		
Purchase of property, plant, and equipment	(198,562)	(158,729)
Purchases of long-term securities	(314,137)	(59,552)
Sales and maturities of long-term securities	155,141	52,237
Proceeds on sale of property, plant, and equipment	20,394	-
Change in restricted cash for property, plant, and equipment	(40,692)	(9,371)
Net cash used in investing activities	<u>(377,856)</u>	<u>(175,415)</u>
Cash flows from financing activities		
Proceeds from issuance of long-term debt	329,719	-
Debt issuance costs	(3,035)	-
Repayment of long-term debt	(108,100)	(4,583)
Principal payments under capital lease obligations	(1,191)	(552)
Change in bank overdrafts	-	(13,846)
Restricted contributions for endowments and property, plant, and equipment	24,326	17,991
Distributions to noncontrolling interests	(4,234)	(4,519)
Net cash provided by (used in) financing activities	<u>237,485</u>	<u>(5,509)</u>
Net change in cash and cash equivalents	<u>(19,949)</u>	<u>(75,649)</u>
Cash and cash equivalents		
Beginning of the period	520,857	596,506
End of the period	<u>\$ 500,908</u>	<u>\$ 520,857</u>

The accompanying notes are an integral part of these consolidated financial statements.

Vanderbilt University Medical Center

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

1. Description of Organization

Vanderbilt University Medical Center ("VUMC") is a Tennessee not-for-profit corporation incorporated in March 2015 to operate an academic medical center, including a comprehensive research, teaching, and patient care health system (the "Medical Center"). Until April 29, 2016, the Medical Center operated as a unit within Vanderbilt University ("the University" or "VU"), as a part of the University's administrative structure, with the same governing board, legal, financial, and other shared services.

VUMC began operations effective April 30, 2016, following the closing of the sale of the Medical Center by the University (the "Acquisition"). VUMC owns and operates three hospitals located on the main campus of the University in Nashville, Tennessee: Vanderbilt University Adult Hospital ("VUAH"), Monroe Carell Junior Children's Hospital at Vanderbilt ("MCJCHV"), and Vanderbilt Psychiatric Hospital ("VPH"). In addition, VUMC partially owns Vanderbilt Stallworth Rehabilitation Hospital ("VSRH"), also located on the main campus of the University, through a joint venture with HealthSouth Corp. in which VUMC holds a 50% interest, which includes a 1% interest held by Vanderbilt Health Services, LLC, ("VHS"), a VUMC wholly owned subsidiary. VUAH, MCJCHV, and VPH are licensed for 1,051 beds, and VSRH is licensed for 80 beds.

VUMC consists of two major operating divisions and an administrative overhead division. The operating divisions include the Clinical Enterprise and Academic Enterprise divisions. The administrative overhead division is referred to as Medical Center Administration ("MCA").

The Clinical Enterprise division includes the professional clinical practice revenues and related expenses of Vanderbilt Medical Group ("VMG"), and technical revenues and associated expenses for the operation of VUMC's hospitals and clinic facilities, including VUAH, MCJCHV, and VPH. The Clinical Enterprise also includes VHS.

- VUAH is a quaternary care teaching hospital licensed for 692 acute care and specialty beds. VUAH, a Level I trauma center, provides advanced patient care and serves as a key site for medical education and clinical research conducted by physician faculty. VUAH includes a comprehensive burn center, the Vanderbilt Transplant Center, the Vanderbilt Heart and Vascular Institute, and the Vanderbilt Ingram Cancer Center.
- MCJCHV is a pediatric quaternary care teaching hospital licensed for 129 acute and specialty beds, 42 pediatric intensive care beds, and 96 neonatal intensive care beds. MCJCHV is the region's only full-service pediatric hospital, with over 30 pediatric specialties. MCJCHV serves as a site for medical education and clinical research conducted by pediatric physician faculty, houses the only Level IV neonatal intensive care center and the only Level 1 pediatric trauma center within the region, and is a regional referral center for extracorporeal membrane oxygenation (heart and lung failure).
- VPH is a psychiatric hospital licensed for 92 beds and provides both inpatient and outpatient partial hospitalization psychiatric services to both adult and adolescent patients. Also, VPH provides psychiatric assessment services and neuromodulation procedures through electroconvulsive therapy and transcranial magnetic stimulation.
- VMG is the practice group of physicians and advanced practice nurses employed by VUMC, most of whom have faculty appointments from the University, who perform billable professional medical services. VMG is not a separate legal entity. VMG has a board which consists of the VUMC clinical service chiefs, who also serve as clinical department chairs. Under the oversight of VUMC executive leadership, VMG sets professional practice standards, bylaws, policies,

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and procedures. VUMC bills for services rendered by the VMG clinicians in both inpatient and outpatient locations. Collected fees derive a component of each VMG clinician's compensation. VMG includes nationally recognized physicians whose expertise spans the spectrum from primary care to the most specialized quaternary discipline. The entire clinical faculty is "board certified" or eligible for board certification. All staff members are re-credentialed every two years by the National Committee for Quality Assurance standards. All specialties and subspecialties currently recognized by the various national specialty boards are represented on the clinical faculty.

- VHS serves as a holding company for 15 healthcare related subsidiaries and joint ventures owned with various entities, including, but not limited to, VSRH and the Vanderbilt Health Affiliated Network ("VHAN"). VHS operations primarily consist of community physician practices, walk-in and retail health clinics, imaging services, outpatient surgery centers, radiation oncology centers, a home health care agency, a home infusion and respiratory service, an affiliated health network, accountable care organizations, and a rehabilitation hospital. These subsidiaries include clinics managed in multiple outpatient locations throughout middle Tennessee and southwestern Kentucky.
- VUMC also has a holding company that includes four limited liability subsidiaries, which support various business-to-business health care activities in order to improve the quality, affordability, and availability of health care services. These subsidiaries include business focused on pharmacy, supply chain, and consulting services.

The Academic Enterprise division includes all clinically related research, research-support activities, and faculty endeavors supporting post graduate training programs. A significant funding source for VUMC's research has historically been the federal government. Federal funding is received from the Department of Health and Human Services, the National Institutes of Health, the Department of Defense, NASA, and other federal agencies. Sponsored research awards, including multiple-year grants and contracts from government sources, foundations, associations, and corporations, signify future research commitments. Also, core activities supporting research, including advanced computing and grant administration, are included in this division.

The terms "Company," "VUMC," "we," "our", or "us" as used herein and unless otherwise stated or indicated by context refer to Vanderbilt University Medical Center and its affiliates. The terms "facilities" or "hospitals" refer to entities owned and operated by VUMC and its affiliates, and the term "employees" refers to employees of VUMC and its affiliates.

VUMC operates on a fiscal year which ends on June 30. The term "Fiscal" preceding a year refers to a particular VUMC fiscal year.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared on the accrual basis in accordance with accounting principles generally accepted in the U.S. ("GAAP"). Based on the existence or absence of donor-imposed restrictions, VUMC classifies resources into three categories: unrestricted, temporarily restricted, and permanently restricted net assets.

Principles of Consolidation

The consolidated financial statements include the accounts of VUMC and its wholly owned, majority-owned, and controlled organizations. Noncontrolling interests in less-than-wholly owned consolidated subsidiaries of VUMC are presented as a component of net assets to distinguish

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between the interests of VUMC and the interests of the noncontrolling owners. All material intercompany transactions and account balances among the various entities have been eliminated.

VUMC uses the equity method to account for its interests in unconsolidated partnerships, joint ventures, and limited liability entities over which it exercises significant influence. Investment carrying amounts are adjusted for VUMC's share of investee earnings or losses based on percentage of ownership. Distributions received from unconsolidated entities that represent returns on the investor's investment (i.e., dividends) are reported as cash flows from operating activities in the investor's statement of cash flows.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements and accompanying notes. These estimates affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results ultimately could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents are liquid assets with minimal interest rate risk and maturities of three months or less when purchased. VUMC invests operating assets in a diversified manner. At times, VUMC may have cash and cash equivalents at a financial institution in excess of federally insured limits, and therefore, bear a risk of loss. VUMC maintains certain cash balances within the noncurrent investments limited as to use caption in the consolidated balance sheet which are not included in the cash and cash equivalents section.

Revenue Recognition—Healthcare Services

VUMC recognizes revenues from patient services in the period those services are provided and reports these revenues at the net realizable amount expected to be collected from patients or through the assignment or other entitlement to receive patients' benefits payable under patients' health insurance programs, plans, or policies. Amounts realized from patient services are generally less than standard billing charges, due to contractual agreements with third-party payors, state-mandated discounts, governmental programs that require reduced collection rates, or amounts which prove uncollectible. Services are provided before assessing ability to pay and, thus, provision for bad debts is a deduction from net patient service revenue.

In addition to patient payments, VUMC earns revenue and reimbursements from certain services provided under federal healthcare programs and other contracts with third-party payors. These compensation arrangements are complex programs which extend over multiple accounting periods and are subject to the interpretation of federal and state-specific reimbursement rates, new or changing legislation, and final cost report settlements. Estimated settlements under these programs are recorded in the period the related services are performed and are subsequently adjusted, as needed, based on new information.

VUMC receives periodic interim payments from Medicare in lieu of individual payments for patient claims processed by VUMC's fiscal intermediary. These payments are applied against claims processed, with the final settlement of amounts owed for a fiscal year included in the applicable Medicare cost report.

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In evaluating the collectibility of accounts receivable, VUMC analyzes its history and identifies trends for each of its major revenue categories to estimate the appropriate allowance for bad debts and related provision. Management regularly reviews data about these major revenue categories in evaluating the sufficiency of the allowance for bad debts, taking into consideration recent write-off experience by payor category, payor agreement rate changes, and other factors. For third-party payors, the provision is determined by analyzing contractually due amounts from payors who are known to be having financial difficulties. For self-pay patients, which includes self-pay after insurance, the provision is based on an analysis of experience related to patients' payments. The difference between the standard rate charged (less contractual adjustments and discounts) and the amount collected (after reasonable collection efforts have been exhausted) is charged against the allowance for bad debts. VUMC follows established guidelines, Centers for Medicare & Medicaid Services ("CMS") regulations, and Internal Revenue Services ("IRS") Reg. §1.501(r)-6 for placing certain past-due patient balances with external collection agencies.

VUMC provides care to patients who meet the criteria under its financial assistance policy for no payment or at payment amounts less than its established charge rates. VUMC does not recognize the charges that qualify as charity care as revenue because VUMC does not pursue collection of these amounts.

Revenue Recognition— Academic and Research

VUMC receives funding through grants and contracts issued by departments and agencies of the U.S. government, industry, and other foundation sponsors who restrict the use of such funds to academic and research purposes. VUMC recognizes revenue from these grants and contracts upon the incurrence of allowable expenditures, as defined in the agreements governing that funding. VUMC recognizes facilities and administrative ("F&A") costs recovery as revenue when revenue is recognized on the associated grant or contract. This activity represents reimbursement, primarily from the federal government, of F&A costs on sponsored activities.

Grants and contracts receivable include amounts due from these sponsors of externally funded research. These amounts have been billed or are billable to the sponsor. These receivables are reported net of reserves for uncollectible accounts.

Deferred Revenue

The majority of deferred revenue relates to grants and contracts whereby certain grantors pay in advance of incurring eligible costs. In these cases, VUMC records the amount received in excess of reimbursable costs incurred as deferred revenue.

Gift Income and Pledges

VUMC recognizes unconditional promises to give cash and other assets, referred to as pledges, as gift income at fair value when the pledge is received. Conditional promises to give are recognized as pledges once the conditions are substantially met. Gifts received with donor stipulations limiting the use of the donated assets are reported as either temporarily or permanently restricted support, depending on the nature of the restriction. Donor-restricted contributions whose restrictions are met within the same year as received are reported as gift income in the accompanying consolidated statements of operations. Gift income is recognized when a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished. Pledges are treated as unrestricted, temporarily restricted, or permanently restricted net assets depending on the donor instructions associated with the pledge. Gifts of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted net assets until the assets are placed in service, at which point they are reclassified to unrestricted net assets.

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Pledges receivable are reported net of allowances for uncollectible amounts based on an analysis of past collection experience and other judgmental factors. Pledges receivable are included in other current or other noncurrent assets in the consolidated balance sheet based on the expected timing of cash flows. VUMC discounts the noncurrent portion of pledges receivables at a rate commensurate with the scheduled timing of receipt. VUMC applied discount rates ranging from 0.5% to 1.5% to amounts outstanding as of June 30, 2018 and 2017.

Concentrations of Credit Risk

VUMC grants unsecured credit to its patients, primarily residing in Nashville, Tennessee and the surrounding areas of middle Tennessee, most of whom are insured under commercial, Medicare, or TennCare agreements. Medicare, Blue Cross Blue Shield ("BCBS"), and TennCare (which includes BCBS, United, and Amerigroup) represent VUMC's significant concentrations of credit risk from payors.

Inventories

VUMC reports inventories at the lower of cost or market, with cost being determined on the first-in, first-out method. Inventories consist primarily of medical supplies, surgical implants, and pharmaceuticals.

Investments

VUMC reports investments held at fair value on the consolidated balance sheets. VUMC records purchases and sales of securities on the trade dates, and realized gains and losses are determined based on the average historical cost of the securities sold. VUMC reports net receivables and payables arising from unsettled trades as a component of investments.

Property, Plant, and Equipment, Net

VUMC records purchases of property, plant, and equipment at cost and expenses repairs and maintenance costs as incurred. VUMC capitalizes interest cost incurred on borrowed funds during the period of construction of capital assets as a component of the cost of acquiring those assets. VUMC capitalizes donated assets at fair value on the date of donation.

Capitalized software for internal use is recorded during the application development stage. These costs include fees paid to third parties for direct costs of materials and services consumed in developing or obtaining the software; payroll related costs and capitalized interest costs. Costs for training and application maintenance in the post-implementation operation stage are expensed as incurred.

VUMC computes depreciation using the straight-line method over the estimated useful life of land improvements (3 to 18 years), buildings and leasehold improvements (2 to 37 years), and equipment (1 to 20 years). Equipment costs also include capitalized internal use software costs, which are expensed over the expected useful life, which is generally 1.5 to 12 years. VUMC assigns useful lives in accordance with American Hospital Association guidelines.

Software for internal use is amortized on a straight-line basis over its estimated useful life. In determining the estimated useful life, management considers the effects of obsolescence, technology, competition, other economic factors, and rapid changes that may be occurring in the development of software products, operating systems, and computer hardware. Amortization begins once the software is ready for its intended use, regardless of when the software is placed into service.

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Impairment of Long-Lived Assets

VUMC reviews long-lived assets, such as property, plant, and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. VUMC measures the recoverability of assets to be held and used by comparing the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, VUMC recognizes an impairment charge to the extent the carrying amount of the asset exceeds its fair value.

Conditional Asset Retirement Costs and Obligations

VUMC recognizes the estimated fair value of liabilities for existing legal obligations to perform certain activities, primarily asbestos removal, in connection with the retirement, disposal, or abandonment of assets. These liabilities are included in other noncurrent liabilities on the consolidated balance sheets and total \$6.1 million and \$6.0 million as of June 30, 2018 and 2017, respectively. VUMC measures these liabilities using estimated cash flows with an inflation rate applied of 3.0% as of June 30, 2018 and 2017. VUMC discounts those cash flow estimates at a credit-adjusted, risk-free rate, which ranged from 2.9% to 4.2% as of June 30, 2018 and 2017, and adjusts these liabilities for accretion costs and revisions in estimated cash flows.

Long-Term Debt

The carrying value of VUMC's debt is the par amount adjusted for the net unamortized amount of debt issuance costs, and bond premiums and discounts.

Interest Rate Exchange Agreements

VUMC reports interest rate exchange agreements at fair value, which is determined to be the present value of future net cash settlements that reflect market yields as of the measurement date and estimated amounts that VUMC would pay, or receive, to terminate the contracts as of the report date. VUMC considers current interest rates and creditworthiness of the interest rate exchange counterparties when estimating termination settlements.

Self-Insurance Reserves

VUMC elects to self-insure a portion of its medical malpractice, professional, and general liability coverage via an irrevocable self-insurance trust. The maximum annual self-insurance retention was \$5.5 million per occurrence, up to \$43.0 million in the aggregate for both Fiscal 2018 and 2017. Actuarial firms determine expected losses on an annual basis, at which time VUMC records medical malpractice, professional, and general liability expense within the limits of the program. These liabilities are classified as current or noncurrent based on the expected timing of cash flows and are measured at the net present value of those cash flows using a discount rate of 2.5% as of June 30, 2018 and 2017. For both Fiscal 2018 and 2017, VUMC obtained excess medical malpractice, professional, and general liability coverage from commercial insurance carriers for claims in excess of \$5.5 million per occurrence, up to \$125.0 million. These policies would also provide coverage up to \$125.0 million if any claims in the aggregate exceed \$43.0 million.

VUMC also elects to self-insure for employee health and workers' compensation expenses. Actuarial firms determine expected losses on an annual basis. The maximum retention for workers' compensation was \$0.8 million per occurrence for both Fiscal 2018 and 2017. There is no stop loss insurance on health plan claims.

Income Taxes

VUMC is a tax-exempt organization as described in Section 501(c)(3) of the Internal Revenue Code (the "Code") and is generally exempt from federal income taxes under Section 501(a) of the Code.

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The Tax Cuts and Jobs Act (the “Act”) was enacted on December 22, 2017. The Act reduces the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, and creates new taxes on certain foreign sourced earnings. For tax-exempt entities, the Act also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on remuneration above certain thresholds that is paid to executives by the organization, and report income or loss from unrelated business activities on an activity-by-activity basis, among other provisions. At June 30, 2018, the Company has made a reasonable estimate of the tax effects of the enactment of the Act. Certain regulatory guidance provides for a measurement period of up to one year during which the accounting for the tax effects of the Act may be completed. The Company may record further adjustments in future periods upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the date of enactment that would have affected the income tax effects initially reported. The Company will continue to revise and refine the calculations as additional IRS guidance is issued.

Excess of Revenues Over Expenses

The consolidated statements of operations include excess of revenues over expenses as a performance indicator. Excess of revenues over expenses includes all changes in unrestricted net assets except for changes in noncontrolling interest holders’ share of consolidated entities, reclassifications of net assets from the prior period presentation, and certain other adjustments.

Conforming Reclassifications

Certain amounts in the Fiscal 2017 consolidated balance sheet and statement of operations have been reclassified to conform to their Fiscal 2018 presentation.

Recent Accounting Pronouncements

Periodically, the Financial Accounting Standards Board (“FASB”) issues Accounting Standards Updates (“ASUs”) that may impact the recognition, measurement, and presentation of balances and activity in VUMC’s consolidated financial statements or the disclosures contained within those statements. As part of preparing financial statements, VUMC evaluates the effects of the ASUs and applies the updated guidance within the required effective dates.

- In May 2014, the FASB issued the terms ASU 2014-09, which is a principles-based standard on revenue recognition. Companies across all industries will use a five-step model to recognize revenue from customer contracts. The new standard, which replaces nearly all existing GAAP revenue recognition guidance, will require significant management judgment in addition to changing the way many companies recognize revenue in their financial statements. The FASB subsequently issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations*, ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, and ASU 2016-12, *Narrow-Scope Improvements and Practical Expedients*, to address issues arising from implementation of the new revenue recognition standard. For VUMC, the above ASUs are effective for Fiscal 2019. VUMC believes the most significant impact of adopting the new standard will be to the presentation of our consolidated statement of operations where the provision for bad debts will be recorded as a direct reduction to revenues and will not be presented as a separate line item. We expect to adopt the new standard using the full retrospective application.
- In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires lessees to recognize assets and liabilities for most leases. ASU 2016-02’s transition provisions will be applied to the most recent period presented in the financial statements. For VUMC, the amendments in ASU 2016-02 are effective July 1, 2019, although early adoption is permitted. VUMC expects the

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primary effect of adopting the new standard to be a requirement to record assets and offsetting obligations for current operating leases.

- In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements for Not-for-Profit Entities*, which, among other things, replaces the existing three-category classification of net assets (i.e., unrestricted, temporarily restricted, and permanently restricted) with a model that combines temporarily restricted and permanently restricted into a single category called “net assets with donor restrictions.” Differences in the nature of donor restrictions will be disclosed in the notes, with an emphasis on how and when the resources can be used. ASU 2016-14 also provides guidance for classifying deficiencies in endowment funds, accounting for the lapsing of restrictions on gifts to acquire property, plant, and equipment, and providing information about how the nature of expenses relates to programs and supporting activities. For VUMC, ASU 2016-14 is effective for Fiscal 2019. ASU 2016-14’s requirements must be applied retrospectively; however, entities can elect not to provide certain comparative disclosures in the year of adoption.

3. Related Parties

On April 29, 2016, VUMC acquired the assets, liabilities, rights, and obligations of the clinical enterprise, postgraduate medical training programs, and clinically related research of the University’s owned and operated Medical Center “the Acquisition”. VUMC is a 501(c)(3) not-for-profit corporation, governed by a separate and autonomous board apart from the governance of VU; VUMC is responsible for its debt and liabilities, separate and apart from the University.

The assets acquired and liabilities assumed from the Acquisition were detailed in a Master Transfer and Separation Agreement (“MTSA”). In addition to the explanation of the transaction details pertaining to the Medical Center assets and liabilities, the MTSA contains the framework for the ongoing economic relationship between VUMC and the University. The relationship is memorialized in the form of an Academic Affiliation Agreement (“AAA”), a Trademark License Agreement (“TMLA”), a Ground Lease, and a Reciprocal Master Services Agreement (“MSA”). The agreements are described below.

- The AAA outlines the ongoing academic, research, and clinical affiliation between the University and VUMC for all of the University’s degree-granting, certificate, and research programs. The AAA allocates responsibility between the University and VUMC for jointly administered research and academic programs and is an exclusive agreement between VUMC and VU requiring VUMC to be organized, governed, and operated in a manner that supports VU’s academic and research mission. The agreement provides that VU will be the exclusive academic affiliate of VUMC, and VUMC will be the exclusive clinical affiliate of VU.

The AAA requires VUMC to pay VU an annual fee in equal monthly payments adjusted annually for inflation based upon the Biomedical Research and Development Price Index (“BRDPI”) in perpetuity under certain mutually agreed-upon termination or default clauses. During Fiscal 2018 and 2017, VUMC recorded operating expenses totaling \$73.1 million and \$71.5 million, respectively, in connection with fees due under the AAA.

The AAA required a one-time \$12.0 million commitment to fund trans-institutional programs with the University. VUMC paid this commitment in June 2017. This commitment was recorded as additional consideration in the Acquisition.

- Under the TMLA, the University grants, subject to certain consents and approvals, a perpetual license to use various University-owned licensed marks in connection with VUMC’s

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fundamental activities after the Acquisition date. The licensed marks, which VUMC will continue to use as its primary brands, include virtually all those currently in use by VUMC. This agreement requires VUMC to pay VU a monthly royalty payment equal to 1.0% of all operating revenues of VUMC and a percentage of net income from operations (5% in Fiscal 2018, 10% in Fiscal 2019, and 15% in Fiscal 2020 and beyond). Also, VUMC is required to pay VU, in equal monthly installments, an annual base fee, which increases 3% annually, reduced by the amount of principal payments made under the subordinate note payable to VU discussed in Note 11. Long-Term Debt (the "Fixed TMLA Royalty Payment"). The payments related to this base fee, inclusive of the principal payments made under the subordinate note, were approximately \$63.7 million in Fiscal 2018. This agreement is in force in perpetuity under certain mutually agreed-upon termination or default clauses. During Fiscal 2018 and 2017, VUMC recorded operating expenses totaling \$98.0 million and \$96.0 million, respectively, in connection with fees due under the TMLA.

- The Ground Lease is an agreement between VU and VUMC that allows VUMC to use the land on which VUMC's campus and related buildings are located. The initial term of the Ground Lease ends June 30, 2114, with the option to extend the lease for two additional terms of up to 50 to 99 years each with agreement between VU and VUMC. The lease covers 1.7 million square feet or 38.75 acres of space, payable monthly and CPI adjusted annually. During Fiscal 2018 and 2017, VUMC recorded operating expenses totaling \$18.5 million and \$18.1 million, respectively, in connection with fees due under the Ground Lease.
- The University and VUMC provide services to one another for agreed-upon consideration as outlined in the MSA. VU provides services to VUMC, such as information technology infrastructure support, utilities, and law enforcement staffing. VUMC provides various operational services for the University, such as a student health clinic and animal care. Additionally, the MSA encompasses an Employee Matters Agreement ("EMA") and specific Employee Service Agreements ("ESAs"). The EMA and ESAs govern employee transitions and ongoing sharing between VU and VUMC in various capacities, such as research, teaching, clinical, and other administrative services. Services under the MSA can be terminated by either party subject to predetermined cancellation notification periods. In connection with the MSA, during Fiscal 2018 and 2017, VUMC recognized revenue totaling \$50.9 million and \$50.8 million, respectively, and recorded operating expenses totaling \$124.2 million and \$121.3 million, respectively.
- Also, as part of the Acquisition, VUMC issued to VU a \$100.0 million subordinate promissory note payable, which is further described in Note 11. Long-Term Debt, with a balance of \$89.6 million as of June 30, 2018, and \$94.6 million as of June 30, 2017. During Fiscal 2018 and 2017, VUMC recorded interest expense totaling \$2.7 million and \$3.1 million, respectively, associated with this subordinate promissory note payable to VU.

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The impact of these related-party agreements in the consolidated statements of operations during Fiscal 2018 and 2017 is as follows:

<i>(\$ in thousands)</i>	2018	2017
Academic and research revenue	\$ 12,239	\$ 11,919
Other operating revenue	38,647	38,928
Total operating revenues	<u>\$ 50,886</u>	<u>\$ 50,847</u>
Operating expenses		
Salaries, wages, and benefits	\$ 6,973	\$ 700
Supplies and drugs	-	338
Facilities and equipment	57,385	53,989
Services and other	249,482	251,884
Interest	2,743	3,148
Total operating expenses	<u>\$ 316,583</u>	<u>\$ 310,059</u>

Other current assets include amounts receivable from VU, which totaled \$7.0 million as of June 30, 2018, and \$5.8 million as of June 30, 2017. Accounts payable and other accrued expenses include amounts payable to VU, which totaled \$31.8 million as of June 30, 2018, and \$30.0 million as of June 30, 2017.

In the normal course of business, members of VUMC's Board of Directors or VUMC employees may be directly or indirectly associated with companies engaged in business activities with VUMC. VUMC has a written conflict of interest policy that requires, among other things, that members of the VUMC community (including trustees) may not review, approve, or administratively control contracts or business relationships when (i) the contract or business relationship is between VUMC and a business in which the individual or a family member has a material financial interest, or (ii) the individual or a family member is an employee of the business and is directly involved with activities pertaining to VUMC.

Furthermore, VUMC's conflict of interest policy extends beyond the foregoing business activities in that disclosure is required for any situation in which an applicable individual's financial, professional, or other personal activities may directly or indirectly affect, or have the appearance of affecting, an individual's professional judgment in exercising any VUMC duty or responsibility, including the conduct or reporting of research.

The policy extends to all members of the VUMC community (including trustees, faculty, staff, and their immediate family members). Each applicable person is required to certify compliance with the conflict of interest policy on an annual basis. This certification includes specifically disclosing whether VUMC conducts business with an entity in which he or she (or an immediate family member) has a material financial interest, as well as any other situation that could appear to present a conflict with VUMC's best interests.

When situations exist relative to the conflict of interest policy, VUMC takes active measures to appropriately manage the actual or perceived conflict in the best interests of VUMC, including periodic reporting of measures taken to the Audit Committee of the Board of Directors.

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4. Patient Service Revenue, Patient Accounts Receivable, and Estimated Third-Party Settlements

The sources of patient service revenues, net, for Fiscal 2018 and 2017 are as follows:

	2018	2017
Commercial/managed care	63.4 %	63.5 %
Medicare/Managed Medicare	23.0	22.8
TennCare/Medicaid	12.4	12.2
Uninsured (self-pay)	1.2	1.5
	100.0 %	100.0 %

Patient accounts receivable, net of related contractual adjustments, discounts, and bad debt allowances, comprise amounts due from the following sources as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Medicare	\$ 71,405	\$ 56,286
TennCare/Medicaid	77,158	54,621
Blue Cross	95,986	76,692
Other third-party payors, primarily commercial carriers	174,397	147,467
Patient responsibility ⁽¹⁾	55,439	39,620
Patient accounts receivable, net	\$ 474,385	\$ 374,686

⁽¹⁾ Includes self-pay after insurance.

Estimated third-party settlements by major payor category as of June 30, 2018 and 2017, are as follows:

<i>(\$ in thousands)</i>	2018	2017
Receivables under third-party programs		
Tricare/Champus ⁽¹⁾	\$ 8,875	\$ 4,712
Medicare ⁽¹⁾	-	7,930
Total receivables under third-party programs	\$ 8,875	\$ 12,642
Payables under third-party programs		
TennCare/Medicaid	\$ 53,162	\$ 37,072
Medicare ⁽¹⁾	28,660	-
Total payables under third-party programs	\$ 81,822	\$ 37,072

⁽¹⁾ These two federal healthcare programs are combined for presentation purposes on the face of the consolidated balance sheets and are reflected as an obligation in Fiscal 2018 and an asset in Fiscal 2017.

Certain contracts require pay for performance or episode of care settlements whereby VUMC receives additional payment or pays a penalty based on its ability to achieve certain clinical measures or manage the cost of care for patients within various thresholds. VUMC estimates and accrues these adjustments in the period the related services are rendered and adjusts these

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estimates in future periods as settlements are finalized. The aggregate liability associated with pay for performance and episode of care settlements at June 30, 2018 and 2017, was \$0.9 million and \$1.7 million, respectively, with the ultimate resolution of such financial arrangements not expected to have a material impact on the operating results of VUMC.

Medicare

Amounts received under Medicare are subject to review and final determination by program intermediaries or their agents. Final settlements have been reached for program periods ended June 30, 2011. Final settlements have not been reached for subsequent years due to audit delays experienced with the Medicare Administrative Contractor, and thus, those periods remain subject to audit by program representatives. VUMC records provisions in the consolidated financial statements for the effects of estimated final settlements. The receivable and payable above are presented net of these provisions.

TennCare

TennCare is a Medicaid managed care program implemented by the state of Tennessee to provide healthcare coverage to those patients eligible for Medicaid through the Federal 1115 Waiver Program. VUMC contracts with each of the three TennCare managed care organizations ("MCOs"), which offer health maintenance organization ("HMO") and Medicare Special Needs Products for Dual Eligible Enrollees. VUMC receives inpatient reimbursement through payments that are primarily based on the Medicare severity diagnostic related group system ("MS-DRG") for these plans. VUMC receives outpatient payments generally based on an ambulatory payment classification system ("APC"), and/or a payor-developed fee schedule.

In accordance with the Tennessee Hospital Assessment Act, VUMC receives a payment of a portion of its unreimbursed TennCare costs based upon VUMC's share of uninsured TennCare costs for all of the covered hospitals.

There is no assurance that this program will be continued or will not be materially modified in the future. In Fiscal 2018 and 2017, patient service revenue, net, includes the following supplemental amounts from TennCare:

<i>(\$ in thousands)</i>	2018	2017
Essential access	\$ 14,609	\$ 13,731
Disproportionate share	11,511	11,078
Trauma fund	1,900	1,798
Graduate medical education	14,158	14,117
Provision for disproportionate share audit	(11,511)	(27,593)
Total supplemental TennCare revenue, net of audit provision	<u>\$ 30,667</u>	<u>\$ 13,131</u>

5. Charity Care Assistance, Community Benefits, and Other Unrecovered Costs

VUMC maintains a policy which sets forth the criteria under which health care services are provided to patients who have minimal financial resources to pay for medical care. Additionally, VUMC provides other services that benefit the economically disadvantaged for which little or no payment is expected.

Charity care is determined by examining patient and family income relative to the federal poverty guidelines. VUMC provides additional discounts based on the income level of the patient household using a sliding scale for those patients with a major catastrophic medical event not qualifying for full charity assistance. Tennessee law mandates that all uninsured patients receive a discount from billed charges for medically necessary services. These amounts are classified as charity care if the patient meets charity care criteria, for which no revenue is recorded, or as a discount, and included as a part of discounts and contractual adjustments.

VUMC maintains records to identify and monitor the level of charity care provided, and these records include gross charges and patient deductibles, coinsurance and copayments foregone for services furnished under its charity care policy, and the estimated cost of those services. VUMC calculates a ratio of total costs to gross charges and then multiplies the ratio by foregone charity care charges in determining the estimated cost of charity care. The gross amount of foregone charity care revenues in Fiscal 2018 and 2017 total \$323.9 million and \$261.1 million, respectively. The estimated cost of providing care to charity patients in Fiscal 2018 and 2017 totals \$89.9 million and \$70.8 million, respectively.

In addition to the charity care services described above, TennCare/Medicaid and state indigent programs do not cover the full cost of providing care to beneficiaries of those programs. As a result, in addition to direct charity care costs, VUMC provided services related to TennCare/Medicaid and state indigent programs and was reimbursed substantially below the cost of rendering such services. VUMC also provides public health education and training for new health professionals and provides, without charge, services to the community at large for many patients with special needs.

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6. Academic and Research Revenue, and Grants and Contracts Receivable, Net

Academic and research revenue comprises the following for Fiscal 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Grants and contracts revenue		
Federally funded	\$ 288,535	\$ 239,926
Non-federally funded	102,239	93,663
	<u>390,774</u>	<u>333,589</u>
Facilities and administrative costs recovery	104,532	88,187
Academic and research revenue	<u>\$ 495,306</u>	<u>\$ 421,776</u>

Grants and contracts receivable comprises the following as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Federally funded	\$ 29,500	\$ 31,603
Non-federally funded	28,498	37,192
	<u>57,998</u>	<u>68,795</u>
Allowance for bad debts	(250)	(1,546)
Total grants and contracts receivable, net	<u>\$ 57,748</u>	<u>\$ 67,249</u>

7. Pledges Receivable, Net

Pledges receivable, net of applied discounts and allowance for uncollectible pledges, as of June 30, 2018 and 2017, were as follows:

<i>(\$ in thousands)</i>	2018	2017
Amounts due		
Within one year	\$ 9,569	\$ 7,022
In one to five years	11,141	12,417
Total pledges receivable	<u>20,710</u>	<u>19,439</u>
Unamortized discount	(453)	(449)
	<u>20,257</u>	<u>18,990</u>
Allowance for uncollectible pledges	(2,068)	(1,934)
Net pledges receivable	<u>\$ 18,189</u>	<u>\$ 17,056</u>
Net pledges receivable classified as		
Current	\$ 8,070	\$ 5,785
Noncurrent	10,119	11,271
	<u>\$ 18,189</u>	<u>\$ 17,056</u>
Net pledges receivable by asset class		
Temporarily restricted	\$ 14,286	\$ 14,580
Permanently restricted	3,903	2,476
	<u>\$ 18,189</u>	<u>\$ 17,056</u>

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In addition to pledges reported as pledges receivable, VUMC had cumulative bequest intentions and conditional promises to give totaling \$58.1 million as of June 30, 2018, and \$43.0 million as of June 30, 2017. Due to their conditional nature, VUMC does not recognize intentions to give as assets.

8. Other Relevant Financial Information

Other current assets comprise the following as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Prepaid expenses	\$ 29,263	\$ 21,928
Other receivables	29,543	27,610
Amounts due from VU (see Note 3.Related Parties)	7,038	5,814
Current pledges receivable, net (see Note 7.Pledges Receivable, Net)	8,070	5,785
Expected recoveries from commercial insurance excess coverage	5,457	4,028
Other	6,472	7,911
Total other current assets	<u>\$ 85,843</u>	<u>\$ 73,076</u>

Other noncurrent assets comprise the following as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Equity in unconsolidated organizations	\$ 21,822	\$ 20,184
Noncurrent pledges receivable (see Note 7.Pledges Receivable, Net)	10,119	11,271
Other	3,936	3,138
Total other noncurrent assets	<u>\$ 35,877</u>	<u>\$ 34,593</u>

Other operating revenue comprises the following for Fiscal 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Amounts recognized under MSA with VU (see Note 3. Related Parties)	\$ 38,647	\$ 38,928
Clinical contracts	26,527	25,304
VHS other revenue	18,168	14,514
Medical services provided during air transports	10,839	10,561
Nonclinical contracts	7,631	6,326
Resident and house staff rotations	6,972	9,148
Parking fees	6,967	5,936
Cafeteria	6,191	5,557
Other	26,374	30,199
Total other operating revenue	<u>\$ 148,316</u>	<u>\$ 146,473</u>

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9. Investments

VUMC investments are made up of current investments, noncurrent investments, and noncurrent investments limited as to use on the face of the consolidated balance sheets. VUMC investments include assets limited as to use related to the following specified purposes as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Self-insured malpractice program	\$ 66,595	\$ 69,849
Internally designated	87,904	85,865
Donor-designated gifts for capital assets	38,404	31,248
Designated bond proceeds	33,536	-
Donor endowments	26,826	8,283
Split-interest trusts	7,577	7,347
	\$ 260,842	\$ 202,592

Endowment-related assets include both donor-restricted endowment funds, included in donor endowments, and board-designated institutional funds, included in internally designated. VUMC's endowment does not include gift annuities, interests in trusts held by others, contributions pending donor designation, or contributions receivable.

The Board of Directors' interpretation of its fiduciary responsibilities for donor-restricted endowments under the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") requirements is to preserve intergenerational equity, barring the existence of any donor-specific provisions. Under this broad guideline, future endowment beneficiaries should receive at least the same level of real economic support as the current generation. The overarching objective is to preserve and enhance the real (inflation-adjusted) purchasing power of the endowment in perpetuity. VUMC invests assets to provide a relatively predictable and stable stream of earnings to meet spending needs and attain long-term return objectives without the assumption of undue risks.

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Investments were as follows as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Corporate bonds	\$ 122,639	\$ 119,045
Equity mutual funds	135,885	112,704
Cash and cash equivalents	75,972	32,569
Split-interest trusts	7,577	7,347
Hedged equity mutual funds	41,275	14,759
Fixed income mutual funds	97,946	38,211
Certificates of deposit	48,243	38,657
Asset-backed securities	33,547	21,779
Real estate mutual funds	14,098	16,206
Commercial paper	10,284	11,609
Government bonds	1,899	9,097
Hedged debt mutual funds	63,295	5,178
Commodities and managed futures mutual funds	5,495	3,820
Total investments, at fair value	<u>\$ 658,155</u>	<u>\$ 430,981</u>

Investment returns comprise the following elements for Fiscal 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Interest and dividend income	\$ 15,991	\$ 8,417
Net realized gains on sales of securities	14,688	3,493
Realized investment gains, before fees	30,679	11,910
Unrealized investment gains and (losses), net	(3,759)	12,878
Total investment returns before fees	26,920	24,788
Investment manager and trustee fees and other	(2,899)	(3,538)
Total income from investments, net	<u>\$ 24,021</u>	<u>\$ 21,250</u>

VUMC has exposure to risks, including liquidity, interest rate, counterparty, basis, regulatory, market, and credit risks, for marketable securities. Due to the level of risk exposure, it is possible that material near-term valuation changes for investment securities may occur.

VUMC manages all investments, including endowments, as an investment pool.

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10. Property, Plant, and Equipment, Net

Property, plant, and equipment comprise the following as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Land and land improvements	\$ 20,132	\$ 27,762
Buildings and improvements	971,393	893,728
Equipment and software	391,745	205,357
Construction in progress	131,838	196,828
Property, plant, and equipment at cost	1,515,108	1,323,675
Accumulated depreciation and amortization	(208,469)	(103,907)
Property, plant, and equipment, net	<u>\$ 1,306,639</u>	<u>\$ 1,219,768</u>

As part of the MTSA, VUMC acquired land and land improvements and buildings and improvements which are not allowed to be repurposed without the express consent of VU.

Property, plant, and equipment balances above include the following amounts related to capitalized internal use software:

<i>(\$ in thousands)</i>	2018	2017
Equipment and software	\$ 150,568	\$ 6,287
Construction in progress ⁽¹⁾	1,137	92,478
	151,705	98,765
Accumulated amortization	(12,019)	(2,230)
Internal use software, carrying value	<u>\$ 139,686</u>	<u>\$ 96,535</u>

⁽¹⁾ As of June 30, 2018 and 2017, construction in progress includes \$0.2 million and \$24.9 million, respectively, of internal costs, primarily payroll and payroll-related costs, for employees directly associated with and who devoted time to internal use software.

As of June 30, 2018 and 2017, internal use software capitalized includes \$144.3 million and \$92.5 million, respectively, of costs related to the implementation of an integrated electronic health record and revenue cycle system. The system went live in November 2017. These costs are amortized over a 12-year life. In addition to internal use software, VUMC has capitalized \$21.9 million of hardware costs related to this project.

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During Fiscal 2018, VUMC continued the children's hospital expansion, as well as the adult bed expansion and clinical relocation, which are included in buildings and improvements and construction in progress. The children's hospital expansion is expected to be completed in Fiscal 2019, and the adult bed expansion is a phased project, which is also expected to be completed in Fiscal 2019.

Depreciation and amortization comprised the following amounts in Fiscal 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Depreciation of tangible assets	\$ 87,538	\$ 82,836
Amortization of capital leases, leasehold improvements, and internal use software	18,116	8,607
Total depreciation and amortization	<u>\$ 105,654</u>	<u>\$ 91,443</u>

In Fiscal 2018 and 2017, VUMC capitalized interest of \$2.0 million and \$1.1 million, respectively, related to long-term capital projects, primarily internal use software costs, the children's hospital expansion, and the adult bed expansion. As of June 30, 2018 and 2017, there were \$21.5 million and \$20.7 million, respectively, of capital expenditures incurred but not yet paid. These costs are included in accounts payable and other accrued expenses on the consolidated balance sheets.

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11. Long-Term Debt

Long-term debt comprises the following as of June 30, 2018 and 2017:

	2018		2017	
	Carrying Amount	Effective Interest Rate ⁽²⁾	Carrying Amount	Effective Interest Rate ⁽²⁾
(\$ in thousands)				
Series debt				
Fixed-rate debt				
Series 2016A	\$ 476,930	4.1 %	\$ 476,930	4.1 %
Series 2016B	300,000	4.1 %	300,000	4.1 %
Series 2017A	121,270	4.2 %	-	-
Series 2017 Taxable	100,000	4.2 %	-	-
Total fixed-rate debt	998,200	4.1 %	776,930	4.1 %
Variable-rate debt				
Series 2016C	-	-	50,000	2.2 %
Series 2016D	100,000	4.1 %	100,000	3.3 %
Series 2016E	128,070	3.3 %	128,070	3.2 %
Series 2016F	21,900	2.5 %	75,000	3.3 %
Series 2017B	50,000	2.7 %	-	-
Series 2018 Tax-exempt	53,385	2.6 %	-	-
Total variable-rate debt	353,355	3.3 %	353,070	3.1 %
Total series debt	1,351,555		1,130,000	
Other long-term debt				
Note payable to VU	89,583	3.2 %	94,583	3.2 %
Product financing arrangement	28,929	3.7 %	22,273	4.0 %
Capital leases	1,156	4.3 %	1,448	4.5 %
Subtotal ⁽¹⁾	1,471,223	3.9 %	1,248,304	3.8 %
Net unamortized premiums	60,521		57,467	
Net unamortized issuance costs	(13,272)		(11,672)	
Total long-term debt	1,518,472		1,294,099	
Current portion	(5,774)		(5,753)	
Long-term debt, net	\$ 1,512,698		\$ 1,288,346	

⁽¹⁾ The effective interest rate, 3.9% as of June 30, 2018, and 3.8% as of June 30, 2017, is presented exclusive of interest rate exchange agreements discussed in Note 12. Interest Rate Exchange Agreements. Inclusive of these agreements, the overall portfolio effective interest rate was 4.2%.

⁽²⁾ The effective interest rate for each debt instrument is calculated by dividing each instrument's interest expense by the weighted average debt outstanding, and where applicable, interest expense is reduced by premium amortization and increased by original issue discount amortization. Interest rates per the agreements are detailed in the accompanying notes.

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On April 29, 2016, VUMC issued the Series 2016 A, B, C, D, E, and F bonds ("2016 Series Debt") and notes aggregating \$1.3 billion of proceeds for the purpose of financing the Medical Center Acquisition and paying a portion of the costs of issuance associated with the 2016 Series Debt.

The bonds and notes comprising the 2016 Series Debt were issued by the Health and Educational Facilities Board of The Metropolitan Government of Nashville and Davidson County, Tennessee ("HEFB"). As a conduit issuer, the HEFB loaned the debt proceeds to VUMC. VUMC's debt service requirements under these loan agreements coincide with required debt service of the actual HEFB bonds.

- The Series 2016A tax-exempt fixed-rate revenue bonds were issued in the par amount of \$476.9 million and include an original issue premium of \$59.6 million. The Series 2016A bonds have a final maturity date of July 1, 2046, and can be optionally redeemed at par on or after July 1, 2026. The 2016A bonds were structured as serial bonds with maturities from Fiscal 2030 through 2032, as well as three term bonds maturing Fiscal 2036 through 2047, which are subject to mandatory sinking fund redemption in lots. The Series 2016A bonds bear interest at 5% per annum and pay interest semiannually on July 1 and January 1.
- The Series 2016B taxable fixed-rate revenue bonds were issued in the par amount of \$300.0 million, bearing interest at 4.1% per annum. Interest is paid semiannually on July 1 and January 1, and has a bullet maturity of July 1, 2026. VUMC is entitled, at its option, to redeem all or a portion of the Series 2016B bonds before April 1, 2026, at a make-whole redemption price, which equals the greater of (i) 100% of the remaining outstanding principal and (ii) the net present value of the remaining scheduled principal and interest payments to the original maturity date, using a discount rate of 35 basis points above rates for U.S. Treasury securities with comparable maturities.
- The Series 2016C taxable variable-rate revenue bonds ("R-FLOATs") were issued in the par amount of \$50.0 million and bear interest initially at a fixed spread to weekly LIBOR of 1.6%. During Fiscal 2018, VUMC issued the Series 2017B taxable revenue bonds and used the proceeds to extinguish the Series 2016C R-FLOATs, discussed further below.
- The Series 2016D taxable variable-rate revenue notes ("floating rate notes") were issued in the par amount of \$100.0 million and bear interest initially at a fixed spread to one-month LIBOR of 2.5% through the initial mandatory tender date of July 1, 2021, and a final maturity of July 1, 2046. Beginning six months prior to the mandatory tender date of July 1, 2021, the bonds have an optional redemption feature. If the Series 2016D bonds are successfully remarketed at the mandatory tender date, they are subject to mandatory redemption in lots commencing on July 1, 2021, and each July thereafter until final maturity.
- The Series 2016E taxable term loan revenue notes were issued in the par amount of \$128.1 million and were placed privately with a bank. The notes bear interest in a variable-rate mode at a fixed spread to one-month LIBOR of 2.4% through the initial mandatory tender date of July 1, 2022, and a final maturity of July 1, 2046. During Fiscal 2018, VUMC renegotiated the interest to a variable-rate mode at a fixed spread to one-month LIBOR of 1.8%. In addition to optional redemption of all or a portion of the notes at any time, subject to notice, the Series 2016E notes are subject to principal amortization commencing on July 1, 2022, as defined in the Series 2016E loan agreement between VUMC and the lender.
- The Series 2016F taxable variable-rate revenue bonds were issued in the par amount of \$75.0 million and were placed privately with a bank. The bonds bear interest in a variable-rate mode at a fixed spread to one-month LIBOR of 2.5% through the initial mandatory tender date

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of July 1, 2022. During Fiscal 2018, \$53.1 million of the Series 2016F bonds were extinguished using proceeds from the 2018 tax-exempt fixed-rate revenue bonds, discussed further below. The renegotiated interest rate on the remaining \$21.9 million of principal outstanding is a variable-rate mode at a fixed spread to one-month LIBOR of 1.2%. The remaining principal has a mandatory tender date of July 1, 2024. Prior to that, VUMC must pay \$2.1 million of principal on July 1, 2022, and \$2.2 million of principal on July 1, 2023. The remaining \$17.6 million of principal is due on July 1, 2024.

Each of the bonds and notes comprising the 2016, 2017, and 2018 Series Debt represent separate obligations under a Master Trust Indenture ("MTI") structure. The MTI provides the flexibility for multiple parties to participate in debt issuances as part of an obligated group; presently, VUMC has no other third-party members participating in the obligated group. All debt issued under the MTI is a general obligation of the obligated group. Under the provisions of the Leasehold Deed of Trust, Security Agreement, Assignment of Rents and Leases, and Fixture Filing (the "Security Agreement") within the MTI, gross receivables of the obligated group are pledged as collateral. Additionally, the Security Agreement established a mortgage lien on (i) the leasehold interest of the land subject to the Ground Lease; (ii) the buildings, structures, improvements, and fixtures now or hereafter located on the land subject to the Ground Lease; and (iii) certain other collateral.

On July 26, 2017, the Series 2017A Tax-Exempt and Series 2017 Taxable Corporate Bonds were issued, and on August 1, 2017, the Series 2017B Taxable Revenue Bonds was issued ("2017 Series Debt"), aggregating \$271.3 million of proceeds for the purpose of refinancing existing debt, funding capital projects related to the children's bed expansion and the adult bed expansion/clinical relocation, which is a phased project, and paying a portion of the costs of issuance associated with the 2017 Series Debt.

The Series 2017A Tax-Exempt Revenue Bonds and the Series 2017B Taxable Term Loan Revenue Note were issued by the HEFB. The Series 2017 Taxable Bonds were a corporate issue with VUMC as the issuer.

- The Series 2017A tax-exempt fixed-rate revenue bonds were issued in the par amount of \$121.3 million and include an original issue premium of \$5.1 million. The final maturity date is July 1, 2048, and optional redemption at par can occur on or after July 1, 2027. The Series 2017A bonds bear interest at 4.4% per annum and pay interest semiannually on July 1 and January 1.
- The Series 2017 taxable fixed-rate corporate bonds were issued in the par amount of \$100.0 million, bearing interest at 4.2% per annum. Interest is paid semiannually on July 1 and January 1, and the bonds have a final maturity date of July 1, 2037. There is a bullet payable beginning July 1, 2026, that allows VUMC to call the debt.
- The Series 2017B taxable variable-rate term loan notes were issued in the par amount of \$50 million and placed privately with a bank. The notes bear interest initially at a fixed-spread to one-month LIBOR of 1.2%. The notes have a final maturity date of July 1, 2046, and a tender date of August 1, 2024. Proceeds from the issuance of the Series 2017B notes were used to extinguish the Series 2016C R-FLOATs, initially issued on April 29, 2016.

On April 20, 2018, the Series 2018 Tax-Exempt Revenue Bonds ("2018 Series Debt") aggregating \$53.4 million of proceeds were issued for the purpose of refinancing existing debt and paying a portion of the costs of issuance associated with the 2018 Series Debt. The Series 2018 Tax-Exempt Revenue Bonds were issued by the HEFB, were placed privately with a bank, and bear interest at a fixed spread to 81% of one-month LIBOR of 0.6%. The bonds have a final maturity

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date of July 1, 2049, and can be optionally redeemed on or after July 1, 2025. Proceeds from the issuance of the Series 2018 bonds were used to extinguish a portion of the Series 2016F taxable variable-rate bonds.

Trust indentures for certain bond issues contain covenants and restrictions, the most material of which include limitations on the issuance of additional debt, maintenance of a specified debt service coverage ratio, and a minimum amount of days cash on hand. VUMC complied with such covenants and restrictions as of June 30, 2018 and 2017.

On April 29, 2016, VUMC delivered a secured subordinated promissory note in the amount of \$100.0 million to the University to finance the Acquisition (the "VU subordinated note"). The note was issued at a fixed rate of 3.25% with monthly principal payments totaling \$5.0 million annually commencing on May 31, 2016, for a period of 20 years ending on April 30, 2036. VUMC may, at any time and from time to time, without premium or penalty, prepay all or any portion of the unpaid principal amount of the VU subordinated note. This note is secured by the gross receivables and mortgaged property described in the Security Agreement subject to the requirements of the 2016 Series Debt and the MTI.

As part of the Acquisition, VUMC assumed a 10-year, unsecured, noninterest-bearing product financing arrangement with a vendor for the purchase and implementation of internal use software. As part of this agreement, VUMC has committed to an annual payment of \$0.5 million payable in monthly installments through November 2019. These payments will be considered imputed interest. During Fiscal 2020, the annual payment increases to \$4.9 million payable in monthly installments. These payments are considered principal and imputed interest and continue through Fiscal 2027. The balance due under the Product Financing Arrangement is \$28.9 million and \$22.3 million as of June 30, 2018 and 2017, respectively, and is included in the long-term debt caption of the consolidated balance sheets.

In Fiscal 2018 and 2017, noncash investing and financing activities totaled \$5.8 million and \$9.0 million, respectively, related to property, plant, and equipment expenditures financed through the product financing arrangement and capital leases.

Interest paid on all obligations, net of amounts capitalized, was \$54.7 million and \$38.0 million in Fiscal 2018 and 2017, respectively.

Principal retirements and scheduled sinking fund requirements based on nominal maturity schedules for long-term debt due in subsequent fiscal years ending June 30 are as follows:

(\$ in thousands)

2019	\$	5,774
2020		7,566
2021		8,868
2022		109,031
2023		139,369
Thereafter		1,200,615
	\$	<u>1,471,223</u>

VUMC has entered into an agreement with a bank to provide a general use line of credit with a maximum available commitment totaling \$100.0 million. The line of credit, which may be drawn upon for general operating purposes, expires on April 26, 2019, and can be renewed. Interest on

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each advance under this line of credit accrues at a rate of 0.65% plus LIBOR, and a commitment fee of 0.15% per annum accrues on any unused portion of the line of credit. Commitment fees for the line of credit totaled \$0.2 million in Fiscal 2018 and 2017. No amounts were drawn under this credit facility as of June 30, 2018 or 2017.

12. Interest Rate Exchange Agreements

On April 29, 2016, the University transferred an interest rate exchange agreement to VUMC with a total notional amount of \$150.0 million and a maturity date of May 1, 2040. VUMC split the transferred notional amount into two agreements, with key features summarized below:

Notional Amount	Pay Fixed Rate	Receive Variable Rate	Maturity
\$75.0 million	4.12%	68% of one-month LIBOR	April 29, 2021
\$75.0 million	4.18%	68% of one-month LIBOR	April 29, 2023

VUMC incorporated these interest rate exchange agreements into its debt portfolio management strategy. Collateral pledging requirements were removed from the novated agreements, and the agreements were modified to terminate automatically on April 29, 2021 and 2023, at which point the exchange agreements will be settled at fair value.

VUMC recorded the following activity related to the interest rate exchange agreements during Fiscal 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Mark-to-market adjustments	\$ 10,997	\$ 24,333
Cash settlements	<u>(4,618)</u>	<u>(5,488)</u>
Unrealized gain on interest rate exchange agreements, net of cash settlements	<u>\$ 6,379</u>	<u>\$ 18,845</u>

13. Operating Leases

VUMC has entered into certain long-term agreements with respect to facilities and equipment, both as a lessee and a lessor, which VUMC classifies as operating leases. Rental expense and rental income in Fiscal 2018 and 2017 are as follows:

<i>(\$ in thousands)</i>	2018	2017	Location in Consolidated Statements of Operations
Operating lease rental expense	\$ 112,712	\$ 108,008	Operating expenses— Facilities and equipment
Operating lease rental income, including related-party income	7,843	7,764	Operating revenues— Other operating revenue

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The following is a schedule by fiscal year of future minimum rentals on noncancelable operating leases as of June 30, 2018:

<i>(\$ in thousands)</i>	<u>Equipment</u>	<u>Property</u>	<u>Ground Lease</u>	<u>Total</u>
2019	\$ 28,143	\$ 51,534	\$ 19,020	\$ 98,697
2020	21,230	49,477	19,020	89,727
2021	14,807	41,704	19,020	75,531
2022	11,447	32,857	19,020	63,324
2023	4,601	25,907	19,020	49,528
Thereafter	2,321	167,990	1,749,842	1,920,153
Total minimum rentals	<u>\$ 82,549</u>	<u>\$ 369,469</u>	<u>\$ 1,844,942</u>	<u>\$ 2,296,960</u>

Essential provisions of leases considered by management to be material are as follows:

- On April 29, 2016, VUMC entered into a Ground Lease with VU for approximately 1.7 million square feet of space for an initial term ending June 30, 2114, and an option to extend for up to two additional terms of 50 to 99 years each upon agreement by VU and VUMC. The initial annual base rent of \$18.0 million is payable monthly, and CPI is adjusted annually. The Ground Lease allows VUMC to use the land on which its campus and related buildings are located. The \$1.8 billion in ground lease payments in the table above represents future minimum rentals based on current payments.
- In July 2007, VU entered into an agreement to lease approximately 50% of the space in the 850,000-square foot One Hundred Oaks shopping center located approximately five miles from the main campus ("100 Oaks Lease"). VU redeveloped this leased space primarily for medical and office uses. This operating lease commenced during Fiscal 2009 with an initial lease term of 12 years. In October 2014, VU agreed to an amendment which extends the original lease term by an additional 15 years, with an option to renew the lease further for four additional 10-year periods. As part of the lease agreement, the lessee also has first rights on leasing additional space in the shopping center and first rights on purchasing if the landlord desires to sell. On April 29, 2016, the 100 Oaks Lease was assigned to VUMC. As a condition of the assignment, amendments to the 100 Oaks Lease were added which required VUMC to provide the landlord a \$25.0 million irrevocable standby letter of credit, pay a \$13.2 million refinancing penalty payable to the landlord, and pay \$7.8 million of the landlord's closing costs, financing fees, and prepayment penalties associated with a refinancing of the landlord's debt. The prepayment penalty and closing costs were recorded as part of the Acquisition. The irrevocable standby letter of credit must remain in place through April 29, 2026. The amounts related to this standby letter of credit are recorded as facilities and equipment expense and totaled \$0.3 million in Fiscal 2018 and 2017. VUMC included minimum property rental payments totaling \$132.1 million related to this space in the above future minimum property rentals.
- On April 29, 2016, VU assigned to VUMC a lease for approximately 231,000 square feet of office space at 2525 West End Avenue with expiration dates primarily in 2026 through 2030, with options to renew for two additional five-year periods. VUMC included minimum property rental payments totaling \$82.9 million related to this space in the above future minimum property rentals.

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- On April 29, 2016, VUMC and VU entered into certain lease agreements for the use of space in buildings owned by both entities. As of June 30, 2018, VUMC's estimated future minimum property lease payments to VU totaled \$28.9 million, and estimated future lease receipts from VU totaled \$57.2 million. For the fiscal years ended June 30, 2019 through 2023, the minimum annual rental receipts from VU are \$7.2 million.

14. Net Assets

Net asset restrictions relate to the following purposes as of June 30, 2018 and 2017:

<i>(\$ in thousands)</i>	2018	2017
Temporarily restricted		
Property, plant, and equipment	\$ 38,404	\$ 31,248
Research and education	38,331	35,807
Operations	2,761	2,003
Total temporarily restricted net assets	<u>\$ 79,496</u>	<u>\$ 69,058</u>
Permanently restricted		
Research and education	<u>\$ 34,929</u>	<u>\$ 17,865</u>

Unrestricted net assets are free of donor-imposed restrictions. This classification includes all revenues, gains, and losses not temporarily or permanently restricted by donors. VUMC reports all expenditures in the unrestricted class of net assets since the use of restricted contributions in accordance with donors' stipulations results in the release of the restriction.

Temporarily restricted net assets contain donor-imposed stipulations that expire with the passage of time or that can be satisfied by the action of VUMC. These net assets may include unconditional pledges, split-interest agreements, interests in trusts held by others, and accumulated appreciation on donor-restricted endowments not yet appropriated by the Board of Directors for distribution.

Permanently restricted net assets are amounts held in perpetuity as requested by donors. These net assets may include unconditional pledges, donor-restricted endowments (at historical value), split-interest agreements, and interests in trusts held by others. Generally, the donors of these assets permit VUMC to use a portion of the income earned on related investments for specific purposes.

UPMIFA specifies that unless stated otherwise in a gift instrument, donor-restricted assets in an endowment fund are restricted assets until appropriated for expenditure. Barring the existence of specific instructions in gift agreements for donor-restricted endowments, VUMC reports the historical value of such endowments as permanently restricted net assets and the net accumulated appreciation as temporarily restricted net assets. In this context, the historical value represents the original value of initial contributions restricted as permanent endowments plus the original value of subsequent contributions and, if applicable, the value of accumulations made in accordance with the direction of specific donor gift agreements.

15. Fair Value Measurements

Fair value measurements represent the amount at which the instrument could be exchanged in an orderly transaction between market participants at the measurement date. VUMC utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels:

- | | |
|---------|---|
| Level 1 | Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that VUMC has the ability to access. |
| Level 2 | Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in inactive markets, inputs other than quoted prices that are observable for the assets or liabilities, and inputs that are derived principally from or corroborated by observable market data by correlation or other means. |
| Level 3 | Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs reflect VUMC's assumptions about the inputs market participants would use in pricing the asset or liability, including assumptions about risk. Unobservable inputs are developed based on the best information available in the circumstances and may include VUMC's own data. |

VUMC's principal assets and liabilities subject to fair value measurement are cash and cash equivalents, investments, patient accounts receivable, estimated receivables and payables under third-party programs, grants and contracts receivable, pledges receivable, accounts payable and other accrued expenses, self-insurance reserves, long-term debt, and interest rate exchange agreements. Except for long-term debt, the carrying amount of these assets and liabilities approximates fair value.

As of June 30, 2018, the carrying value and estimated fair value of total long-term debt totaled \$1.518 billion and \$1.534 billion, respectively. As of June 30, 2017, the carrying value and estimated fair value of total long-term debt totaled \$1.294 billion and \$1.319 billion, respectively. VUMC bases estimated fair value of long-term debt on market conditions prevailing at fiscal year-end reporting dates. Besides potentially volatile market conditions, fair value estimates typically reflect limited secondary market trading. The fair values of the fixed-rate Series Debt, as defined in Note 11. Long-Term Debt, were based on a Level 2 computation using quoted prices for similar liabilities in inactive markets as of June 30, 2018 and 2017, as applicable. The carrying amounts related to VUMC's variable-rate Series Debt and other long-term debt obligations approximate their fair values as of June 30, 2018 and 2017. As of June 30, 2018 and 2017, the fair values of the promissory note payable to VU and the product financing arrangement were based on a Level 2 discounted cash flow approach applying a risk-adjusted spread for issuers of similar credit quality to U.S. Treasury yields for securities with comparable maturities.

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For financial instruments measured at fair value on a recurring basis, the following tables summarize valuation hierarchy levels as of June 30, 2018 and 2017, determined by the nature of the financial instrument and the least observable input significant to the fair value measurement:

Fair Value Measurements as of June 30, 2018				
				Total
<i>(\$ in thousands)</i>	Level 1	Level 2	Level 3	Carrying Amount
Assets				
Corporate bonds	\$ 9,507	\$ 113,132	\$ -	\$ 122,639
Equity mutual funds	36,269	99,616	-	135,885
Cash and cash equivalents	75,972	-	-	75,972
Beneficial interests in split-interest trusts	7,577	-	-	7,577
Hedged equity mutual funds	-	41,275	-	41,275
Fixed-income mutual funds	21,079	76,867	-	97,946
Certificates of deposit	-	48,243	-	48,243
Asset-backed securities	-	33,547	-	33,547
Real estate mutual funds	-	14,098	-	14,098
Commercial paper	-	10,284	-	10,284
Government bonds	-	1,899	-	1,899
Hedged debt mutual funds	-	63,295	-	63,295
Commodities and managed futures mutual funds	-	5,495	-	5,495
Total assets reported at fair value	\$ 150,404	\$ 507,751	\$ -	\$ 658,155
Liabilities				
Interest rate exchange agreements	\$ -	\$ 54,206	\$ -	\$ 54,206
Total liabilities reported at fair value	\$ -	\$ 54,206	\$ -	\$ 54,206

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Fair Value Measurements as of June 30, 2017				
(\$ in thousands)	Level 1	Level 2	Level 3	Total Carrying Amount
Assets				
Corporate bonds	\$ 60,214	\$ 58,831	\$ -	\$ 119,045
Equity mutual funds	38,637	74,067	-	112,704
Cash and cash equivalents	32,569	-	-	32,569
Beneficial interests in split-interest trusts	7,347	-	-	7,347
Hedged equity mutual funds	4,267	10,492	-	14,759
Fixed-income mutual funds	2,080	36,131	-	38,211
Certificates of deposit	-	38,657	-	38,657
Asset-backed securities	-	21,779	-	21,779
Real estate mutual funds	-	16,206	-	16,206
Commercial paper	-	11,609	-	11,609
Government bonds	-	9,097	-	9,097
Hedged debt mutual funds	-	5,178	-	5,178
Commodities and managed futures mutual funds	-	3,820	-	3,820
Total assets reported at fair value	\$ 145,114	\$ 285,867	\$ -	\$ 430,981
Liabilities				
Interest rate exchange agreements	\$ -	\$ 65,203	\$ -	\$ 65,203
Total liabilities reported at fair value	\$ -	\$ 65,203	\$ -	\$ 65,203

VUMC employs derivatives, primarily interest rate exchange agreements, to help manage interest rate risks associated with variable-rate debt. In addition to the credit risk of the counterparty owing a balance, VUMC calculates the fair value of interest rate exchange agreements based on the present value of future net cash settlements that reflect market yields as of the measurement date.

Parties to interest rate exchange agreements are subject to risk for changes in interest rates, as well as the risk of credit loss in the event of nonperformance by the counterparty. VUMC deals only with high-quality counterparties that meet rating criteria for financial stability and credit-worthiness.

16. Retirement Plans

VUMC's full-time employees participate in a 403(b) defined contribution retirement plan administered by a third party. For eligible employees with one year of continuous service, these plans require employer matching of employee contributions up to 5% of eligible compensation. The employee immediately vests in these contributions.

VUMC funds the obligations under these plans through monthly transfers to the respective retirement plan administrators with the corresponding expenses recognized in the year incurred. During Fiscal 2018 and 2017, VUMC recognized \$60.7 million and \$56.6 million, respectively, of expense in connection with these plans.

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17. Functional Expenses

Total operating expenses by function for Fiscal 2018 and 2017 were as follows:

<i>(\$ in thousands)</i>	2018	2017
Healthcare services	\$ 3,272,198	\$ 2,974,923
Academic research and education	610,457	597,625
Administrative and other	147,576	152,558
Total operating expenses	<u>\$ 4,030,231</u>	<u>\$ 3,725,106</u>

18. Commitments and Contingencies

Management has policies, procedures, and an organizational structure to enforce and monitor compliance with government statutes and regulations. VUMC's compliance with such laws and regulations is subject to future government review and interpretations, as well as regulatory actions unknown or unasserted at this time.

- **Litigation.** VUMC is a defendant in certain lawsuits alleging medical malpractice and civil action.

On August 16, 2016, VUMC received written notice from VU of a third-party claim which may, if determined adversely to VU, require indemnification by VUMC pursuant to the provisions of the MTSA, dated as of April 29, 2016. The third-party claim is a lawsuit (Cassell v. Vanderbilt University, et al., No. 3:16-cv-02086 (U.S.D.C. M.D. TN)) brought by current and former employees of VU which alleges claims relating to administration of the Vanderbilt University Retirement Plan and New Faculty Plan. Due to the early stage of the litigation, it is not possible to assess the likely outcome of the litigation or to estimate the amount of the indemnification obligation which VUMC might have, were the matter decided adversely to VU.

In January 2018, VUMC received a subpoena from the United States Department of Health and Human Services, Office of Inspector General ("OIG") dated January 18, 2018, requesting medical and billing records for 62 patients who received certain cardiac diagnostic testing services at VUMC. VUMC completed its production of records responsive to the subpoena in April 2018. To date, the OIG has not asserted any claims or identified any overpayments with respect to these 62 patients. At this time, there is not enough information to conclude whether a claim in connection with the OIG's subpoena is estimable or probable.

Through the operation of its compliance program, VUMC from time to time initiates the review of billing for clinical services provided by VUMC and its affiliated providers. VUMC has established a liability reserve relating to certain matters under review as of June 30, 2018, which is not material to VUMC's overall financial position.

- **Regulations.** VUMC's compliance with regulations and laws is subject to future government reviews and interpretations, as well as regulatory actions unknown at this time. VUMC believes that the liability, if any, from such reviews will not have a significant effect on VUMC's consolidated financial position.

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- **Medical Malpractice Liability Insurance.** The consolidated balance sheet includes reserves for medical malpractice, professional, and general liability coverage totaling \$74.1 million as of June 30, 2018, and \$71.5 million as of June 30, 2017. These liabilities are measured at the net present value of those cash flows using a discount rate of 2.5% at both dates and are classified as current or noncurrent based on the expected timing of cash flows. Other current assets include expected recoveries from commercial insurance carriers under excess coverage arrangements totaling \$5.5 million as of June 30, 2018, and \$4.0 million as of June 30, 2017.
- **Employee Health and Workers' Compensation Insurance.** Accrued compensation and benefits included actuarially determined liabilities for employee health and workers' compensation claims totaling \$17.0 million and \$7.5 million, respectively, as of June 30, 2018, and \$16.0 million and \$7.3 million, respectively, as of June 30, 2017. During Fiscal 2018 and 2017, VUMC recorded expenses for self-insured employee health benefit plans, net of employee premiums, totaling \$160.4 million and \$154.8 million, respectively. During Fiscal 2018 and 2017, VUMC recorded expenses for self-insured workers' compensation plans of \$3.7 million and \$3.0 million, respectively.
- **Federal and State Contracts and Other Requirements.** Expenditures related to federal and state grants and contracts are subject to adjustment based upon review by the granting agencies. Amounts of expenditures that granting agencies might disallow cannot be determined at this time. These amounts affect government grants and contracts revenue, as well as facilities and administrative costs recovery. VUMC does not expect these costs to influence the consolidated financial position by material amounts.
- **Health Care Services.** In Fiscal 2018 and 2017, 84% and 85%, respectively, of VUMC's operating revenue was generated by providing health care services, where revenue is affected by reimbursement arrangements with federal and state healthcare programs, commercial insurance, and other managed care payors. If reimbursement rates from third-party payors decrease or if contract terms become less favorable in future periods, VUMC's net operating revenues may decline. See Note 4. Patient Service Revenue, Patient Accounts Receivable, and Estimated Third-Party Settlements, for further information regarding healthcare revenues and related receivables.
- **HIPAA Compliance.** Under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), the federal government has authority to complete fraud and abuse investigations. HIPAA has established substantial fines and penalties for offenders. VUMC maintains policies, procedures, and organizational structures to enforce and monitor compliance with HIPAA, as well as other applicable local, state, and federal statutes and regulations.
- **Construction.** VUMC had contractual commitments under major construction and equipment contracts totaling \$119.5 million and \$109.2 million as of June 30, 2018 and 2017, respectively.
- **Letter of Credit.** As a requirement of the assignment of the 100 Oaks Lease described in Note 13. Operating Leases, VUMC provided an irrevocable standby letter of credit of \$25.0 million to the landlord of the property dated June 10, 2016.

Vanderbilt University Medical Center
Notes to Consolidated Financial Statements
June 30, 2018 and 2017

19. Subsequent Events

Management evaluated events after June 30, 2018 through October 26, 2018, the date on which the consolidated financial statements were issued. During this period, there were no subsequent events requiring recognition in the consolidated financial statements that have not been recorded.

On July 3, 2018, VU completed the sale of the VU subordinated note by a royalty purchase agreement to an unrelated third party. No terms of the note were changed. The June Fiscal 2018 payment was due after the date that the promissory note was purchased and the final payment was made to the unrelated third party.

In addition, on July 3, 2018, VU completed the sale to an unrelated third party of the portion of the Fixed TMLA Royalty Payment payable by VUMC to VU that is payable through July 2018. The sales transaction did not change the amount, length, or timing of VUMC's payment obligation under the TMLA with respect to the Fixed TMLA Royalty Payment. The Fixed TMLA Royalty Payment for June 2018 was due after the consummation of the sale and was made to the unrelated third party.

Report of Independent Auditors on Supplementary Information

The Board of Directors Vanderbilt University Medical Center

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. Consolidated financial statements for the year ended June 30, 2017 were audited by other auditors whose report dated October 19, 2017 expressed an unmodified opinion on such information. The accompanying Vanderbilt University Medical Center consolidating information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information, except for that pertaining to the year ended June 30, 2017, has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, based on our audit and the report of other auditors, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Ernst & Young LLP

October 26, 2018

Vanderbilt University Medical Center
Consolidating Balance Sheet
June 30, 2018

(\$ in thousands)	Obligated Group	Nonobligated Entity	Consolidated
Assets			
Current assets:			
Cash and cash equivalents	\$ 469,123	\$ 31,785	\$ 500,908
Current investments	134,467	-	134,467
Patient accounts receivable, net	467,135	7,250	474,385
Grants and contracts receivable, net	57,748	-	57,748
Inventories	72,077	559	72,636
Other current assets	76,210	9,633	85,843
Total current assets	1,276,760	49,227	1,325,987
Noncurrent investments	262,846	-	262,846
Noncurrent investments limited as to use	260,842	-	260,842
Property, plant, and equipment, net	1,303,174	3,465	1,306,639
Other noncurrent assets	25,070	10,807	35,877
Total assets	\$ 3,128,692	\$ 63,499	\$ 3,192,191
Liabilities and Net Assets			
Current liabilities:			
Current installments of long-term debt	\$ 5,774	\$ -	\$ 5,774
Accounts payable and other accrued expenses	257,114	10,973	268,087
Estimated payables under third-party programs	72,947	-	72,947
Accrued compensation and benefits	195,189	2,756	197,945
Current portion of deferred revenue	35,195	2,108	37,303
Current portion of medical malpractice self-insurance reserves	16,558	-	16,558
Total current liabilities	582,777	15,837	598,614
Long-term debt, net of current installments	1,512,698	-	1,512,698
Fair value of interest rate exchange agreements	54,206	-	54,206
Noncurrent portion of medical malpractice self-insurance reserves	57,520	-	57,520
Noncurrent portion of deferred revenue	18,443	276	18,719
Other noncurrent liabilities	22,798	6	22,804
Total liabilities	2,248,442	16,119	2,264,561
Net assets:			
Unrestricted net assets controlled by VUMC	765,825	41,656	807,481
Unrestricted net assets related to noncontrolling interests	-	5,724	5,724
Total unrestricted net assets	765,825	47,380	813,205
Temporarily restricted net assets	79,496	-	79,496
Permanently restricted net assets	34,929	-	34,929
Total net assets	880,250	47,380	927,630
Total liabilities and net assets	\$ 3,128,692	\$ 63,499	\$ 3,192,191

The accompanying notes are an integral part of these consolidating financial statements.

Vanderbilt University Medical Center
Consolidating Balance Sheet
June 30, 2017

(\$ in thousands)	Obligated Group	Nonobligated Entity	Consolidated
Assets			
Current assets:			
Cash and cash equivalents	\$ 502,090	\$ 18,767	\$ 520,857
Current investments	133,977	-	133,977
Patient accounts receivable, net	369,756	4,930	374,686
Estimated receivables under third-party programs	12,642	-	12,642
Grants and contracts receivable, net	67,249	-	67,249
Inventories	66,955	523	67,478
Other current assets	65,926	7,150	73,076
Total current assets	1,218,595	31,370	1,249,965
Noncurrent investments	94,412	-	94,412
Noncurrent investments limited as to use	202,592	-	202,592
Property, plant, and equipment, net	1,216,614	3,154	1,219,768
Other noncurrent assets	24,624	9,969	34,593
Total assets	\$ 2,756,837	\$ 44,493	\$ 2,801,330
Liabilities and Net Assets			
Current liabilities:			
Current installments of long-term debt	\$ 5,753	\$ -	\$ 5,753
Accounts payable and other accrued expenses	255,736	10,929	266,665
Estimated payables under third-party programs	37,072	-	37,072
Accrued compensation and benefits	192,363	2,376	194,739
Current portion of deferred revenue	37,972	1,381	39,353
Current portion of medical malpractice self-insurance reserves	17,161	-	17,161
Total current liabilities	546,057	14,686	560,743
Long-term debt, net of current installments	1,288,346	-	1,288,346
Fair value of interest rate exchange agreements	65,203	-	65,203
Noncurrent portion of medical malpractice self-insurance reserves	54,373	-	54,373
Noncurrent portion of deferred revenue	10,290	404	10,694
Other noncurrent liabilities	21,069	-	21,069
Total liabilities	1,985,338	15,090	2,000,428
Net assets:			
Unrestricted net assets controlled by VUMC	684,576	23,512	708,088
Unrestricted net assets related to noncontrolling interests	-	5,891	5,891
Total unrestricted net assets	684,576	29,403	713,979
Temporarily restricted net assets	69,058	-	69,058
Permanently restricted net assets	17,865	-	17,865
Total net assets	771,499	29,403	800,902
Total liabilities and net assets	\$ 2,756,837	\$ 44,493	\$ 2,801,330

The accompanying notes are an integral part of these consolidating financial statements.

Vanderbilt University Medical Center
Consolidating Statement of Operations
Year Ended June 30, 2018

<i>(\$ in thousands)</i>	Obligated Group	Nonobligated Entity	Consolidated
Operating revenues			
Patient service revenue, net of contractual adjustments and discounts	\$ 3,492,587	\$ 85,938	\$ 3,578,525
Provision for bad debts	(131,907)	(3,841)	(135,748)
Patient service revenue, net	3,360,680	82,097	3,442,777
Academic and research revenue	495,306	-	495,306
Other operating revenue	134,565	13,751	148,316
Total operating revenues	3,990,551	95,848	4,086,399
Operating expenses			
Salaries, wages, and benefits	2,142,546	37,101	2,179,647
Supplies and drugs	761,176	9,283	770,459
Facilities and equipment	245,819	11,119	256,938
Services and other	625,159	34,296	659,455
Depreciation and amortization	105,233	421	105,654
Interest	58,078	-	58,078
Total operating expenses	3,938,011	92,220	4,030,231
Income from operations	52,540	3,628	56,168
Nonoperating revenues and expenses			
Income from investments	24,021	-	24,021
Gift income	11,945	-	11,945
Earnings of unconsolidated organizations	(654)	4,350	3,696
Unrealized gain on interest rate exchange agreements, net of cash settlements	6,379	-	6,379
Total nonoperating revenues and expenses	41,691	4,350	46,041
Excess of revenues over expenses	94,231	7,978	102,209
Excess of revenues over expenses attributable to noncontrolling interests	-	(4,068)	(4,068)
Excess of revenues over expenses attributable to VUMC	\$ 94,231	\$ 3,910	\$ 98,141

The accompanying notes are an integral part of these consolidating financial statements.

Vanderbilt University Medical Center
Consolidating Statement of Operations
Year Ended June 30, 2017

<i>(\$ in thousands)</i>	Obligated Group	Nonobligated Entity	Consolidated
Operating revenues			
Patient service revenue, net of contractual adjustments and discounts	\$ 3,368,846	\$ 75,592	\$ 3,444,438
Provision for bad debts	(105,643)	(3,476)	(109,119)
Patient service revenue, net	3,263,203	72,116	3,335,319
Academic and research revenue	421,772	4	421,776
Other operating revenue	138,020	8,453	146,473
Total operating revenues	3,822,995	80,573	3,903,568
Operating expenses			
Salaries, wages, and benefits	2,003,748	31,515	2,035,263
Supplies and drugs	691,697	7,503	699,200
Facilities and equipment	234,929	10,487	245,416
Services and other	575,198	30,104	605,302
Depreciation and amortization	91,005	438	91,443
Interest	48,482	-	48,482
Total operating expenses	3,645,059	80,047	3,725,106
Income from operations	177,936	526	178,462
Nonoperating revenues and expenses			
Income from investments	21,250	-	21,250
Gift income	9,769	1	9,770
Earnings of unconsolidated organizations	72	3,838	3,910
Unrealized gain on interest rate exchange agreements, net of cash settlements	18,845	-	18,845
Other nonoperating gains, net	(861)	-	(861)
Total nonoperating revenues and expenses	49,075	3,839	52,914
Excess of revenues over expenses	227,011	4,365	231,376
Excess of revenues over expenses attributable to noncontrolling interests	-	(4,883)	(4,883)
Excess (deficiency) of revenues over (under) expenses attributable to VUMC	\$ 227,011	\$ (518)	\$ 226,493

The accompanying notes are an integral part of these consolidating financial statements.

Vanderbilt University Medical Center
Note to Supplementary Information
June 30, 2018 and 2017

Basis of Presentation

As discussed in Note 11. Long-Term Debt, each of the bonds and notes comprising the Series Debt represent separate obligations under an MTI structure. All debt issued under the MTI are general obligations of the obligated group, which, for purposes of the preceding consolidating financial statements comprises VUMC and its affiliates, as described in Note 1. Description of Organization, except for VHS, which is a nonobligated entity.

The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and the results of operations of the individual companies.

The accompanying notes are an integral part of these consolidating financial statements.

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