Vanderbilt University Medical Center

Consolidated Financial Statements
June 30, 2017 and 2016 and
Year Ended June 30, 2017

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Report of Independent Auditors

To the Board of Directors of
Vanderbilt University Medical Center

We have audited the accompanying consolidated financial statements of Vanderbilt University Medical Center (the "Medical Center"), which comprise the consolidated balance sheets as of June 30, 2017 and June 30, 2016, and the related consolidated statement of operations, statement of changes in net assets, and statement of cash flows for the year ended June 30, 2017.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Vanderbilt University Medical Center as of June 30, 2017 and June 30, 2016, and the results of its operations and its cash flows for the year ended June 30, 2017, in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

October 19, 2017

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Vanderbilt University Medical Center
Consolidated Balance Sheets
June 30, 2017 and 2016

($ in thousands)	2017	2016
Assets		
Current		
Cash and cash equivalents	$ 520,857	$ 596,506
Current investments	133,977	-
Patient accounts receivable, net of allowance for bad debts of $130.5 million and $20.2 million as of June 30, 2017 and 2016, respectively	378,704	343,241
Estimated receivables under third-party programs	12,642	9,123
Grants and contracts receivable, net	67,249	60,943
Inventories	67,478	61,925
Other current assets	69,058	87,020
Total current assets	1,249,965	1,158,758
Noncurrent investments	94,412	-
Noncurrent investments limited as to use	202,592	196,944
Property, plant, and equipment, net	1,219,768	1,130,116
Other noncurrent assets	34,593	33,166
Total assets	$ 2,801,330	$ 2,518,984
Liabilities and Net Assets		
Current		
Current installments of long-term debt	$ 5,753	$ 5,000
Accounts payable and other accrued expenses	272,641	206,034
Bank overdrafts	-	13,846
Estimated payables under third-party programs	37,072	30,990
Accrued compensation and benefits	194,739	200,110
Current portion of deferred revenue	39,353	38,345
Current portion of medical malpractice self-insurance reserves	17,161	20,657
Total current liabilities	566,719	514,982
Long-term debt, net of current installments	1,288,346	1,286,063
Fair value of interest rate exchange agreements	65,203	89,536
Noncurrent portion of medical malpractice self-insurance reserves	54,373	67,319
Noncurrent portion of deferred revenue	10,694	6,268
Other noncurrent liabilities	15,093	11,641
Total liabilities	2,000,428	1,975,809
Net assets		
Unrestricted net assets controlled by Vanderbilt University Medical Center	708,088	503,894
Unrestricted net assets related to noncontrolling interests	5,891	5,527
Total unrestricted net assets	713,979	509,421
Temporarily restricted net assets	69,058	26,985
Permanently restricted net assets	17,865	6,769
Total net assets	800,902	543,175
Total liabilities and net assets	$ 2,801,330	$ 2,518,984

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

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

($ in thousands)

Operating revenues	
Patient service revenue, net of contractual adjustments and discounts	$ 3,444,438
Provision for bad debts	(109,119)
Patient service revenue, net	3,335,319
Academic and research revenue	416,338
Other operating revenue	151,911
Total operating revenues	3,903,568
Operating expenses	
Salaries, wages, and benefits	2,035,263
Supplies and drugs	699,200
Facilities and equipment	245,731
Services and other	604,987
Depreciation and amortization	91,443
Interest	48,482
Total operating expenses	3,725,106
Income from operations	178,462
Nonoperating revenues and expenses	
Income from investments	21,250
Gift income	9,770
Earnings of unconsolidated organizations	3,910
Unrealized gain on interest rate exchange agreements, net of cash settlements	18,845
Other nonoperating gains (losses), net	(861)
Total nonoperating revenues and expenses	52,914
Excess of revenues over expenses	231,376
Excess of revenues over expense attributable to noncontrolling interests	(4,883)
Excess of revenues over expense attributable to VUMC	226,493
Other changes in unrestricted net assets	
Change in noncontrolling interest's net assets	364
Net asset reclassification	(22,234)
Other changes	(65)
Total changes in unrestricted net assets	$ 204,558

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

Vanderbilt University Medical Center
Consolidated Statement of Changes in Net Assets
Year Ended June 30, 2017

($ in thousands)

Unrestricted net assets		
Unrestricted net assets at the beginning of the period	$	509,421
Excess of revenue over expense		226,493
Change in noncontrolling interest's net assets		364
Net asset reclassification		(22,234)
Other changes		(65)
Change in unrestricted net assets		204,558
Unrestricted net assets at the end of the period	$	713,979
Temporarily restricted net assets		
Temporarily restricted net assets at the beginning of the period	$	26,985
Contributions		27,681
Endowment appreciation		749
Net assets released from restrictions		(6,114)
Net asset reclassification		19,757
Change in temporarily restricted net assets		42,073
Temporarily restricted net assets at the end of the period	$	69,058
Permanently restricted net assets		
Permanently restricted net assets at the beginning of the period	$	6,769
Contributions		8,619
Net asset reclassification		2,477
Change in permanently restricted net assets		11,096
Permanently restricted net assets at the end of the period	$	17,865
Total net assets		
Beginning of the period	$	543,175
Change in total net assets		257,727
End of the period	$	800,902

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

Vanderbilt University Medical Center
Consolidated Statement of Cash Flows
Year Ended June 30, 2017

($ in thousands)

Cash flows from operating activities	
Change in total net assets	$ 257,727
Adjustments to reconcile change in total net assets to net cash provided by operating activities	
Depreciation and amortization	91,443
Amortization of debt issuance costs, and original issue premium and discount	(902)
Provision for bad debts	109,119
Loss on disposal of assets	3,409
Undistributed equity in earnings of equity method affiliates	(1,156)
Net realized and unrealized gain on investments	(16,371)
Purchases of trading securities	(312,072)
Sales of trading securities	112,056
Change in split-interest trusts	(963)
Unrealized gain on interest rate exchange agreements	(24,333)
Restricted contributions for endowments and property, plant, and equipment	(17,991)
(Decrease) increase in cash due to changes in	
Patient accounts receivable	(144,582)
Inventories	(5,553)
Other assets and other liabilities, net	8,641
Accounts payable and other accrued expenses	49,612
Estimated net receivables and payables under third-party programs	2,563
Accrued compensation and benefits	(5,372)
Net cash provided by operating activities	105,275
Cash flows from investing activities	
Purchase of property, plant, and equipment	(158,729)
Purchases of long-term securities	(59,552)
Sales and maturities of long-term securities	52,237
Change in restricted cash for property, plant, and equipment contributions	(9,371)
Net cash used in investing activities	(175,415)
Cash flows from financing activities	
Repayment of long-term debt	(4,583)
Principal payments under capital lease obligations	(552)
Change in bank overdrafts	(13,846)
Restricted contributions for endowments and property, plant, and equipment	17,991
Distributions to noncontrolling interests	(4,519)
Net cash used in financing activities	(5,509)
Net change in cash and cash equivalents	(75,649)
Cash and cash equivalents	
Beginning of the period	596,506
End of the period	$ 520,857

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

1. Description of Organization

Vanderbilt University Medical Center ("VUMC") is a Tennessee not-for-profit corporation incorporated in March of 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 primarily 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 1,025 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 the 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 670 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 88 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.

- The VMG is the practice group of physicians and advanced practice nurses employed by VUMC, with faculty appointments from the University, who perform billable professional medical services. The VMG is not a separate legal entity. The 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, the VMG sets professional practice standards, bylaws, policies, and procedures for the administration of a group practice. 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.

- The 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 13 health care 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, imaging services, outpatient surgery centers, radiation oncology centers, a home health care agency, a home infusion and respiratory service, an affiliated health network, and a rehabilitation hospital. These subsidiaries include clinics managed in multiple outpatient locations throughout middle Tennessee and southwestern Kentucky.

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 term “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 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 billing rates, or amounts which prove uncollectible.

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, 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.

In evaluating the collectability 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, 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) are charged against the allowance for doubtful accounts. VUMC follows established guidelines, Centers for Medicare & Medicaid Services (CMS) regulations, and IRS Reg. §1.501(r)-6 for placing certain past-due patient balances with external collection agencies. During Fiscal 2017, cash collections related to the professional and technical component of our patient accounts receivable balance exceeded the receivable recorded as of June 30, 2016 by $40.4 million.

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.

Research grants and contracts receivable includes 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 statement 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.

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 reflected as current or 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, 2017 and 2016.

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 has elected the fair value option related to investments, including investments limited as to use, and 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.

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 accounts payable and other accrued expenses and total $6.0 million as of June 30, 2017, and $5.7 million as of June 30, 2016. VUMC measures these liabilities using estimated cash flows with an inflation rate applied of 3.0% as of June 30, 2017 and 2016. 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, 2017, and from 4.1% to 4.2% as of June 30, 2016, 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 sum 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 2017 and 2016. 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 were classified as current or noncurrent based on the expected timing of cash flows and were measured at the net present value of those cash flows using a discount rate of 2.5% as of June 30, 2017 and 2016. For both Fiscal 2017 and 2016, 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 $100.0 million. These policies would also provide coverage up to $100.0 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 2017 and Fiscal 2016. 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.

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 2016 balance sheet have been reclassified to conform to their Fiscal 2017 presentation. Compared to previously reported amounts as of June 30, 2016, the balance of accounts payable and other accrued expenses has been reduced by $9.2 million, with a corresponding increase in other noncurrent liabilities, related to accrued rental costs. Additionally, compared to previously reported amounts as of June 30, 2016, the balance of cash and cash equivalents has been reduced by $6.6 million, with a corresponding increase in noncurrent investments limited as to use, related to gifts restricted for usage in capital projects.

Recent Accounting Pronouncements

Periodically, the Financial Accounting Standards Board ("FASB") issues Accounting Standards Updates ("ASU") 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.

During Fiscal 2017, VUMC adopted ASU 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. The amendments require management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the amendments (i) provide a definition of the term substantial doubt, (ii) provide principles for considering the mitigating effect of management's plans, (iii) require certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (iv) require an express statement and other disclosures when substantial doubt is not alleviated, and (v) require an assessment for a period of one year after the date that the financial statements are issued, or available to be issued. The adoption of ASU No. 2014-15 had no effect on VUMC's financial statements

Following is a summary of ASUs which VUMC believes have a reasonably possible likelihood of having a material effect on the recognition, measurement, and presentation of balances and activity in VUMC's consolidated financial statements:

- In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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 No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations,* ASU No. 2016-10, *Revenue from Contracts with Customer (Topic 606) Identifying Performance Obligations and Licensing*, and ASU No. 2016-12, *Narrow-Scope Improvements and Practical Expedients* to address issues arising from implementation of the new revenue recognition standard. For VUMC, the revised ASU will be adopted for Fiscal 2019. VUMC continues to evaluate the effects the adoption of this standard will have on our consolidated financial statements and disclosures.

- 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 using a modified retrospective approach at the beginning of the earliest comparative period presented in the financial statements. For VUMC, the amendments in ASU 2016-02 are effective for Fiscal 2020, although early adoption is permitted. VUMC expects the 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, although early adoption is permitted. ASU 2016-14’s requirements must be applied retrospectively; however, entities can elect not to provide certain comparative disclosures in the year of adoption.

- In January 2017, the FASB issued ASU 2017-02, Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity. Under the new guidance, Not-for-Profit (NFP) investors in a limited partnership or similar entity will continue to apply a presumption that the general partner has control and should consolidate the investment unless substantive kick-out or participating rights held by any limited partners overcome that presumption. If the general partner does not have control, the limited partners have to evaluate whether they have control. If a limited partner has control, consolidation is required unless the investment is part of a portfolio for which the NFP “portfolio-wide” fair value option has been elected. In that situation, the limited partner can instead report its interest at fair value, mirroring an exception that already exists for NFP general partners. For VUMC, ASU 2017-02 is effective for Fiscal 2018.

3. Acquisitions

On April 29, 2016, VUMC acquired the assets, liabilities, rights, and obligations of the clinical enterprise, post-graduate medical training programs and clinically-related research of the University owned and operated Medical Center for consideration of $1.23 billion (“the Acquisition”). To fund the Acquisition, VUMC entered into certain debt agreements to borrow $1.13 billion of publically and privately placed debt and committed to a $100.0 million subordinate note to the University payable over twenty years (May 2016 through April 2036). VUMC paid VU cash of $1.13 billion to acquire the Medical Center assets and liabilities which included $529.0 million of cash. The net cash paid of $601.0 million represents the $1.13 billion of cash paid to VU net of the $529.0 million of cash included in the assets acquired. In addition to the cash consideration paid and subordinate note payable, VUMC committed to additional consideration in the form of other payables of $31.7 million; a $12.0 million commitment to fund trans-institutional programs and a $19.7 million memorandum of understanding (“MOU”) to fund certain University capital projects both of which were previously agreed to be funded by the Medical Center. These Medical Center assets and operations were used to form the two major operating divisions of VUMC.

VUMC accounted for the Acquisition using the acquisition method of accounting under ASC 805-10-05-4 as modified by ASC 958-805-25, whereby the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired entity are recognized and measured at their fair values on the date VUMC obtained control of the Medical Center. The Acquisition resulted in an inherent contribution from the University totaling $509.0 million. The inherent contribution is a result of the University’s interest in the success of VUMC and the shared missions of the two organizations which are memorialized in the agreements discussed within this note. No goodwill was recorded as a result of this transaction.

The table below summarized the allocation of the purchase price (including assumed liabilities) for the Medical Center as of the acquisition date:

($ in thousands)

Identifiable net assets contributed		
Current assets	$	492,709
Property, plant, and equipment		1,121,845
Other noncurrent assets		207,101
Liabilities		(574,466)
Noncontrolling interests		(5,502)
Total identifiable net assets contributed		1,241,687
Less: Total consideration paid to VU		
Net cash consideration paid		600,971
Note payable to VU		100,000
Other VU payables		31,700
Total consideration		732,671
Inherent contribution from VU	$	509,016

The inherent contribution from VU is included in the following fund balances from April 29, 2016, the date of the Acquisition:

($ in thousands)

Unrestricted	$	476,895
Temporarily restricted		25,360
Permanently restricted		6,761
Total inherent contribution from VU	$	509,016

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”).

4. Related Parties

After the Acquisition, when control of the assets necessary to operate VUMC transferred from VU, VUMC has operated as 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. At legal separation, VUMC and VU entered into several agreements that govern the relationship between the two entities moving forward as 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 academic and residency 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 annualized fee of $70.0 million 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 2017, VUMC recorded operating expenses totaling $71.5 million 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, as discussed in Note 3—Acquisitions.

- 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 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 (as defined in the TMLA) of VUMC and a percentage of net income (0% in Fiscal 2017, 5% in Fiscal 2018, 10% in Fiscal 2019, and 15% in Fiscal 2020 and beyond) from operations (as defined in the TMLA). Also, VUMC is required to pay VU, in equal monthly installments, an annualized fee of $61.8 million, increasing by 3% annually, and reduced by the amount of principal payments made under the subordinate note payable to VU discussed in Note 12—Long-Term Debt. This agreement is in force in perpetuity under certain mutually agreed upon termination or default clauses. During Fiscal 2017, VUMC recorded operating expenses totaling $96.0 million 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 fifty to ninety-nine years each with agreement between VU and VUMC. The lease covers 1.7 million square feet or 38.75 acres of space with an annual base rent of $18.0 million payable monthly and CPI adjusted annually beginning in Fiscal 2017. During Fiscal 2017, VUMC recorded operating expenses totaling $18.1 million 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 will provide services to VUMC such as information technology infrastructure support, utilities, and law enforcement staffing. VUMC will provide various operational services for the University such as student health centers, a psychological counseling center, 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 on-going 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 pre-determined cancellation notification periods. In connection with the MSA, during Fiscal 2017, VUMC recognized revenue totaling $50.8 million and recorded operating expenses totaling $121.3 million.

- Also, as part of the Acquisition, VUMC issued to VU a $100.0 million subordinate promissory note payable, which is further described in Note 12—Long-Term Debt, with a balance of $94.6 million as of June 30, 2017, and $99.2 million as of June 30, 2016. During Fiscal 2017, VUMC recorded interest expense totaling $3.1 million associated with this subordinate promissory note payable to VU.

The impact of these related party agreements in the statement of operations during Fiscal 2017 is as follows:

($ in thousands)

Other operating revenues	$	50,847
Operating expenses		
Salaries, wages, and benefits	$	700
Supplies and drugs		338
Facilities and equipment		53,989
Services and other		251,884
Interest		3,148
Total operating expenses	$	310,059

Other current assets include amounts receivable from VU, which totaled $5.8 million as of June 30, 2017, and $21.2 million as of June 30, 2016. Accounts payable and other accrued expenses include amounts payable to VU, which totaled $30.0 million as of June 30, 2017, and $26.2 million as of June 30, 2016, for services provided to VUMC under the MSA. As of June 30, 2017, the receivable from VU relates to services provided by VUMC to VU under the MSA. As of June 30, 2016, $17.3 million of the receivable from VU represents the final settlement of the Acquisition, with the remainder relating to services provided by VUMC to VU under the MSA.

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, and 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 manage appropriately the actual or perceived conflict in the best interests of VUMC, including periodic reporting of the measures taken to the Board of Directors Audit Committee.

5. Patient Service Revenue, Patient Accounts Receivable, and Estimated Third-party Settlements

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

Commercial/managed care	63.5 %
Medicare/Managed Medicare	22.8
TennCare/Medicaid	12.2
Uninsured (self-pay)	1.5
	100.0 %

Patient service receivables, net, comprise the following as of June 30, 2017 and 2016:

($ in thousands)	**2017**	**2016**
Patient accounts receivable, net of contractual adjustments and discounts[(1)]	$ 509,180	$ 363,459
Allowance for bad debts[(1)]	(130,476)	(20,218)
Patient accounts receivable, net	$ 378,704	$ 343,241

[(1)] At the Acquisition, patient accounts receivable were recorded at their fair value, thus the opening balance of the allowance for bad debts was zero. The allowance as of June 30, 2016 represents two months of activity post-Acquisition.

Patient accounts receivable, net of related contractual adjustments, discounts, and bad debt allowances comprise amounts due from the following sources as of June 30, 2017 and 2016:

($ in thousands)	**2017**	**2016**
Medicare	$ 56,890	$ 51,238
TennCare/Medicaid	55,207	51,769
Blue Cross	77,514	76,847
Other third-party payors, primarily commercial carriers	149,049	127,828
Patient responsibility[(1)]	40,044	35,559
Patient accounts receivable, net	$ 378,704	$ 343,241

[(1)] Includes self-pay after insurance.

Estimated third-party settlements by major payor category as of June 30, 2017 and 2016, are as follows:

($ in thousands)		**2017**		**2016**
Receivables under third-party programs				
Tricare/Champus	$	4,712	$	9,123
Medicare		7,930		-
Total receivables under third-party programs	$	12,642	$	9,123
Payables under third-party programs				
TennCare/Medicaid	$	37,072	$	12,385
Medicare		-		18,024
Other		-		581
Total payables under third-party programs	$	37,072	$	30,990

Certain contracts require pay for performance or episode of care settlements whereby VUMC receives additional payment or pays a penalty based on 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 estimates in future periods as settlements are finalized. The aggregate liability associated with pay for performance and episode of care settlements at June 30, 2017 and 2016, was $1.7 million and $0.6 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 more recent years due to audit delays experienced with the Medicare Administrative Contractor. VUMC expects final settlements relative to periods through June 30, 2013, to be complete during Fiscal 2018. Years without final settlement determinations are subject to audit by program representatives. VUMC records provisions in the financial statements for the effects of estimated final settlements. The receivable above is 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 2017, patient service revenues, net, include the following supplemental amounts from TennCare:

($ in thousands)

Essential access	$	13,731
Disproportionate share		11,078
Trauma fund		1,798
Graduate medical education		14,117
Reserve for disproportionate share audit		(27,593)
Total supplemental TennCare revenue, net of audit reserves	$	13,131

6. 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 forgone 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 2017 total $261.1 million. The estimated cost of providing care to charity patients in Fiscal 2017 totals $70.8 million, an amount which has been reduced by any reimbursements from governmental assistance programs to subsidize its care of indigent patients.

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, together with support groups for many patients with special needs.

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

Academic and research revenue comprises the following for Fiscal 2017:

($ in thousands)

Grants and contracts revenue		
Federally funded	$	234,389
Nonfederally funded		93,762
		328,151
Facilities and administrative costs recovery		88,187
Facilities and administrative costs recovery	$	416,338

Grants and contracts receivable comprise the following as of June 30, 2017 and 2016:

($ in thousands)		2017		2016
Federally funded	$	31,603	$	33,353
Nonfederally funded		37,192		28,331
		68,795		61,684
Allowance for bad debts		(1,546)		(741)
Total grants and contracts receivable, net	$	67,249	$	60,943

8. Pledges Receivable, net

Pledges receivable, net of applied discounts and allowance for uncollectible pledges as of June 30, 2017 and 2016 were as follows:

($ in thousands)	**2017**	**2016**
Amounts due		
Within one year	$ 7,022	$ 6,136
In one to five years	12,417	7,928
Total pledges receivable	19,439	14,064
Unamortized discount	(449)	(266)
	18,990	13,798
Allowance for uncollectible pledges	(1,934)	(65)
Net pledges receivable	$ 17,056	$ 13,733
Net pledges receivable classified as		
Current	$ 5,785	$ 6,070
Noncurrent	11,271	7,663
	$ 17,056	$ 13,733
Net pledges receivable by asset class		
Unrestricted	$ 105	$ 194
Temporarily restricted	14,475	13,347
Permanently restricted	2,476	192
	$ 17,056	$ 13,733

In addition to pledges reported as pledges receivable, VUMC had cumulative bequest intentions and conditional promises to give totaling $43.0 million as of June 30, 2017, and $37.7 million as of June 30, 2016. Due to their conditional nature, VUMC does not recognize intentions to give as assets.

9. Other Relevant Financial Information

Other current assets comprise the following as of June 30, 2017 and 2016:

($ in thousands)	**2017**	**2016**
Prepaid expenses	$ 20,137	$ 23,243
Other receivables	27,363	28,274
Amounts due from VU (see Note 4—Related Parties)	5,814	21,178
Current pledges receivable, net (see Note 8— Pledges Receivable, net)	5,785	6,070
Expected recoveries from commercial insurance carriers	4,028	6,759
Other	5,931	1,496
Total other current assets	$ 69,058	$ 87,020

Other noncurrent assets comprise the following as of June 30, 2017 and 2016:

($ in thousands)		**2017**		**2016**
Equity in unconsolidated organizations	$	20,184	$	19,028
Noncurrent pledges receivable (see Note 8— Pledges Receivable, net)		11,271		7,663
Other		3,138		6,475
Total other noncurrent assets	$	34,593	$	33,166

Other operating revenue comprises the following for Fiscal 2017:

($ in thousands)		
Amounts recognized under MSA with VU (see Note 3—Acquisitions and Note 4—Related Parties)	$	50,847
Clinical contracts		25,304
Medical services provided during air transports		10,561
Resident and house staff rotations		9,147
Other		56,052
Total other operating revenue	$	151,911

In Fiscal 2017, noncash investing and financing activities totaled $9.0 million related to property, plant, and equipment expenditures financed through the product financing arrangement and capital leases discussed in Note 12—Long-Term Debt.

10. Investments

VUMC investment balances are as follows as of June 30, 2017 and 2016:

($ in thousands)		**2017**		**2016**
Current				
Unrestricted investments	$	133,977	$	-
		133,977		-
Noncurrent				
Unrestricted investments		94,412		-
Investments limited as to use		202,592		196,944
		297,004		196,944
	$	430,981	$	196,944

VUMC investments include assets limited as to use related to the following specified purposes as of June 30, 2017 and 2016:

($ in thousands)	**2017**	**2016**
Assets held in trust		
Self-insured malpractice program	$ 69,849	$ 79,280
Self-insured workers' compensation program[1]	-	9,040
	69,849	88,320
Internally designated	85,865	79,380
Externally designated		
Donor-designated gifts for capital assets	31,248	22,315
Donor endowments	8,283	545
Split-interest trusts	7,347	6,384
	46,878	29,244
	$ 202,592	$ 196,944

(1) In Fiscal 2017, VUMC obtained a surety bond to meet state security requirements for its self-insured workers' compensation program, eliminating the need to set aside investments for this purpose.

Endowment-related assets include both donor-restricted endowment funds, included in externally designated, 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 Director's 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.

Investments were as follows as of June 30, 2017 and 2016:

($ in thousands)	**2017**	**2016**
Corporate bonds	$ 119,045	$ -
Equity mutual funds	112,704	88,565
Restricted cash	32,569	22,956
Split-interest trusts	7,347	6,384
Hedged equity funds	14,759	14,740
Fixed income mutual funds	38,211	35,377
Certificates of deposit	38,657	-
Asset-backed securities	21,779	-
Real estate mutual funds	16,206	13,398
Commercial paper	11,609	-
Government bonds	9,097	9,019
Hedged debt funds	5,178	3,200
Commodities and managed futures mutual funds	3,820	3,305
Total investments, at fair value	$ 430,981	$ 196,944

Investment returns comprise the following elements for Fiscal 2017:

($ in thousands)	
Interest and dividend income	$ 8,417
Net realized gains on sales of securities	3,493
Realized investment gains, before fees	11,910
Unrealized investment gains and losses, net	12,878
Total investment returns before fees	24,788
Investment manager and trustee fees and other	(3,538)
Total income from investments	$ 21,250

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.

11. Property, Plant, and Equipment, Net

Property, plant, and equipment comprise the following as of June 30, 2017 and 2016:

($ in thousands)	2017	2016
Land and land improvements	$ 27,762	$ 18,117
Buildings and improvements	893,728	863,023
Equipment	205,357	164,395
Construction in progress	196,828	98,860
Property, plant, and equipment at cost	1,323,675	1,144,395
Accumulated depreciation and amortization	(103,907)	(14,279)
Property, plant, and equipment, net	$ 1,219,768	$ 1,130,116

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:

($ in thousands)	2017	2016
Equipment	$ 6,287	$ 5,800
Construction in progress(1)	92,478	33,378
	98,765	39,178
Accumulated amortization	(2,230)	(319)
Internal use software, carrying value	$ 96,535	$ 38,859

(1) As of June 30, 2017 and 2016, construction in progress includes $24.9 million and $3.0 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, 2017 and 2016, internal use software capitalized includes $92.5 million and $33.4 million, respectively, of costs related to the implementation of an integrated electronic health record and revenue cycle system. The system is scheduled to go-live in November 2017. Once the software is ready for its intended use, these costs will be amortized over the estimated 12 year life. VUMC anticipates approximately $130 million of capitalizable internal software costs related to this project. In addition to internal use software, VUMC has capitalized $23.8 million of hardware costs related to this project and does not anticipate incurring material amounts of additional hardware costs through the go-live date.

Depreciation and amortization comprised the following amounts in Fiscal 2017:

($ in thousands)

Depreciation of tangible assets	$	82,836
Amortization of capital leases, leasehold improvements, and internal use software		8,607
Total depreciation and amortization	$	91,443

In Fiscal 2017, VUMC capitalized interest of $1.1 million related to long-term capital projects, primarily internal use software costs. As of June 30, 2017 there were $16.7 million of capital expenditures incurred but not yet paid. These costs are included in accounts payable and other accrued expenses on the consolidated balance sheet.

12. Long-Term Debt

Long-term debt comprises the following as of June 30, 2017 and 2016:

($ in thousands)	2017 Carrying Amount	2017 Effective Interest Rate	2016 Carrying Amount	2016 Effective Interest Rate
2016 Series Debt, at par				
Fixed-rate debt				
Series 2016A	$ 476,930	4.1 %	$ 476,930	4.3 %
Series 2016B	300,000	4.1 %	300,000	4.3 %
Total fixed-rate debt	776,930	4.1 %	776,930	4.3 %
Variable-rate debt				
Series 2016C	50,000	2.2 %	50,000	1.9 %
Series 2016D	100,000	3.3 %	100,000	3.2 %
Series 2016E	128,070	3.2 %	128,070	3.0 %
Series 2016F	75,000	3.3 %	75,000	3.1 %
Total variable-rate debt	353,070	3.1 %	353,070	2.9 %
Total 2016 Series Debt, par	1,130,000		1,130,000	
Other long-term debt				
Note payable to VU	94,583	3.2 %	99,166	3.2 %
Product financing arrangement	22,273	4.0 %	14,977	4.1 %
Capital leases	1,448	4.5 %	-	
Subtotal[(1)]	1,248,304	3.8 %	1,244,143	3.9 %
Net unamortized premiums	57,467		59,328	
Net unamortized issuance costs	(11,672)		(12,408)	
Total long-term debt	1,294,099		1,291,063	
Current portion	(5,753)		(5,000)	
Long-term debt, net	$ 1,288,346		$ 1,288,346	

(1) The effective interest rate, 3.8% as of June 30, 2017, and 3.9% as of June 30, 2016, is presented exclusive of interest rate exchange agreements discussed in Note 13—Interest Rate Exchange Agreements. Inclusive of these agreements, the overall portfolio effective interest rate was 4.2%.

On April 29, 2016, VUMC issued the Series 2016 A,B,C,D,E, and F bonds ("2016 Series Debt") and notes aggregating $1.278 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 semi-annually on July 1st and January 1st.

- The Series 2016B taxable fixed-rate revenue bonds were issued in the par amount of $300.0 million bear interest at 4.1% per annum, and have 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 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%. The R-FLOATs have an optional tender provision whereby the bondholder can tender the bond to the trustee for purchase in whole or part. The funds for optional redemption are derived solely from remarketing proceeds or funds provided by VUMC; however, VUMC is not required to provide such funds. If the bonds cannot be remarketed at optional redemption, they are returned to the bondholder and enter a term out period of 24 months. If bonds cannot be successfully remarketed by the end of the 24-month term out period, they are subject to mandatory redemption. In addition to optional redemption of all or a portion of the bonds, the Series 2016C bonds are subject to mandatory sinking fund redemption starting on July 1, 2030 through final maturity of July 1, 2046.

- 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. 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 of July 1, 2022. If the Series 2016F bonds are successfully remarketed, the bonds can be optionally redeemed in-part or in-whole in the current interest mode at par on or after July 1, 2022, at which time the bonds are also subject to mandatory sinking fund redemption until the final maturity date of July 1, 2041.

Each of the bonds and notes comprising the 2016 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 members participating in the obligated group. All debt issued under the MTI are general obligations 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.

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, 2017 and 2016.

On April 29, 2016, VUMC delivered a secured subordinated promissory note in the amount of $100.0 million to Vanderbilt 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 twenty 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 of 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 2026. The balance due under the Product Financing Arrangement is $22.3 million and $15.0 million as of June 30, 2017 and 2016, respectively, and is included in the long-term debt caption of the consolidated balance sheets.

Interest paid on all obligations, net of amounts capitalized was $38.0 million in Fiscal 2017.

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:

2018	$ 5,753
2019	5,391
2020	7,486
2021	8,866
2022	109,030
Thereafter	1,111,778
	$ 1,248,304

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 27, 2018, and can be renewed. Interest on each advance under this line of credit accrues at a rate of 0.75% plus LIBOR, and a commitment fee of 0.20% 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 2017. No amounts were drawn under this credit facility as of June 30, 2017, or June 30, 2016.

13. 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 with 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 2017:

($ in thousands)

Mark-to-market adjustments	$ 24,333
Cash settlements	(5,488)
Unrealized gain on interest rate exchange agreements, net of cash settlements	$ 18,845

14. 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 2017 are as follows:

($ in thousands)			**Location in Consolidated Statement of Operations**
Operating lease rental expense	$	108,008	Operating Expenses— Facilities and equipment
Operating lease rental income, including related party income		7,764	Operating Revenues— Other operating revenue

The following is a schedule by fiscal year of future minimum rentals on noncancelable operating leases as of June 30, 2017:

($ in thousands)	**Equipment**	**Property**	**Ground Lease**	**Total**
2018	$ 18,794	$ 46,053	$ 18,602	$ 83,449
2019	14,684	44,159	18,602	77,445
2020	10,406	43,016	18,602	72,024
2021	6,392	35,899	18,602	60,893
2022	5,234	28,167	18,602	52,003
Thereafter	4,652	170,149	1,730,023	1,904,824
Total minimum rentals	$ 60,162	$ 367,443	$ 1,823,033	$ 2,250,638

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 fifty to ninety-nine years each upon agreement by VU and VUMC. The initial annual base rent of $18.0 million is payable monthly and CPI 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 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 twelve years. In October 2014, VU agreed to an amendment which extends the original lease term by an additional fifteen years, with an option to renew the lease further for four additional ten-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 2017. VUMC included minimum property rental payments totaling $138.8 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 $90.9 million related to this space in the above future minimum property rentals.
- 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, 2017, VUMC's estimated future minimum property lease payments to VU totaled $34.3 million, and estimated future lease receipts from VU totaled $61.4 million. For the fiscal years ended June 30, 2018 through 2022, the minimum rental receipts from VU are $6.8 million.

15. Net Assets

Net assets restrictions relate to the following purposes as of June 30, 2017 and 2016:

($ in thousands)	**2017**	**2016**
Temporarily restricted		
Property, plant, and equipment	$ 31,248	$ 15,737
Research and education	35,807	11,087
Operations	2,003	161
Total temporarily restricted net assets	$ 69,058	$ 26,985
Permanently restricted		
Research and education	$ 17,865	$ 6,769

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.

In Fiscal 2017 VUMC recorded adjustments whose net impact on net asset balances as of June 30, 2016, was to decrease unrestricted net assets by $22.2 million, increase temporarily restricted net assets by $19.7 million, and increase permanently restricted net assets by $2.5 million. The reclassification resulted from donor-restricted pledges and capital gifts totaling $15.6 million and $6.6 million, respectively, which were included in unrestricted net assets as of June 30, 2016.

16. 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 asset 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 approximate fair value.

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. As of June 30, 2016, the carrying value and estimated fair value of total long-term debt totaled $1.291 billion and $1.378 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 2016 Series Debt, as defined in Note 12—Long-Term Debt, were based on a Level 2 computation using quoted prices for similar liabilities in inactive markets as of June 30, 2017 and 2016, as applicable. The carrying amounts related to VUMC's variable rate 2016 Series Debt and other long-term debt obligations approximate their fair values as of June 30, 2017 and 2016. As of June 30, 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. As of June 30, 2016, fair values of the promissory note payable to VU and the product financing arrangement approximate their carrying value.

For financial instruments measured at fair value on a recurring basis, the following tables summarize valuation hierarchy levels as of June 30, 2017 and 2016, 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, 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
Restricted cash	32,569	-	-	32,569
Beneficial interests in split-interest trusts	7,347	-	-	7,347
Hedged equity 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 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

	Fair Value Measurements as of June 30, 2016			
($ in thousands)	**Level 1**	**Level 2**	**Level 3**	**Total Carrying Amount**
Assets				
Equity mutual funds	$ 12,038	$ 76,527	-	$ 88,565
Restricted cash	22,956	-	-	22,956
Beneficial interests in split-interest trusts	6,384	-	-	6,384
Hedged equity funds	4,567	10,173	-	14,740
Fixed income mutual funds	4,926	30,451	-	35,377
Real estate mutual funds	-	13,398	-	13,398
Government bonds	9,019	-	-	9,019
Hedged debt funds	-	3,200	-	3,200
Commodities and managed futures mutual funds	-	3,305	-	3,305
Total assets reported at fair value	$ 59,890	$ 137,054	$ -	$ 196,944
Liabilities				
Interest rate exchange agreements	$ -	$ 89,536	$ -	$ 89,536
Total liabilities reported at fair value	$ -	$ 89,536	$ -	$ 89,536

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 sum 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.

17. 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 2017, VUMC recognized $56.7 million of expense in connection with these plans.

18. Functional Expenses

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

($ in thousands)

Healthcare services	$ 2,974,923
Academic research and education	597,625
Administrative and other	152,558
Total operating expenses	$ 3,725,106

19. Commitments and Contingencies

Management has policies, procedures, and a compliance overview 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.

One such legal action was a qui tam civil action related to billing and government reimbursement for certain professional health care services provided by VUMC, which was filed in 2011. The parties agreed to settlement terms prior to June 30, 2017; VUMC has accrued an amount equal to the agreed upon settlement, which is not material to VUMC's overall financial position.

In February 2015, VUMC received a letter from the Office of Audit Services (OAS) of the Office of Inspector General (OIG) in connection with its nationwide review to determine whether, in certain cases, services were provided to certain Medicare beneficiaries in accordance with national coverage criteria. OAS has issued their final report regarding their audit which contains an overpayment amount. VUMC resolved the matter by repaying certain funds previously received prior to June 30, 2017; the repayment amount was not material to VUMC's overall financial position.

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. That 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.

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, 2017, 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.

- Medical Malpractice Liability Insurance. The consolidated balance sheet includes reserves for medical malpractice, professional, and general liability coverage totaling $71.5 million as of June 30, 2017, and $88.0 million as of June 30, 2016. 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. The $16.5 million reduction in total medical malpractice self-insurance reserves from June 30, 2016 to June 30, 2017 primarily reflects a $12.2 million change in estimate recorded during Fiscal 2017 to reflect improved claims experience observed during Fiscal 2017. Other current assets include expected recoveries from commercial insurance carriers under excess coverage arrangements totaling $4.0 million as of June 30, 2017, and $6.8 million as of June 30, 2016.

- Employee Health and Workers' Compensation Insurance. Accrued compensation and benefits included actuarially determined liabilities for employee health and workers' compensation claims totaling $16.0 million and $7.3 million, respectively, as of June 30, 2017, and $19.1 million and $7.9 million, respectively, as of June 30, 2016. During Fiscal 2017, VUMC recorded expenses totaling $154.8 million for self-insured employee health benefit plans, net of employee premiums, and $3.0 million for self-insured workers' compensation insurance plans.

- 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 would not expect these costs to influence the consolidated financial position by material amounts.

- Health Care Services. In Fiscal 2017, 85% 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 5—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 $109.2 million as of June 30, 2017.

- Letter of Credit. As a requirement of the assignment of the 100 Oaks Lease described in Note 14—Operating Leases, VUMC provided an irrevocable standby letter of credit of $25.0 million to the landlord of the property dated June 10, 2016.

20. Subsequent Events

Management evaluated events after June 30, 2017, through October 19, 2017, the date on which the financial statements were available for issuance. During this period, there were no subsequent events requiring recognition in the consolidated financial statements that have not been recorded.

On July 26, 2017, VUMC issued the Series 2017A tax-exempt and Series 2017 taxable fixed-rate bonds in the aggregate amount of $221.3 million to provide new project funding to finance the construction, expansion, and renovation of various facilities and related equipment. The Series 2017A bonds were issued by the HEFB, as VUMC's conduit, at a par amount of $121.3 million, include an original issue premium of $5.1 million, and have an average coupon of 4.38%. Of the $121.3 million par amount, $75.0 million mature in 2047, with the remainder maturing in 2048. The Series 2017 taxable bonds were issued by VUMC at a par amount of $100.0 million, bear interest at 4.172% per annum, and mature in 2037.

On August 1, 2017, VUMC issued the Series 2017B taxable notes through the HEFB at a par amount of $50.0 million for fully redeeming the Series 2016C taxable variable-rate revenue bonds (R-FLOATs). The Series 2017B notes were placed privately with a bank and were issued in a variable-rate mode to bear interest at a fixed spread to one-month LIBOR of 1.15%.

On August 1, 2017, VUMC restructured certain terms of its Series 2016E and F variable rates bonds which are placed privately with two banks. The credit spread on the Series 2016E bonds was reduced to 1.75% from 2.4%, while the credit spread for the Series 2016F bonds was reduced to 1.15% from 2.5%. Additionally, the mandatory tender date of the Series 2016F bonds was extended two years to July 1, 2024.

Subsequent to June 30, 2017, the previously disclosed qui tam civil action was settled for an amount not material to VUMC's overall financial position.

Report of Independent Auditors on Supplemental Schedules

To the Board of Directors of
Vanderbilt University Medical Center

We have audited the consolidated financial statements of Vanderbilt University Medical Center as of June 30, 2017 and for the year then ended and our report thereon appears on page one of this document. That audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating 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 consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual companies and is not a required part of the consolidated financial statements. Accordingly, we do not express an opinion on the financial position or results of operations of the individual companies.

PricewaterhouseCoopers LLP

October 19, 2017

PricewaterhouseCoopers LLP, 150 3rd Avenue South, Suite 1400, Nashville, TN 37201
T: (615) 503 2860, F: (615) 503 2870, www.pwc.com/us

Vanderbilt University Medical Center
Consolidating Balance Sheet
June 30, 2017

($ in thousands)	Obligated Group	Nonobligated Entity	Consolidated
Assets			
Current			
Cash and cash equivalents	$ 520,631	$ 226	$ 520,857
Current investments	133,977	-	133,977
Patient accounts receivable, net	373,774	4,930	378,704
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	61,908	7,150	69,058
Total current assets	1,237,136	12,829	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	$ 2,775,378	$ 25,952	$ 2,801,330
Liabilities and Net Assets			
Current			
Current installments of long-term debt	$ 5,753	$ -	$ 5,753
Accounts payable and other accrued expenses	261,712	10,929	272,641
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	552,033	14,686	566,719
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	15,093	-	15,093
Total liabilities	1,985,338	15,090	2,000,428
Net assets			
Unrestricted net assets controlled by VUMC	703,117	4,971	708,088
Unrestricted net assets related to noncontrolling interests	-	5,891	5,891
Total unrestricted net assets	703,117	10,862	713,979
Temporarily restricted net assets	69,058	-	69,058
Permanently restricted net assets	17,865	-	17,865
Total net assets	790,040	10,862	800,902
Total liabilities and net assets	$ 2,775,378	$ 25,952	$ 2,801,330

Vanderbilt University Medical Center
Consolidating Balance Sheet
June 30, 2016

($ in thousands)	Obligated Group	Nonobligated Entity	Consolidated
Assets			
Current			
Cash and cash equivalents	$ 592,977	$ 3,529	$ 596,506
Patient accounts receivable, net	339,386	3,855	343,241
Estimated receivables under third-party programs	9,123	-	9,123
Grants and contracts receivable, net	60,943	-	60,943
Inventories	61,330	595	61,925
Other current assets	80,721	6,299	87,020
Total current assets	1,144,480	14,278	1,158,758
Noncurrent investments limited as to use	196,944	-	196,944
Property, plant, and equipment, net	1,126,490	3,626	1,130,116
Other noncurrent assets	23,567	9,599	33,166
Total assets	$ 2,491,481	$ 27,503	$ 2,518,984
Liabilities and Net Assets			
Current			
Current installments of long-term debt	$ 5,000	$ -	$ 5,000
Accounts payable and other accrued expenses	201,189	4,845	206,034
Bank overdrafts	13,846	-	13,846
Estimated payables under third-party programs	30,990	-	30,990
Accrued compensation and benefits	197,769	2,341	200,110
Current portion of deferred revenue	37,317	1,028	38,345
Current portion of medical malpractice self-insurance reserves	20,657	-	20,657
Total current liabilities	506,768	8,214	514,982
Long-term debt, net of current installments	1,286,063	-	1,286,063
Fair value of interest rate exchange agreements	89,536	-	89,536
Noncurrent portion of medical malpractice self-insurance reserves	67,319	-	67,319
Noncurrent portion of deferred revenue	6,110	158	6,268
Other noncurrent liabilities	11,641	-	11,641
Total liabilities	1,967,437	8,372	1,975,809
Net assets			
Unrestricted net assets controlled by VUMC	490,290	13,604	503,894
Unrestricted net assets related to noncontrolling interests	-	5,527	5,527
Total unrestricted net assets	490,290	19,131	509,421
Temporarily restricted net assets	26,985	-	26,985
Permanently restricted net assets	6,769	-	6,769
Total net assets	524,044	19,131	543,175
Total liabilities and net assets	$ 2,491,481	$ 27,503	$ 2,518,984

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

($ in thousands)	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	416,334	4	416,338
Other operating revenue	143,458	8,453	151,911
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	235,247	10,484	245,731
Services and other	574,880	30,107	604,987
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 revenue and expense	49,075	3,839	52,914
Excess of revenues over expense	227,011	4,365	231,376
Excess of revenues over expense attributable to noncontrolling interests	-	(4,883)	(4,883)
Excess (deficiency) of revenues over (under) expenses attributable to VUMC	$ 227,011	$ (518)	$ 226,493

Basis of Presentation

As discussed in Note 12—Long-Term Debt, each of the bonds and notes comprising the 2016 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.