

# **SPECTRUM HEALTH SYSTEM AND AFFILIATES**

## **CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2016**



# **SPECTRUM HEALTH SYSTEM AND AFFILIATES**

## **CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2016**

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- II. Other Financial Information
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  - B. Key Statistics
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(prepared by Ernst & Young)

# SPECTRUM HEALTH SYSTEM AND AFFILIATES

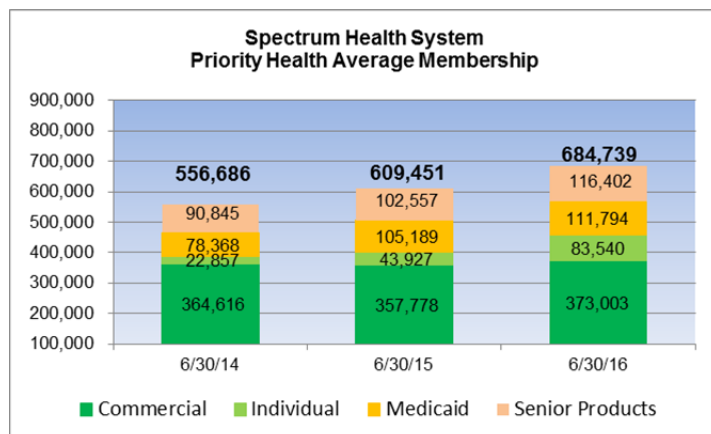
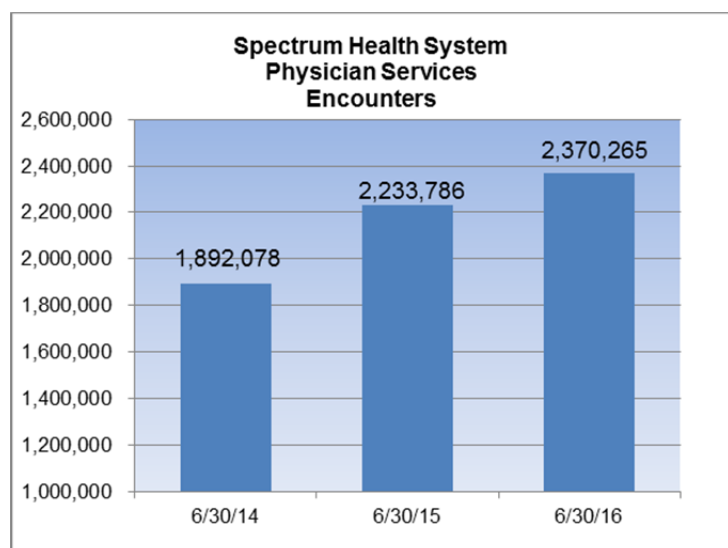
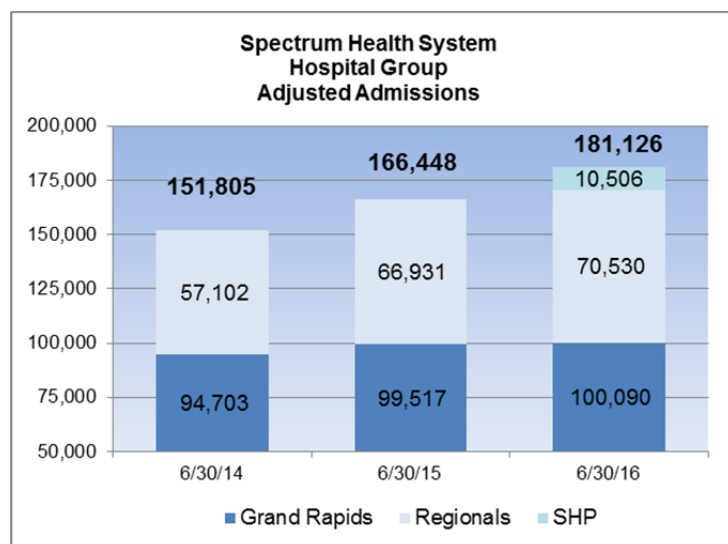
## Chief Financial Officer's Report

FOR THE YEAR ENDED JUNE 30, 2016

The enclosed package represents the consolidated financial statements for Spectrum Health System and its Affiliates (the System). The financial statements have been summarized by the System's delivery, insurance and other operations.

### Volume

Spectrum Health Grand Rapids adjusted (for outpatient) admissions, totaling 100,090 were slightly above June 30, 2015 levels, and better than plan on a year-to-date basis. Regional hospitals adjusted admissions increased over 2015, and are slightly below plan for the year. Spectrum Health Physicians Services encounters totaled 2.4 million which was an increase of 6.1% over the prior year. Health insurance average membership increased to 684,739, which was a 12.4% increase compared to June 30, 2015. Actual membership at June 30, 2016 was 731,802.

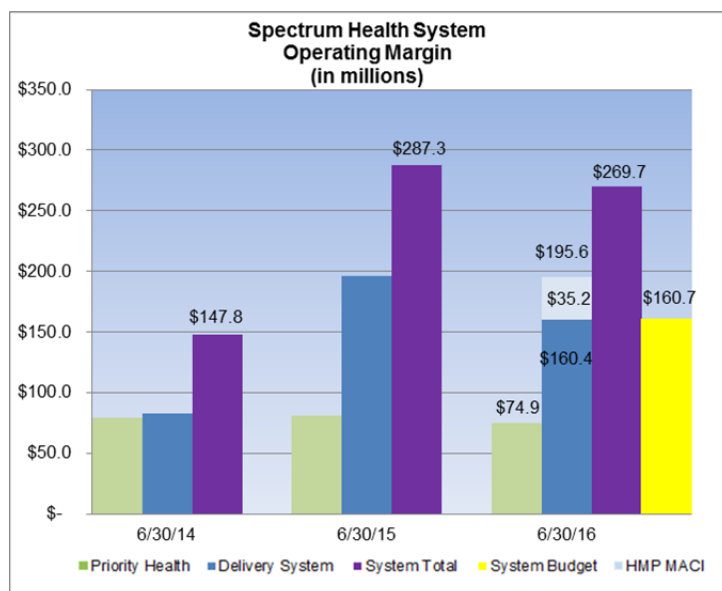


### Margin

The System's excess of revenue over expense for the year ended June 30, 2016, was \$212.0 million or 4.1% of total revenue. The System's operating margin was \$269.7 million or 5.2% of net operating revenue.

The Delivery System's operating margin was \$195.6 million, or 6.6%, which was favorable to budget by \$65.4 million. The impact of a \$35.2 million payment for the Healthy Michigan Medicaid Access to Care Initiative (HMP MACI), and increased volumes in the high acuity areas are driving the favorable variance. The Delivery System is comprised of the Hospital Group and Physician Services.

Priority Health's operating margin was \$74.9 million, or 2.5%, which was \$16.7 million favorable to budget and \$5.7 million less than prior year. The variance to budget was driven by a favorable medical cost ratio and better than expected membership.



# SPECTRUM HEALTH SYSTEM AND AFFILIATES

## Chief Financial Officer's Report

FOR THE YEAR ENDED JUNE 30, 2016

### Other Revenue (Expense)

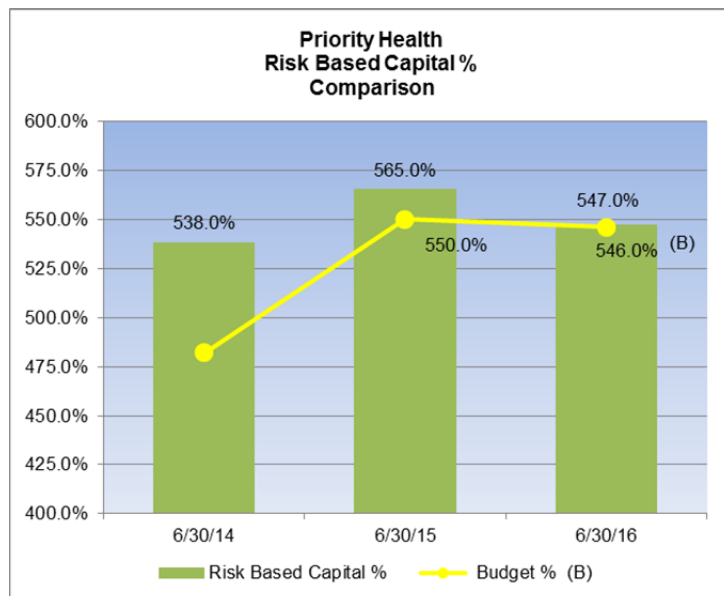
The net other expense of \$52.0 million was comprised primarily of \$57.2 million of swap losses and other expense of \$19.5 million, offset by \$24.7 million of investment gains. The \$24.7 million of investment gains consisted of \$49.9 million of realized investment returns, partially offset by \$25.2 million of unrealized losses, which are a function of the market. The \$52.0 million loss was \$137.7 million worse than the prior year ended June 30, 2015.

### Liquidity and Cash Flow

At June 30, 2016, total cash and investments for the System were at \$2.5 billion, an increase of \$260.8 million over June 30, 2015. Operating cash flow provided \$467.7 million and working capital provided \$5.9 million for the year, offset by a net decrease in long term debt of \$6.1 million. Cash used for facility, information technology, and equipment additions totaled \$200.9 million through June 30, 2016. The non-operating cash decrease of \$8.3 million was primarily due to unrealized losses on investments and swaps.

### Ratios

Days cash on hand for the System decreased to 196.4 at June 30, 2016, down 0.9% from 198.2 days reported at June 30, 2015. Priority Health's risk based capital (RBC) was 547.0% at June 30, 2016. Operating cash flow margin was 9.0% at June 30, 2016, which is just below Moody's Aa3 median of 10.0% for 2014.

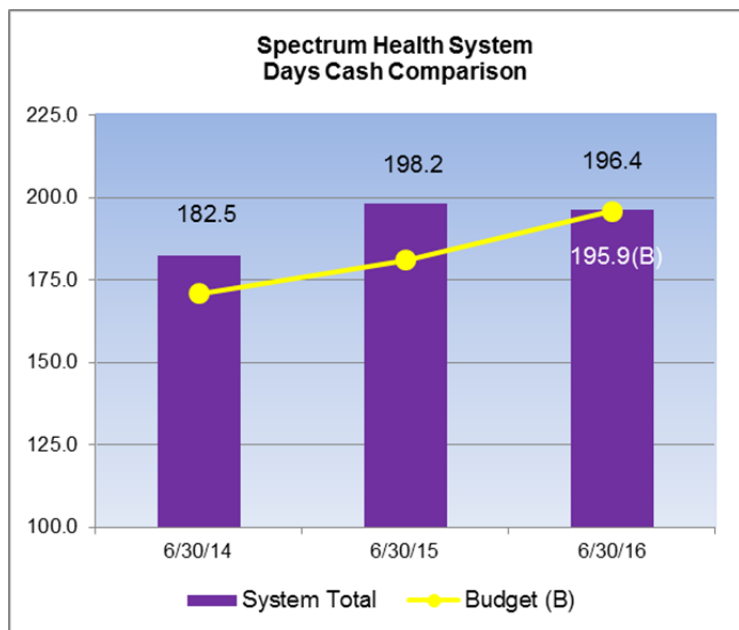


### Equity Structure

Debt was approximately \$858.4 million at the end of June and fund balance was approximately \$2.8 billion. The long-term debt to capitalization ratio for the System at June 30, 2016 was 24.9%, which was lower than the Moody's Aa3 median of 29.6% for 2014. Total assets for the System were approximately \$5.0 billion.

Respectfully submitted,

Ronald J. Knaus  
Senior Vice President & Chief Financial Officer  
(ron.knaus@spectrumhealth.org)  
June, 2016



# SPECTRUM HEALTH SYSTEM AND AFFILIATES

## Ratio Analysis - Total System

June 30, 2016

	June 30, 2016	Total System June 30, 2015	Total System Budget June 30, 2016	2014 Moody's Median
<b><u>Profitability Ratios</u></b>				
Operating Margin	5.2%	6.2%	3.2%	3.7%
Total Margin	4.1%	7.8%	4.1%	7.4%
Return on Assets	4.2%	8.0%	4.2%	5.7%
Operating Cash Flow Margin	9.0%	10.4%	7.4%	10.0%
<b><u>Liquidity Indicators</u></b>				
Days in Patient Receivables	50.5	49.3	45.6	48.0
Days Cash (unrestricted) on Hand	196.4	198.2	195.9	267.0
Current Ratio	1.3	1.3	1.2	1.7
Cash to Debt %	298.4%	261.8%	280.2%	199.1%
<b><u>Capital Structure</u></b>				
Long Term Debt to Capitalization	24.9%	26.1%	25.3%	29.6%
Proforma Long Term Debt to Capitalization - Leases*	28.3%	n/a	28.2%	n/a
Debt Service Coverage	9.9	13.4	10.7	7.6
Debt to Cash Flow	2.2	1.6	2.3	2.5
Risk Based Capital (PH only)	547.0%	565.0%	546.0%	409.0% (a)
Average Age of Plant	9.6	9.0	9.1	10.3
Capital expenditures to depreciation	1.1	0.9	1.4	1.1

(a) AM Best benchmark based on December 31, 2015.

Note: Moody's figures are medians for hospitals with Aa3 bond ratings for 2014.  
Spectrum Health's current rating from Moody's is Aa3.

\* Estimated impact of proposed lease accounting standard in FY19.

## SPECTRUM HEALTH SYSTEM AND AFFILIATES

### Key Statistics

Year ended June 30, 2016

### DELIVERY SYSTEM

	Actual	Better (Worse) than Budget	Prior Year
<b><u>Spectrum Health Grand Rapids</u></b>			
Admissions	58,767	1,080	58,627
Admissions - SHCAR	621	(50)	592
Patient Days - Acute care	284,297	6,230	279,018
Patient Days - Observation	12,191	1,596	11,869
Patient Days - SHCAR	7,753	(299)	7,103
Adjusted Admissions	100,090	1,438	99,517
Cost per Adj. Patient Admission	\$ 17,745	\$ (213)	\$ 16,413
<b><u>Spectrum Health Regional Hospitals</u></b>			
Admissions	14,505	(486)	12,761
Patient Days - Acute care	43,124	(1,811)	38,032
Patient Days - Observation	4,341	(339)	3,932
Patient Days - Long Term Care	40,459	(941)	41,081
Adjusted Admissions	81,036	(212)	66,931
Cost per Adj. Patient Admission	\$ 6,299	\$ 39	\$ 6,090
<b><u>Spectrum Health Post Acute Care</u></b>			
Patient Days - combined	230,746	(6,534)	231,163
VNA Admissions (Home Health)	8,290	1,562	6,483
Hospice Days	88,324	4,214	80,497
<b><u>Physician Services</u></b>			
SHMG Ambulatory Practice Panel Size	338,118	7,750	287,960
Encounters	2,370,265	(215,034)	2,233,786
wRVU's	3,869,780	(363,879)	3,600,053
wRVU's / Encounter	1.63	-	1.61
Cost per wRVU	\$ 175.24	\$ (9.74)	\$ 154.13

## SPECTRUM HEALTH SYSTEM AND AFFILIATES

### Key Statistics

Year ended June 30, 2016

### PRIORITY HEALTH

	<u>Actual</u>	<u>Better (Worse) than Budget</u>	<u>Prior Year</u>
Number of Member Months			
- Group	3,481,174	203,771	3,384,144
- ASO Stop Loss	994,855	31,408	909,186
<b><i>Total Group</i></b>	<u>4,476,029</u>	<u>235,179</u>	<u>4,293,330</u>
<b><i>Individual</i></b>	1,002,474	71,608	527,118
- Senior Products	1,396,843	14,654	1,230,695
- Medicaid	1,341,523	13,782	1,262,265
<b><i>Total Governmental Programs</i></b>	<u>2,738,366</u>	<u>28,436</u>	<u>2,492,960</u>
<b><i>Total Member Months</i></b>	<u>8,216,869</u>	<u>335,223</u>	<u>7,313,408</u>
Membership for the month ended June, 2016	<u>731,802</u>	<u>57,973</u>	<u>647,269</u>

**Spectrum Health System  
Liquidity Worksheet\*  
June 30, 2016  
(Dollars in 000s)**

<b>Assets</b>				
	<b>Assets With Same-Day Liquidity</b>	<b>Assets With Next-Day Liquidity</b>	<b>Assets &gt; Next-Day Liquidity</b>	<b>Total</b>
Cash & Cash Equivalents	\$193,917	\$0	\$0	\$193,917
S&P Rated Money Market Funds (> Am)	144,851	-	-	144,851
U.S. Treasury Debt Obligations (> 1 year)	-	144,323	-	144,323
U.S. TIPs	-	29,487	-	29,487
U.S. Agencies (> 1 year)	-	-	129,019	129,019
Investment Grade Debt (not included above)	-	39,072	239,034	278,107
Equities	-	-	387,136	387,136
Non-Investment Grade Debt	-	-	1,206	1,206
<b>Total</b>	<b>\$338,768</b>	<b>\$212,883</b>	<b>\$756,396</b>	<b>\$1,308,046</b>

<b>Self-Liquidity Backed Debt</b>				
	<b>Same-Day Notice</b>	<b>Next-Day Notice</b>	<b>&gt; Next-Day Notice</b>	<b>Total</b>
Series 2015A Variable Rate Demand Obligation (Windows)	\$ -	\$ -	\$78,400	\$78,400

\*The table represents assets that would be reasonably available to Spectrum Health System to satisfy a liquidity event. The table does not include assets held by affiliates that would not be reasonably available to satisfy a liquidity event, including assets held by Spectrum Health Foundation and Priority Health, among others.



CONSOLIDATED FINANCIAL STATEMENTS AND  
SUPPLEMENTAL INFORMATION

Spectrum Health System and Affiliates  
Years Ended June 30, 2016 and 2015  
With Reports of Independent Auditors

Ernst & Young LLP



Spectrum Health System and Affiliates

Consolidated Financial Statements and Supplemental Information

Years Ended June 30, 2016 and 2015

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## Report of Independent Auditors

The Board of Directors  
Spectrum Health System and Affiliates

We have audited the accompanying consolidated financial statements of Spectrum Health System and Affiliates (collectively, the System), which comprise the consolidated balance sheets as of June 30, 2016 and 2015, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### **Management's Responsibility for the Financial Statements**

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

### **Auditor's Responsibility**

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

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

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

## **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Spectrum Health System and Affiliates at June 30, 2016 and 2015, and the consolidated results of their operations and changes in net assets, and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

*Ernst + Young LLP*

August 29, 2016

# Spectrum Health System and Affiliates

## Consolidated Balance Sheets

(In Thousands)

	June 30	
	2016	2015
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 496,108	\$ 296,129
Short-term investments	256,450	247,697
Accounts receivable:		
Patients, less allowances of \$415,096 in 2016 and \$349,009 in 2015	320,377	283,475
Other	146,955	109,102
Third-party settlement receivables	282	2,460
Pledges receivable	12,760	11,085
Inventories	41,365	39,452
Prepaid expenses and other current assets	72,336	57,333
Total current assets	1,346,633	1,046,733
Investments	1,951,784	1,856,312
Property and equipment – net	1,492,979	1,469,674
Other assets:		
Investments in joint ventures	9,578	7,535
Goodwill	20,171	20,171
Intangible assets and other costs	12,851	14,563
Pledges receivable	45,920	51,023
Other	112,179	98,692
	200,699	191,984
Total assets	<u>\$ 4,992,095</u>	<u>\$ 4,564,703</u>

Spectrum Health System and Affiliates

Consolidated Balance Sheets (continued)  
(In Thousands)

	June 30	
	2016	2015
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 401,554	\$ 313,894
Salaries, wages, and related withholdings	244,198	204,297
Health plan claims payable	274,347	210,870
Current maturities of long-term debt	19,609	18,579
Short-term debt	78,400	78,400
Total current liabilities	1,018,108	826,040
Third-party settlement liabilities	23,687	26,685
Long-term debt, less current maturities	760,347	767,439
Professional liability accrual	41,552	45,272
Accrued pension obligation	128,960	71,456
Interest rate swaps	141,747	98,067
Other long-term liabilities	105,288	95,789
Total liabilities	2,219,689	1,930,748
Net assets:		
Controlling interest in unrestricted net assets	2,583,248	2,449,257
Noncontrolling interest in subsidiaries	39,123	33,432
Total unrestricted	2,622,371	2,482,689
Temporarily restricted	97,068	103,072
Permanently restricted	52,967	48,194
Total net assets	2,772,406	2,633,955
Total liabilities and net assets	<u>\$ 4,992,095</u>	<u>\$ 4,564,703</u>

*See accompanying notes.*

# Spectrum Health System and Affiliates

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

	<b>Year Ended June 30</b>	
	<b>2016</b>	<b>2015</b>
<b>Operating revenue</b>		
Health plan	\$ 2,784,764	\$ 2,419,782
Patient service revenue (net of allowances and adjustments)	2,416,917	2,181,004
Provision for bad debts	(93,564)	(82,837)
Net patient service revenue	2,323,353	2,098,167
Other	112,398	107,227
Total operating revenue	5,220,515	4,625,176
<b>Operating expenses</b>		
Salaries, wages, and employee benefits	1,619,571	1,416,170
Supplies and other	1,098,560	984,131
Health plan expense to providers	2,034,735	1,743,133
Depreciation and amortization	176,153	171,053
Interest	21,770	23,414
Total operating expenses	4,950,789	4,337,901
Net operating income	269,726	287,275
<b>Other nonoperating revenue (expenses)</b>		
Investment income, net	24,743	32,819
Loss on interest rate swaps, net	(57,182)	(26,450)
Loss on extinguishment of debt	—	(484)
Contribution received in donation of affiliates	—	80,098
Other expenses, net	(19,552)	(273)
Total other nonoperating revenue (expense)	(51,991)	85,710
Excess of revenue over expenses	217,735	372,985
Less: Excess of revenue over expenses attributable to noncontrolling interest	5,691	5,674
Excess of revenue over expenses	212,044	367,311

# Spectrum Health System and Affiliates

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

	Year Ended June 30, 2016			Year Ended June 30, 2015		
	Total	Controlling	Non-controlling	Total	Controlling	Non-controlling
<b>Unrestricted net assets</b>						
Excess of revenue over expenses	\$ 217,735	\$ 212,044	\$ 5,691	\$ 372,985	\$ 367,311	\$ 5,674
Contributions	404	404	—	550	550	—
Expenditures for donor-sponsored programs	(280)	(280)	—	(115)	(115)	—
Net assets released for capital acquisitions	1,472	1,472	—	1,844	1,844	—
Pension-related changes other than net periodic pension costs	(81,805)	(81,805)	—	(29,664)	(29,664)	—
Other	2,156	2,156	—	(73)	(73)	—
Increase in unrestricted net assets	139,682	133,991	5,691	345,527	339,853	5,674
<b>Temporarily restricted net assets</b>						
Contributions	12,630	12,630	—	16,813	16,813	—
Contributions received in donation of affiliate	—	—	—	1,021	1,021	—
Expenditures for donor-sponsored programs	(16,923)	(16,923)	—	(14,555)	(14,555)	—
Investment (loss) returns	(1,149)	(1,149)	—	1,756	1,756	—
Net assets released for capital acquisitions	(1,472)	(1,472)	—	(1,844)	(1,844)	—
Other	910	910	—	3,222	3,222	—
(Decrease) increase in temporarily restricted net assets	(6,004)	(6,004)	—	6,413	6,413	—
<b>Permanently restricted net assets</b>						
Contributions	6,339	6,339	—	5,999	5,999	—
Contributions received in donation of affiliate	—	—	—	457	457	—
Investment (loss) returns	(850)	(850)	—	700	700	—
Other	(716)	(716)	—	(860)	(860)	—
Increase in permanently restricted net assets	4,773	4,773	—	6,296	6,296	—
Increase in net assets	138,451	132,760	5,691	358,236	352,562	5,674
Net assets, beginning of year	2,633,955	2,600,523	33,432	2,275,719	2,247,961	27,758
Net assets, end of year	<u>\$ 2,772,406</u>	<u>\$ 2,733,283</u>	<u>\$ 39,123</u>	<u>\$ 2,633,955</u>	<u>\$ 2,600,523</u>	<u>\$ 33,432</u>

See accompanying notes.



# Spectrum Health System and Affiliates

## Consolidated Statements of Cash Flows

(In Thousands)

	Year Ended June 30	
	2016	2015
<b>Operating activities and other revenue</b>		
Increase in net assets	\$ 138,451	\$ 358,236
Adjustments to reconcile increase in net assets to net cash provided by operating activities and other revenue:		
Contributions and other net asset activity	(4,670)	(13,437)
Contributions received in donation of affiliates	–	(81,576)
Unrealized loss in market value of interest rate swaps	43,680	12,691
Pension-related changes other than net periodic pension costs	81,805	29,664
Depreciation and amortization	176,153	171,053
Changes in operating assets and liabilities:		
Trading securities	(104,224)	(244,341)
Changes in net patient accounts receivable, other accounts receivable, inventories, prepaid expenses, third-party settlement receivables, and other operating assets	(102,617)	(55,183)
Changes in accounts payable and accrued expenses, accrued salaries, wages, and related withholdings, health plan claims payable, third-party settlement liabilities, and other operating liabilities	169,518	71,759
Other	6,188	(2,996)
Net cash provided by operating activities and other revenue	404,284	245,870
<b>Investing activities</b>		
Additions to property and equipment	(200,870)	(159,823)
Net cash acquired in integration	–	4,959
Other	(2,043)	(1,477)
Net cash used in investing activities	(202,913)	(156,341)
<b>Financing activities</b>		
Contributions and other net asset activity	4,670	13,437
Proceeds from issuance of long-term debt	17,000	152,268
Payments on long-term debt	(23,062)	(174,598)
Net cash used in financing activities	(1,392)	(8,893)
Increase in cash and cash equivalents	199,979	80,636
Cash and cash equivalents at beginning of year	296,129	215,493
Cash and cash equivalents at end of year	\$ 496,108	\$ 296,129

See accompanying notes.

# **Spectrum Health System and Affiliates**

## **Notes to Consolidated Financial Statements** *(In Thousands)*

June 30, 2016

### **1. Significant Accounting Policies**

#### **The Reporting Entity and Principles of Consolidation**

Spectrum Health System is a nonprofit Michigan corporation formed as a holding company to direct the activities of an integrated health care delivery system. The consolidated financial statements include the accounts of Spectrum Health System and its wholly owned or controlled affiliates (collectively, the System). The controlled affiliates include Spectrum Health Hospitals' acute care campuses located in Grand Rapids, Michigan; Priority Health, a managed care health plan; Spectrum Health Medical Group, a physician organization; and various other affiliates and subsidiaries providing acute care, long-term care, home health care, physician, and other services in their respective markets in Michigan. All intercompany accounts and transactions have been eliminated in consolidation.

#### **Use of Estimates**

The preparation of financial statements in accordance with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Although actual results could differ from these estimates, management believes estimated amounts recorded are reasonable and appropriate.

#### **Mission Statement and Other Nonoperating Revenue and Expenses**

The System's mission is to improve the health of the communities it serves. Only those activities directly related to this mission are considered operating activities. Other activities that result in revenue or expenses unrelated to the primary mission are considered to be other nonoperating revenue and expenses.

#### **Cash and Cash Equivalents**

Cash and cash equivalents include short-term, highly liquid investments with a maturity of three months or less when purchased, excluding amounts whose use is limited by Board designation or other arrangements under trust agreements.

## Spectrum Health System and Affiliates

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

#### **1. Significant Accounting Policies (continued)**

##### **Short-Term Investments**

Short-term investments primarily consist of debt obligations and are internally designated as current assets because such amounts are available to meet the System's operating cash requirements.

##### **Inventories**

Inventories consist primarily of medical supplies and pharmaceuticals and are stated at the lower of cost or market, with cost being determined primarily on an average cost basis.

##### **Investments and Investment Return**

Investments include assets held by trustees under indenture, statutory requirements, and self-insurance agreements; health plan and foundation assets; and designated assets set aside by the Board of Directors (the Board) over which it retains control and may, at its discretion, subsequently use for other purposes. Investments in equity and debt securities are measured at fair value.

All investments are considered to be trading securities. Investment income or loss (including realized and unrealized gains and losses on investments, interest, and dividends) is included in excess of revenue over expenses unless the income or loss is restricted by donor or law. Gains and losses with respect to disposition of marketable securities are based on the specific-identification method. Investment income related to temporarily and permanently restricted net assets is added to or deducted from the appropriate net asset balance based on donor intent.

Investment securities purchased and sold are reported based on trade date. Due to the period lag between the trade date and the settlement date, the System reports receivables for securities sold but not settled and reports liabilities for securities purchased but not settled. These receivables and payables are settled from within the investment portfolio and are presented on a net basis within investments in the consolidated balance sheets.

## Spectrum Health System and Affiliates

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

#### 1. Significant Accounting Policies (continued)

##### Property and Equipment

Property and equipment are stated on the basis of cost or approximate fair value at the date of acquisition or donation. Included in property and equipment are costs for software developed for internal use. Depreciation is provided on a straight-line basis over the estimated useful lives of the property. Leasehold improvements are amortized over the lesser of the estimated useful lives of the assets or the length of the lease.

Property and equipment under capital lease obligations are amortized on a straight-line basis in accordance with lease accounting standards. Such amortization is included within depreciation and amortization in the accompanying consolidated statements of operations and changes in net assets. Interest cost incurred in connection with borrowings to finance major construction or facility expansion is capitalized during the construction period and subsequently amortized over the lives of the related assets.

##### Asset Impairment

The System considers whether indicators of impairment are present and performs the necessary test to determine if the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating income at the time the impairment is identified.

##### Goodwill, Intangible Assets, and Other Costs

In connection with business combinations, the System has recorded goodwill and definite-lived intangible assets in the accompanying consolidated balance sheets. Goodwill represents the excess of the purchase price over the fair value of net tangible and identifiable intangible assets of acquired organizations. Intangible assets and other costs consist primarily of acquired customer contracts, provider networks, and bond financing costs. The System evaluates goodwill for impairment annually or more frequently if events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. The goodwill impairment analysis, performed at the reporting unit level, includes estimating the fair market value and comparing that to the carrying value. If fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired. These valuation methods require the System to make estimates and assumptions regarding future operating results, cash flows, changes in working capital, capital expenditures, profitability, and the cost of capital. It has been determined that there was no impairment to goodwill during 2016 or 2015.

## Spectrum Health System and Affiliates

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

#### 1. Significant Accounting Policies (continued)

The net carrying amount of goodwill is \$20,171 for the years ended June 30, 2016 and 2015.

Intangible assets and other costs are amortized using the straight-line method over their estimated useful lives (periods ranging from 1 to 30 years). The following is a summary of the System's intangible assets and other costs:

	Gross Carrying Amount	Less Accumulated Amortization	Net Carrying Amount
<b>June 30, 2016</b>			
Customer relationships	\$ 19,287	\$ (13,820)	\$ 5,467
Bond financing costs	4,964	(1,160)	3,804
Provider networks and other	7,775	(4,195)	3,580
	<u>\$ 32,026</u>	<u>\$ (19,175)</u>	<u>\$ 12,851</u>
<b>June 30, 2015</b>			
Customer relationships	\$ 19,287	\$ (12,870)	\$ 6,417
Bond financing costs	4,964	(848)	4,116
Provider networks and other	7,775	(3,745)	4,030
	<u>\$ 32,026</u>	<u>\$ (17,463)</u>	<u>\$ 14,563</u>

Estimated aggregate amortization expense for intangible assets for each of the five fiscal years subsequent to June 30, 2016 is as follows: 2017 – \$1,700; 2018 – \$1,697; 2019 – \$1,683; 2020 – \$1,655; and 2021 – \$1,647. Total amortization expense was \$1,712 and \$1,755 in 2016 and 2015, respectively.

#### Derivative Financial Instruments

The System has entered into interest rate swap agreements with certain banks to manage risks associated with changes in interest rates. The System records its derivative instruments as either assets or liabilities in the accompanying consolidated balance sheets at fair value. None of the System's current derivatives are designated as a hedge. Accordingly, both unrealized and realized derivative gains and losses related to the interest rates swaps are included in loss on interest rate swaps, net, on the consolidated statements of operations and changes in net assets.

# Spectrum Health System and Affiliates

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

### 1. Significant Accounting Policies (continued)

#### Temporarily and Permanently Restricted Net Assets and Gifts

Temporarily restricted net assets are those funds whose use has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the System in perpetuity.

Unconditional promises to give cash and other assets are recorded at fair value at the date the promise is received and are reported in other nonoperating income. If the gifts are received with donor stipulations that limit the use of the donated assets, the gifts are reported as either temporarily or permanently restricted. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in the accompanying consolidated financial statements. Management believes these are Level 2 measurements (as defined in Note 7) recorded on a nonrecurring basis.

The System has received unconditional promises to give from donors, which include the following:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
In less than one year	\$ 13,252	\$ 11,626
In one to five years	19,672	18,708
In more than five years	3,750	7,850
	<b>36,674</b>	38,184
Less amounts representing interest	(2,683)	(3,213)
	<b>33,991</b>	34,971
Beneficial interest in perpetual pledge from Kent Community Hospital Foundation, less current portion	<b>24,689</b>	27,137
Amount recognized in consolidated balance sheets	<b>\$ 58,680</b>	\$ 62,108

## Spectrum Health System and Affiliates

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

#### **1. Significant Accounting Policies (continued)**

##### **Noncontrolling Interest in Subsidiaries**

The System attributed income of \$5,691 and \$5,674 for the years ended June 30, 2016 and 2015, respectively, to the noncontrolling interests based on the ownership percentage of the noncontrolling interests in certain of the System's consolidated subsidiaries. These amounts are recognized in unrestricted net assets in the consolidated balance sheets, net of distributions.

##### **Net Patient Service Revenue, Patient Accounts Receivable, and Allowance for Uncollectible Accounts**

Patient service revenue is reported net of contractual allowances and adjustments at estimated net realizable amounts from patients, third-party payers, and others for services rendered. Net patient service revenue is reported net of provisions for bad debt. Revenue is recognized by provider affiliates at the time services are provided, and the billings for such services to third-party payers are included in operating revenue. Contractual adjustments are recorded to reduce related billings, as necessary, to the estimated amount to be paid by these programs. Final determinations of amounts earned under third-party programs are subject to review and audit by the appropriate payer. Patient service revenue (net of contractual allowances and adjustments) in the accompanying consolidated statements of operations and changes in net assets was not materially affected in 2016 and 2015 by changes in estimated settlements from prior years. During fiscal year 2016, Centers for Medicare and Medicaid Services approved additional Medicaid Access to Care Initiative (MACI) payments to the State of Michigan for the Healthy Michigan Program (HMP) related to the April 1, 2014 through September 30, 2015 time period. The distribution of these funds is being based on the methodology used for the existing non-HMP MACI program and are not based on any single hospital's experience or utilization related to HMP. During the year ended June 30, 2016, the System recorded \$35,150 related to these additional payments.

The System received 40% and 41% of patient service revenue (net of allowances and adjustments) in 2016 and 2015, respectively, from services to individuals under Medicare and Medicaid reimbursement programs. These third-party payers generally reimburse inpatient acute services by payment for each discharge and reimburse outpatient services on a fee schedule basis.

# Spectrum Health System and Affiliates

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

### 1. Significant Accounting Policies (continued)

The composition of patient service revenue (net of contractual allowances and adjustments) by third-party payer is as follows:

	June 30	
	2016	2015
Medicare	\$ 622,653	\$ 575,206
Medicaid	346,099	309,601
Managed care and other	1,382,252	1,250,039
Self-pay	65,913	46,158
Total all payers	<u>\$ 2,416,917</u>	<u>\$ 2,181,004</u>

Patient accounts receivable consist of amounts due for health care services provided. The System does not require collateral or other security for the delivery of health care services from its patients, the majority of whom are residents of the state of Michigan. However, assignment of benefit payments payable under patients' health insurance programs and plans (e.g., Medicare, Medicaid, health maintenance organizations, and commercial insurance policies) is routinely obtained. In 2016 and 2015, 37% and 34%, respectively, of patient accounts receivable, net, were collectible from governmental payers.

As of June 30, 2016 and 2015, 42% and 34%, respectively, of all amounts due from self-pay patients (including patients without insurance and patients with deductibles and copayment balances due for which third-party coverage exists for part of the bill) were expected to be collected. The provision for uncollectible accounts is based upon management's assessment of historical and expected net collections considering business and general economic conditions in its service area, trends in health care coverage, and other collection indicators. Periodically, management assesses the adequacy of the allowance for uncollectible accounts based upon accounts receivable payer composition and aging and historical write-off experience by payer category and other factors. The results of this review are then used to make any modifications to the provision for uncollected accounts to establish an appropriate allowance for uncollectible accounts. For third-party payers, the provision is determined by analyzing contractually due amounts from payers who are known to be having financial difficulties. For self-pay patients, the provision is based on an analysis of past experience related to patients unwilling to pay standard rates charged. The difference between the standard rate charged (less the negotiated discounted



# Spectrum Health System and Affiliates

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

### 1. Significant Accounting Policies (continued)

rate) and the amount actually collected after the reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. The System follows established guidelines for placing certain past-due patient balances with external collection agencies.

Patient accounts receivable consist of the following:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
Gross patient accounts receivable	\$ 735,473	\$ 632,484
Less allowance for contractual adjustments	(357,349)	(292,537)
Less allowance for uncollectible accounts	(54,805)	(49,974)
Less allowance for charity care	(2,942)	(6,498)
	<u>(415,096)</u>	<u>(349,009)</u>
Patient accounts receivable, less allowances	<u>\$ 320,377</u>	<u>\$ 283,475</u>

The health care industry is subject to numerous laws and regulations of federal, state, and local governments, and the laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and noncompliance with regulations by health care providers. The System is not exempt from these regulatory efforts. In the opinion of management, there are no known regulatory inquiries or compliance matters that are expected to have a material adverse effect on the consolidated financial statements of the System. The System has established a formal corporate compliance function, which management believes will help monitor the System's compliance with applicable laws and regulations.

## Spectrum Health System and Affiliates

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

#### **1. Significant Accounting Policies (continued)**

##### **Health Plan Revenue and Health Plan Payments**

Priority Health has various agreements with participating providers to furnish health care services to participating subscribers and their dependents. The agreements with certain participating providers call for reimbursement at various capitated rates or percentages of fees, less applicable member copayments, coinsurance, or deductibles, on a current basis. The agreements provide for contingent reimbursement to participating providers based upon the results of operations within their defined pay for performance groups. In the event the pay for performance group's utilization of defined measures meets, exceeds, or is less than documented thresholds (depending on the threshold), the providers may share in the surplus and be eligible for the return of previously withheld fees, as defined in their respective contracts. In addition, Priority Health provides for a quality incentive to be paid to certain providers contingent upon achieving specified quality goals.

Premiums are billed and collected monthly from employer groups and members in Medicare, Medicaid, and commercial products. Premium revenue is recognized as income in the period members are entitled to receive services and is net of estimated uncollectible amounts and retroactive membership adjustments.

Priority Health's costs under provider arrangements are recognized as expenses when services are rendered and include an estimate of costs incurred but not reported at the consolidated balance sheet dates.

Priority Health has maintained capital and surplus, as determined in accordance with accounting practices prescribed or permitted by the Michigan Department of Insurance and Financial Services, in which it is licensed, in excess of the minimum requirements.

## Spectrum Health System and Affiliates

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

#### 1. Significant Accounting Policies (continued)

The following table provides a reconciliation of the beginning and ending balances of health plan claims payable at June 30:

	<u>2016</u>	<u>2015</u>
Reserves at beginning of year	\$ 210,870	\$ 193,636
Add provision for claims and claims adjustment expense occurring in:		
Current year	2,059,827	1,765,774
Prior years	(25,092)	(22,641)
Incurred losses during current year	<u>2,034,735</u>	<u>1,743,133</u>
Deduct payments for claims occurring in:		
Current year	1,823,067	1,613,533
Prior years	148,191	112,366
Claim payments during current year	<u>1,971,258</u>	<u>1,725,899</u>
Reserves at end of year	<u><u>\$ 274,347</u></u>	<u><u>\$ 210,870</u></u>

In 2016 and 2015, favorable development of previously recorded claim reserve estimates was experienced due to lower than expected medical expense trends and favorable shifts in the utilization and cost of services.

#### Meaningful Use Revenue

The American Recovery and Reinvestment Act of 2009 established incentive payments under Medicare and Medicaid programs for certain eligible professionals, hospitals, and critical access hospitals (Providers). Providers can receive incentive payments by adopting, implementing, and upgrading electronic health records (EHR) technology. Providers can also receive incentive payments for demonstrating meaningful use of EHR technology. Upon satisfaction of the meaningful use criteria, using a grant accounting model, the System recognized \$4,567 and \$9,994 of these incentive payments within total operating revenue on the consolidated statements of operations and changes in net assets for the years ended June 30, 2016 and 2015, respectively. If specified meaningful use criteria are met in future periods, the System may qualify for additional incentive payments.

## Spectrum Health System and Affiliates

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

#### **1. Significant Accounting Policies (continued)**

##### **Operating Indicator (Net Operating Income)**

The System's operating indicator includes health plan revenue, net patient service revenue, and other revenue and expenses from the System's operations for the reporting period. The operating indicator excludes investment income, net; loss on interest rate swaps, net; loss on extinguishment of debt; contribution received in donation of affiliates; and other expenses, net.

##### **Performance Indicator**

The System's performance indicator (excess of revenue over expenses) includes all changes in unrestricted net assets other than contributions to (from) related organizations, expenditures for donor-sponsored programs, net assets released for capital acquisitions, and certain changes in the pension obligations.

##### **Income Taxes**

The System and most of its controlled affiliates are tax-exempt organizations as described in Section 501(c)(3) of the Internal Revenue Code (IRC). These controlled affiliates are tax-exempt under IRC Section 501(c)(3) pursuant to a group exemption ruling obtained from the Internal Revenue Service in May 2014. Certain other affiliates are tax-exempt organizations under IRC Section 501(c)(4). Tax-exempt organizations are subject to income tax on any income from unrelated business activities. The System also owns or controls certain taxable affiliates. Net deferred tax assets of \$23,874 and \$34,204 at June 30, 2016 and 2015, respectively, which are primarily related to net operating loss carryforwards, have respective valuation allowances of \$22,067 and \$28,474, recorded against them due to the uncertainty of realizing those benefits in the future.

##### **Taxes Based on Claims**

Effective January 1, 2012, the state of Michigan began assessing a tax based on claims paid to providers, also known as the Health Insurance Claims Assessment (HICA). The System passes this tax through to covered groups or individuals, but is ultimately responsible for the payment of the final tax liability. Gross amounts collected are included in health plan revenue on the consolidated statements of operations and changes in net assets. Tax expenses totaled \$11,619

## Spectrum Health System and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(In Thousands)*

#### **1. Significant Accounting Policies (continued)**

and \$10,888 in 2016 and 2015, respectively, and are in health plan revenue on the consolidated statements of operations and changes in net assets. Outstanding liabilities as of June 30, 2016 totaled \$5,485 (\$5,803 as of June 30, 2015), and are included in accounts payable and accrued expenses on the consolidated balance sheets.

#### **Fees Paid to the Federal Government by Health Insurers**

The System has adopted the Financial Accounting Standards Board's (FASB) accounting guidance for the health insurance industry assessment (the fee) mandated by Health Care Reform. This nondeductible fee is being levied based on a ratio of an insurer's net health insurance premiums written for the previous calendar year compared to the U.S. health insurance industry total. The System reported \$22,391 and \$22,754 in accounts payable and accrued expenses related to these fees for the years ended June 30, 2016 and 2015, respectively. As of June 30, 2016 and 2015, \$21,904 and \$18,547, respectively, of the deferred cost were recognized in supplies and other expense, and the remainder will be recognized on a straight-line basis through December 31, 2016. The System expects to be notified of and pay the final 2016 assessment in 2017.

#### **Taxes Based on Premiums**

Priority Health Choice is subject to a use tax based on premium revenue collected. Premium tax expense related to the use tax totaled \$23,869 and \$24,643 for the years ended June 30, 2016 and 2015, respectively, and is presented net within health plan revenue on the consolidated statements of operations and changes in net assets. Assessments were paid monthly based on estimated premium revenue and adjusted annually based on actual premium revenue.

#### **Functional Expenses**

The System's accounting policies conform to GAAP applicable to health care organizations. Substantially all expenses are related to providing health care services to the community.

## Spectrum Health System and Affiliates

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

#### 1. Significant Accounting Policies (continued)

##### Endowments

The System's endowments consist of 120 individual funds established for a variety of purposes. The endowments include donor-restricted endowment funds, and as required by GAAP, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions. As of June 30, 2016 and 2015, such temporarily and permanently restricted endowment net assets were \$60,592 and \$55,758, respectively.

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) requires the System to exercise ordinary and prudent care in good faith in its discretion to invest and appropriate some or all of the net appreciation or depreciation of investments. In the absence of a relevant law or donor stipulations, fiduciary responsibility to exercise ordinary care and prudence does not extend donor stipulations to the earnings and losses on investments. UPMIFA, along with other relevant state laws, guides the System's investment policies for restricted funds.

##### Charity Care

In support of its mission, the System provides various health-related services, at a loss, to the indigent and other residents in its service area. Policies have been established that define charity care and provide guidelines for assessing a patient's ability to pay. Evaluation procedures for charity care qualification have been established for those situations when previously unknown financial circumstances are revealed or when incurred charges are significant when compared to the individual patient's income and/or net assets. Because the System does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported in net patient service revenue. In addition, the System provides services to other medically indigent patients under various Medicare and Medicaid programs, which pay providers amounts that are less than the costs incurred for the services provided to the recipients.

The estimated costs of charity care are \$2,470 and \$4,042 for the years ended June 30, 2016 and 2015, respectively. Costs are estimated using the ratio of each facility's costs to its charges at a department level applied to gross charity charges. These ratios are then applied to all System costs to determine the value of charity care. Any reimbursements are then deducted from the cost to arrive at the estimated cost of charity care.

## Spectrum Health System and Affiliates

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

#### 1. Significant Accounting Policies (continued)

##### Recently Issued Accounting Standards

In May 2015, the FASB issued Accounting Standards Update (ASU) 2015-07, *Fair Value Measurement (Topic 820)*. This ASU amends ASC 820, and removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share as a practical expedient. The guidance is effective for the System for fiscal years beginning after December 15, 2016, with early adoption permitted. The System does not expect any impact to net assets or changes in net assets due to implementation of this ASU.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements for Not-for-Profit Entities*. This ASU simplifies and improves the information provided in financial statements and accompanying notes of not-for-profit entities. The amendments set forth the FASB's improvements to net asset classification requirements and the information presented about a not-for-profit entity's liquidity, financial performance, and cash flows. The guidance is effective for the System for reporting periods beginning after December 15, 2017, with early adoption permitted. The System is currently evaluating the impact that the new guidance will have on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU requires lessees to recognize assets and liabilities on the balance sheet for leases with lease terms greater than twelve months. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. This amends current guidance that requires only capital leases to be recognized on the lessee balance sheet. ASU 2016-02 will also require additional disclosures on the amount, timing and uncertainty of cash flows arising from leases. The guidance is effective for the System for reporting periods beginning after December 15, 2018, with early adoption permitted. The System is currently evaluating the impact that the new guidance will have on its consolidated financial statements.

## Spectrum Health System and Affiliates

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

#### 1. Significant Accounting Policies (continued)

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*, which outlines a single comprehensive model for recognizing revenue and supersedes most existing revenue recognition guidance, including guidance specific to the health care industry. This ASU provides companies with the option of applying a full or modified retrospective approach upon adoption. In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers*. The amendments in this ASU defer the effective date of ASU 2014-09 to reporting periods beginning after December 15, 2018. The System is currently evaluating the effects of the standard on its consolidated financial statements.

#### Subsequent Events

The System evaluated subsequent events after June 30, 2016 through August 29, 2016, representing the date that the consolidated financial statements were issued. The System concluded that no material events or transactions occurred subsequent to June 30, 2016, that provided additional evidence about conditions that existed at June 30, 2016, or after, requiring adjustment to or disclosure in the consolidated financial statements.

#### 2. Business Combinations

In May 2015, the System entered into an agreement to integrate with Pennock Healthcare System and Affiliates (PHS), whereby the System became the sole corporate member of PHS through a noncash business combination transaction. The integration was designed to enable both organizations to further their common charitable missions of improving the health of their respective patients and communities they serve. The transaction with PHS was accounted for as a purchase, and financial results of PHS are included in the System's consolidated financial statements from the date of integration. As the fair value of assets acquired exceeded the fair value of liabilities assumed, the System recognized a contribution of \$80,098 in the consolidated statement of operations and changes in net assets. The fair value of the assets was determined based on an independent valuation obtained by the System. In addition, the System recognized an increase of \$1,021 and \$457 in temporarily and permanently restricted net assets, respectively, as appropriate.



## Spectrum Health System and Affiliates

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

#### 3. Property and Equipment

Property and equipment include the following:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
Land and improvements	\$ 89,931	\$ 84,716
Buildings	1,594,236	1,564,347
Equipment	943,090	894,753
Software	342,605	303,982
Leasehold improvements	99,463	91,492
In progress:		
Software	42,658	21,908
Construction and equipment	45,064	22,428
	<u>3,157,047</u>	<u>2,983,626</u>
Less accumulated depreciation and amortization	<u>(1,664,068)</u>	<u>(1,513,952)</u>
	<u><u>\$ 1,492,979</u></u>	<u><u>\$ 1,469,674</u></u>

The System has several ongoing construction projects and purchase commitments. Outstanding purchase commitments to complete various construction and renovation projects approximate \$75,120 at June 30, 2016. These projects will largely be funded from existing cash reserves and debt proceeds. There was no interest capitalized in 2016 or 2015.

Certain buildings and equipment are accounted for as capital leases expiring in various years through 2041 and are included in property and equipment. Amortization of assets under capital leases is included in depreciation expense. Interest rates are imputed based on the lower of the incremental borrowing rate at the inception of each lease or the lessor's implicit rate of return.

## Spectrum Health System and Affiliates

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

#### 3. Property and Equipment (continued)

The following is a summary of property and equipment held under capital leases:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
Buildings	\$ 65,352	\$ 65,352
Equipment	789	2,532
	<b>66,141</b>	67,884
Less accumulated amortization	<b>(15,148)</b>	(14,706)
	<b>\$ 50,993</b>	\$ 53,178

The System leases certain office space and equipment under noncancelable operating leases. Future minimum lease payments for capital leases and noncancelable operating leases are as follows:

	<b>Operating Leases</b>	<b>Capital Leases</b>
Year ending June 30:		
2017	\$ 25,431	\$ 5,989
2018	23,047	5,955
2019	19,383	6,062
2020	16,785	6,149
2021	13,014	6,273
Thereafter	42,104	139,946
Total minimum lease payments	<b>\$ 139,764</b>	170,374
Less amount representing interest		(107,399)
Present value of net minimum lease payments		<b>\$ 62,975</b>

Total rent expense was \$35,713 and \$35,052 in 2016 and 2015, respectively.

## Spectrum Health System and Affiliates

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

#### 4. Investments

The fair value of investments is as follows:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
Cash and cash equivalents	\$ 86,420	\$ 154,679
Short-term investments	292,640	269,065
U.S. treasury securities	234,594	210,282
Corporate debt securities	252,834	216,289
Mortgage-backed securities	305,167	266,613
Mutual funds – domestic equity	125,925	86,083
Mutual funds – international equity	315,237	295,047
Mutual funds – fixed income	130,237	144,033
Marketable equity securities	157,015	145,915
Commingled funds	322,832	335,791
	<u>2,222,901</u>	<u>2,123,797</u>
Due to broker, net	(14,667)	(19,788)
	<u><u>\$ 2,208,234</u></u>	<u><u>\$ 2,104,009</u></u>

The System's investments are exposed to various types and levels of risk. Fixed income securities expose the System to interest rate risk, credit risk, and liquidity risk. As interest rates change, the value of many fixed income securities is affected, particularly those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligation. Liquidity risk is affected by the willingness of market participants to buy and sell a particular security.

Equity securities expose the System to market risk, performance risk, and liquidity risk. Market risk is the risk associated with major movements of the equity markets, both domestic and international. Performance risk is the risk associated with a particular company's operating performance. Liquidity risk, as previously defined, tends to be higher for international and domestic small capitalized equity companies.

# Spectrum Health System and Affiliates

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

### 4. Investments (continued)

Investments have been designated as follows:

	<b>Year Ended June 30</b>	
	<b>2016</b>	<b>2015</b>
For funded depreciation	\$ 1,265,828	\$ 1,249,631
For health plan operations	799,660	716,340
For donor-restricted purposes	137,597	133,896
For professional and general liability claims	2,657	1,650
Restricted funds (by state insurance commissioner)	2,492	2,492
	<u>\$ 2,208,234</u>	<u>\$ 2,104,009</u>

Investment income, net, as reported in the consolidated statements of operations and changes in net assets, consists of the following:

	<b>Nonoperating</b>	<b>Restricted Funds</b>	<b>Year Ended June 30</b>	
			<b>2016</b>	<b>2015</b>
Investment income	\$ 42,395	\$ 93	\$ 42,488	\$ 36,096
Net realized gains on sale of investments	11,946	56	12,002	47,894
	<u>54,341</u>	<u>149</u>	<u>54,490</u>	<u>83,990</u>
Less investment management fees	(4,393)	—	(4,393)	(3,417)
	<u>49,948</u>	<u>149</u>	<u>50,097</u>	<u>80,573</u>
Net unrealized losses on investments held	(25,205)	(2,148)	(27,353)	(45,298)
	<u>\$ 24,743</u>	<u>\$ (1,999)</u>	<u>\$ 22,744</u>	<u>\$ 35,275</u>

## Spectrum Health System and Affiliates

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

#### 5. Borrowings

##### Obligated Group

The System operates under a Master Trust Indenture (MTI) that provides for issuance of long-term debt under an obligated group structure. The members of the Obligated Group under the terms of the MTI dated June 1, 1998, as amended, are Spectrum Health System and Spectrum Health Hospitals. Certain of Spectrum Health System's affiliates are Designated Affiliates under the MTI (the Designated Affiliates). Designated Affiliates consist of Spectrum Health United, Spectrum Health Continuing Care, including its wholly owned subsidiaries and excluding Spectrum Health Kent Community Campus, Newaygo County General Hospital Association (dba Spectrum Health Gerber Memorial) and Zeeland Community Hospital (dba Spectrum Health Zeeland Community Hospital). The Credit Group consists of the Obligated Group and the Designated Affiliates.

Long-term debt (net of issuance discount/premium) consists of the following obligations:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
<b>Credit Group</b>		
Hospital Facilities Refunding Revenue Bonds:		
Series 2015A, variable rate demand bonds (0.66% at June 30, 2016), maturing in varying amounts through 2047	\$ 78,400	\$ 78,400
Series 2015B at an interest rate of 3.5%, maturing in varying amounts through 2030	47,570	50,000
Series 2014A, variable rate demand bonds (0.96% at June 30, 2016), maturing in varying amounts through 2047	68,115	69,815
Series 2014B, variable rate demand bonds (0.92% at June 30, 2016), maturing in varying amounts through 2047	40,025	40,025
Series 2012A, variable rate demand bonds (1.42% at June 30, 2016), maturing in varying amounts through 2045	56,490	56,490
Series 2012B, variable rate demand bonds (1.29% at June 30, 2016), maturing in varying amounts through 2045	56,490	56,490
Series 2011A at interest rates from 4.7% to 5.5%, maturing in varying amounts through 2029	83,655	88,687
Series 2011B, variable rate demand bonds (1.52% at June 30, 2016), maturing in varying amounts through 2047	103,770	103,770
Series 2011C at an interest rate of 5.0%, maturing in varying amounts through 2042	75,693	75,648

# Spectrum Health System and Affiliates

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

### 5. Borrowings (continued)

	June 30	
	2016	2015
<b>Credit Group (continued)</b>		
Hospital Facilities Refunding Revenue Bonds (continued):		
Series 2008B, variable rate demand bonds (0.42% at June 30, 2016), maturing in varying amounts through 2047	\$ 50,000	\$ 50,000
Series 2008C, variable rate demand bonds (0.41% at June 30, 2016), maturing in varying amounts through 2026	52,800	57,800
Capital leases	62,825	63,033
Spectrum Health revolving credit facility	28,500	16,000
Other	2,178	2,612
	<b>806,511</b>	<b>808,770</b>
<b>Other entities (non-Credit Group)</b>		
Priority Health loan bearing interest based on one-month LIBOR (0.46% at June 30, 2016) plus 120 basis points, maturing in December 2017	25,003	26,117
Spectrum Health Ludington Hospital revenue bonds at an interest rate of 2.29%, maturing in varying amounts through 2032	16,765	17,665
Other	10,077	11,866
	<b>51,845</b>	<b>55,648</b>
Total long-term debt	<b>858,356</b>	<b>864,418</b>
Less current maturities	(19,609)	(18,579)
Less short-term debt	(78,400)	(78,400)
Total long-term debt	<b>\$ 760,347</b>	<b>\$ 767,439</b>

In January 2015, Kent Hospital Finance Authority issued the Hospital Revenue Refunding Bonds (Spectrum Health System) Series 2015A Windows Bonds, totaling \$78,400. Proceeds were used to refund all amounts outstanding on the Series 2008A Bonds. The Series 2015A variable rate bonds are supported by Spectrum Health's self-liquidity and have maturities with an initial term of 32 years.

The 2015A bonds can be tendered on any day by the bondholders, and the System has up to 210 days to remarket the bonds, convert the bonds to a different mode, or pay off the bonds. As such, the 2015A bonds are classified as short-term debt on the consolidated balance sheets. As of June 30, 2016, no bonds had been tendered.

## Spectrum Health System and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(In Thousands)*

#### **5. Borrowings (continued)**

In February 2015, the 2015B taxable bonds totaling \$50,000 were issued directly to an insurance company and have an initial term of 15 years. Proceeds were used to refund outstanding amounts on the Spectrum Health revolving credit facility.

In January 2014, Kent Hospital Finance Authority issued the Hospital Revenue Refunding Bonds (Spectrum Health System) Series 2014A and 2014B Bonds, totaling \$111,850. Proceeds were used to refund certain amounts outstanding on the Series 2008A Bonds, Gerber variable rate revenue bonds, and the Zeeland Series 2010 Bonds. The Series 2014A and 2014B Bonds were issued directly to banks for terms expiring on January 1, 2024 and January 15, 2021, respectively, and have maturities with an initial term of 33 years.

In November 2011, Kent Hospital Finance Authority issued the Hospital Revenue Refunding Bonds (Spectrum Health System) Series 2011C, totaling \$75,511, net of discount. In January 2012, Kent Hospital Finance Authority issued the Hospital Revenue Refunding Bonds (Spectrum Health System) Series 2012A and 2012B Bonds, totaling \$112,980. Proceeds were used to refund certain amounts outstanding on the Series 2008A and Series 2008B Bonds. The Series 2011C Bonds have an initial term of 30 years. The Series 2012A and 2012B Bonds were issued directly to banks for terms expiring on July 1, 2022 and January 1, 2019, respectively, and have maturities with an initial term of 33 years.

In June 2011, Kent Hospital Finance Authority issued the Hospital Revenue Refunding Bonds (Spectrum Health System) Series 2011A and 2011B, totaling \$212,860, including premium. Proceeds were used to refund certain amounts outstanding on the Series 2008B and 2005B Bonds and to reduce amounts outstanding on the Spectrum Health revolving credit facility. The Series 2011A Bonds have an initial term of 18 years. The Series 2011B Bonds were issued directly to a bank for a term expiring on June 22, 2021, and have an initial term of 36 years.

In September 2008, Kent Hospital Finance Authority issued the Hospital Revenue Refunding Bonds (Spectrum Health System) Series 2008C. Proceeds were used to refund all amounts outstanding on the Series 1998B Bonds. Variable rate bonds are remarketed weekly, with the option to convert to a fixed rate. The bonds are secured by a letter of credit that is scheduled to terminate on September 10, 2018.

## Spectrum Health System and Affiliates

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

#### 5. Borrowings (continued)

In April 2008, Kent Hospital Finance Authority issued the Hospital Revenue and Refunding Bonds (Spectrum Health System) Series 2008A and 2008B. Proceeds were used to refund certain amounts outstanding on the Series 2001B, Series 2007A, and Series 2007B Bonds. The remaining proceeds were used for capital expenditures and reimbursement for prior capital expenditures. The bonds were issued at fixed and variable rates and have term maturities, which generally have an initial term of 40 years. The Series 2008B Bonds are secured by a standby bond purchase agreement scheduled to terminate on April 12, 2019.

Other long-term debt consists primarily of HELP loans, term loans, and other obligations related to the acquisition of property and equipment. Capital leases primarily consist of two building lease agreements, with a related party of the System, with remaining terms varying from 21 to 25 years. As of June 30, 2016, \$62,282 remains outstanding under the agreements.

The System has revolving credit facilities through its syndicated facility with various banks. Under this credit agreement, the System may borrow up to \$200,000. The credit agreement expires on September 30, 2019, at which time all amounts outstanding will become due. Interest is paid at a floating rate based on the designated one-month LIBOR rate, plus 75 basis points.

The System is required to meet certain debt coverage and other financial covenants. As of June 30, 2016, the System was in compliance with all financial covenants.

Principal maturities of long-term debt, due subsequent to June 30, 2017, according to the long-term amortization schedule, are as follows:

Year ending June 30:	
2018	\$ 43,064
2019	23,511
2020	47,047
2021	19,031
Thereafter	627,694

Interest paid on long-term debt totaled \$24,115 and \$24,154 in 2016 and 2015, respectively.



## Spectrum Health System and Affiliates

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

#### 6. Interest Rate Swaps

The System has entered into interest rate swap agreements to manage exposure to certain risks. The interest rate swap agreements utilized by the System effectively modify the System's exposure to interest rate risk. Certain interest rate swap agreements convert the System's floating rate debt to a fixed rate basis for the next 31 years, thus reducing the impact of interest rate changes on future interest expense. This involves the receipt of floating rate amounts in exchange for fixed rate interest payments over the life of the agreements, without an exchange of the underlying principal amount. In addition, the System utilizes a basis swap to reduce exposure to rising variable rates. This agreement involves the receipt of a short-term taxable rate in exchange for a short-term tax-exempt rate.

Outstanding interest rate swap agreements are as follows:

Notional Amount	Maturity Date	Rate Received	Rate Paid
\$ 52,800	January 2026	66% of one-month LIBOR	Fixed rate of 3.853% Securities Industry and Financial Markets Association (SIFMA) (0.41% as of June 30, 2016)
196,000	July 2022	75.125% of one-month LIBOR	
76,785	July 2031	62.4% of one-month LIBOR plus 0.29%	Fixed rate of 3.857%
251,520	January 2047	67% of three-month LIBOR (0.65% at June 30, 2016)	Fixed rate of 3.698%
13,795	December 2023	SIFMA	Fixed rate of 4.18%

Guidance on fair value accounting stipulates that a credit valuation adjustment (CVA) should be applied to the mark-to-market valuation position of interest rate swaps to more clearly capture the fair value of such instruments. As of June 30, 2016, the fair value of the interest rate swaps was a liability of \$141,747, which is net of CVA of \$9,067. As of June 30, 2015, the fair value of the interest rate swaps was a liability of \$98,067, which is net of CVA of \$5,100. Changes in the fair value of these derivative financial instruments are included in the accompanying consolidated statements of operations and changes in net assets within other nonoperating revenue (expenses).

## Spectrum Health System and Affiliates

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

#### 6. Interest Rate Swaps (continued)

The System recorded the following loss in the accompanying consolidated statements of operations and changes in net assets related to these derivative financial instruments:

	<b>Year Ended June 30</b>	
	<b>2016</b>	<b>2015</b>
Loss on interest rate swaps, net:		
Unrealized loss on interest rate swaps	\$ (43,680)	\$ (12,691)
Realized loss on interest rate swaps	(13,502)	(13,759)
	\$ (57,182)	\$ (26,450)

The System has used various derivative contracts in connection with certain prior obligations and investments. Although minimum credit ratings are required for counterparties for four of the derivative instruments having a notional value of \$577,105, this does not eliminate the risk that the counterparty may fail to honor its obligations. Derivative contracts are subject to periodic mark-to-market valuations. A derivative contract may, at any time, have a positive or negative value to the System. In the event that the negative value reached certain thresholds established in the derivative contracts, the System is required to post collateral, which could adversely affect its liquidity. Collateral arrangements reduce the credit exposure and are considered in determining the CVA. The aggregate fair value of all derivative instruments, with credit-risk-related contingent features, which are in a liability position on June 30, 2016 and 2015, was \$139,385 and \$95,894, respectively. There was no collateral posted at June 30, 2016 or 2015. The System's accounting policy is not to offset collateral amounts against fair value amounts recognized for derivative instrument obligations.

#### 7. Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The FASB's Accounting Standards Codification Topic 820, *Fair Value Measurement*, establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

## Spectrum Health System and Affiliates

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

#### 7. Fair Value Measurements (continued)

Certain of the System's financial assets and financial liabilities are measured at fair value on a recurring basis, including money market, fixed income and equity instruments, and interest rate swap contracts. The three levels of the fair value hierarchy and a description of the valuation methodologies used for instruments measured at fair value are as follows:

*Level 1* – Quoted prices (unadjusted) in active markets for identical assets or liabilities as of the reporting date. Level 1 primarily consists of financial instruments such as money market securities and listed equities.

*Level 2* – Pricing inputs other than quoted prices included in Level 1 that are either directly observable or that can be derived or supported from observable data as of the reporting date. Instruments in this category include certain U.S. government agency and sponsored entity debt securities and interest rate swap contracts.

*Level 3* – Pricing inputs include those that are significant to the fair value of the financial asset or liability and are not observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

The carrying values of cash and cash equivalents, patient accounts receivable, other accounts receivable, and accounts payable are reasonable estimates of fair value due to the short-term nature of these financial instruments. The carrying value of pledges receivable is estimated by management to approximate fair value. The fair values of the System's fixed rate bonds are based on quoted market prices for the same or similar issues, and total \$231,132 and \$231,433 as of June 30, 2016 and 2015, respectively, and represent Level 2 measurements. The fair value of the System's variable rate debt approximates the carrying amount as of June 30, 2016 and 2015, and excludes the impact of third-party credit enhancements. The variable rate debt represents a Level 2 measurement.

# Spectrum Health System and Affiliates

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

### 7. Fair Value Measurements (continued)

The value of financial assets measured at fair value on a recurring basis was determined using the following inputs at June 30, 2016:

	Fair Market Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial assets:				
Cash and cash equivalents	\$ 582,528	\$ 582,528	\$ —	\$ —
Short-term investments	292,640	89,470	203,170	—
U.S. treasury securities	234,594	233,553	1,041	—
Corporate debt securities	252,834	—	252,834	—
Mortgage-backed securities	305,167	—	305,167	—
Mutual funds – domestic equity	125,497	125,497	—	—
Mutual funds – international equity	313,847	313,847	—	—
Mutual funds – fixed income	155,532	155,532	—	—
Marketable equity securities	157,015	157,015	—	—
Commingled funds	322,832	—	322,832	—
Total financial assets at fair value	2,742,486	\$ 1,657,442	\$ 1,085,044	\$ —
Due to broker, net	(14,667)			
	<u>\$ 2,727,819</u>			
Financial liabilities:				
Interest rate swap agreements	\$ 141,747	\$ —	\$ 141,747	\$ —
Total financial liabilities at fair value	<u>\$ 141,747</u>	<u>\$ —</u>	<u>\$ 141,747</u>	<u>\$ —</u>

# Spectrum Health System and Affiliates

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

### 7. Fair Value Measurements (continued)

The value of financial assets measured at fair value on a recurring basis was determined using the following inputs at June 30, 2015:

	Fair Market Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial assets:				
Cash and cash equivalents	\$ 450,808	\$ 450,808	\$ —	\$ —
Short-term investments	269,065	32,981	236,084	—
U.S. treasury securities	210,282	210,282	—	—
Corporate debt securities	216,289	—	216,289	—
Mortgage-backed securities	266,613	—	266,613	—
Mutual funds – domestic equity	103,719	103,719	—	—
Mutual funds – international equity	297,393	297,393	—	—
Mutual funds – fixed income	150,287	150,287	—	—
Marketable equity securities	145,915	145,915	—	—
Commingled funds	335,791	—	335,791	—
Total financial assets at fair value	2,446,162	\$ 1,391,385	\$ 1,054,777	\$ —
Due to broker, net	(19,788)			
	<u>\$ 2,426,374</u>			
Financial liabilities:				
Interest rate swap agreements	\$ 98,067	\$ —	\$ 98,067	\$ —
Total financial liabilities at fair value	<u>\$ 98,067</u>	<u>\$ —</u>	<u>\$ 98,067</u>	<u>\$ —</u>

The fair values of the securities included in Level 1 were determined through unadjusted quoted market prices. The fair values of Level 2 securities (primarily fixed income) were determined using third-party quotes based on quoted market prices of similar securities and other observable inputs. The fair values of the interest rate swap agreements are based on forward interest rate curves and reflect a credit spread adjustment in order to reflect the CVA for nonperformance risk. The CVA is derived from other comparably rated entities' bonds priced in the market. Due

## Spectrum Health System and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(In Thousands)*

#### **7. Fair Value Measurements (continued)**

to the volatility of the capital markets, there is a reasonable possibility of significant changes in fair value and additional gains or losses in the near term subsequent to June 30, 2016. The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

#### **8. Professional, General Liability, and Other Insurance**

The System maintains coverage for professional and general liability risks through a combination of policies with an insurance reciprocal (self-funded) and commercial insurance carriers. The first tier of coverage is provided through Michigan Professional Insurance Exchange and is funded by actuarially computed premium payments with specific retention limits that vary by year. The risk management plan provides for consolidated supplemental comprehensive excess insurance provided through commercial insurance carriers. Amounts exceeding the insurance provided by other commercial insurance would be the responsibility of the System.

Malpractice and general liability claims have been asserted against the System's affiliates by various claimants and are in various stages of discovery. Also, known and unknown incidents have occurred through June 30, 2016, that may result in the assertion of additional claims. Although the System is unable to precisely estimate the ultimate cost of settlements, management has accrued its best estimate for claims identified and an amount for potential claims incurred but not reported based on historical experience. The estimated cost of claims is actuarially determined based upon past experience and is discounted using a discount rate of 1.7% and 1.19% in 2016 and 2015, respectively. Provisions for malpractice insurance charged to operations amounted to \$17,110 and \$19,460 in 2016 and 2015, respectively, which include additional amounts related to incurred but not reported claims.

The System's risk management plan for other insurance is a combination of retained and reinsured limits. Priority Health has reinsurance contracts whereby it cedes exposure to potential losses arising from large claims. Management believes, after considering legal counsel and claim management advisors' evaluations of all actions and claims, that insurance coverage and accruals for estimated losses are adequate to cover expected settlements.

## Spectrum Health System and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(In Thousands)*

#### **9. Employee Benefit Plans**

##### **Defined Contribution Plans**

The System maintains defined contribution retirement plans. Employer contributions to those plans are based on either a percentage of a participant's contribution or a percentage of a participant's compensation. Contributions to the defined contribution plans were \$59,260 and \$52,267 in 2016 and 2015, respectively.

##### **Defined Benefit Plans**

The System sponsors defined benefit pension plans. The benefits are based on years of service and compensation. The defined benefit plans have been frozen, and no new participants are permitted. Contributions to these plans are sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974, as amended, plus such additional amounts as may be determined to be appropriate from time to time.

The System recognized the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligation) of its pension plans in the consolidated balance sheets. The annual adjustment to unrestricted net assets represents the unrecognized actuarial losses and unrecognized prior service costs, which will be subsequently recognized as net periodic pension costs. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net pension costs in the same period will be recognized as a component of unrestricted net assets. Those amounts will be subsequently recognized as a component of net periodic pension cost on the same basis as amounts recognized in unrestricted net assets.

# Spectrum Health System and Affiliates

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

### 9. Employee Benefit Plans (continued)

A summary of the information related to all of the System's defined benefit plans is as follows:

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
<b>Change in benefit obligation</b>		
Projected benefit obligation at beginning of year	\$ 397,429	\$ 386,263
Interest cost	15,121	14,111
Actuarial losses	63,664	19,300
Benefits paid	(21,895)	(21,493)
Business combinations	—	—
Plan amendments	—	(752)
Settlements	—	—
Projected benefit obligation at end of year	<b>454,319</b>	397,429
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	325,973	319,282
Actual return on plan assets	(1,793)	5,291
Employer contributions	23,074	22,893
Benefits paid	(21,895)	(21,493)
Business combinations	—	—
Settlements	—	—
Fair value of plan assets at end of year	<b>325,359</b>	325,973
Funded status and amount recognized in balance sheets	<b>\$ (128,960)</b>	\$ (71,456)
<b>Amounts recognized in the consolidated balance sheets</b>		
Accumulated adjustments to unrestricted net assets:		
Net actuarial loss	\$ 279,005	\$ 197,344
Prior service credit	(2,022)	(2,166)
Net amount recognized	<b>\$ 276,983</b>	\$ 195,178



# Spectrum Health System and Affiliates

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

### 9. Employee Benefit Plans (continued)

	<b>June 30</b>	
	<b>2016</b>	<b>2015</b>
<b>Components of net periodic benefit cost</b>		
Interest cost	\$ 15,121	\$ 14,111
Expected return on plan assets	(24,540)	(23,650)
Amortization of unrecognized prior service credit	(143)	(103)
Amortization of unrecognized net loss	8,336	7,345
Settlement loss	—	—
Net periodic (benefit) cost	<u>\$ (1,226)</u>	<u>\$ (2,297)</u>
Accumulated benefit obligation at end of year	<u>\$ 434,791</u>	<u>\$ 382,287</u>

Accumulated adjustments to unrestricted net assets at June 30, 2016 include amounts related to net actuarial loss and unrecognized prior service credit that have not yet been recognized in net periodic benefit cost. Expected amortization of amounts included in unrestricted net assets is expected to increase net periodic pension costs by \$12,073 during fiscal 2017.

	<b>2016</b>	<b>2015</b>
<b>Weighted-average assumptions used to determine benefit obligation as of June 30</b>		
Discount rate	3.17%	3.95%
Rate of compensation increase	3.00	3.00
<b>Weighted-average assumptions used to determine net periodic benefit cost as of June 30</b>		
Discount rate for periodic pension costs	3.95%	3.76%
Expected return on plan assets	7.76	7.76
Rate of compensation increase	3.00	3.00

Actuarial losses of \$66,664 related to fiscal year 2016 increased the projected benefit obligation and are primarily attributable to the changes in the discount rate and mortality assumptions.

The expected return on plan assets is determined by applying the target allocation in each asset category of plan investments to the anticipated return for each asset category based on historical and projected returns.

## Spectrum Health System and Affiliates

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

#### 9. Employee Benefit Plans (continued)

The investment strategy for the System's defined benefit plans is both to meet the liabilities of the plans as they become due and to maximize the return on invested assets within appropriate risk tolerances. The System's pension plan asset allocations by major asset category are as follows:

<b>Asset Category</b>	<b>Plan Assets at June 30 2016</b>	<b>2015</b>	<b>Target Asset Allocation</b>
Cash and cash equivalents	5%	3%	0–10.0%
Equity securities	49	52	27.5–77.5
Debt securities	46	45	35.0–60.0
Total	<u>100%</u>	<u>100%</u>	

The following table presents the plans' financial instruments as of June 30, 2016, measured at fair value on a recurring basis within the fair value hierarchy as disclosed in Note 7:

	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Cash and cash equivalents	\$ 14,872	\$ 14,872	\$ –	\$ –
Short-term investments	3,815	3,192	623	–
U.S. treasury securities	15,607	15,607	–	–
Corporate debt securities	13,376	–	13,376	–
Mortgage-backed securities	25,888	–	25,888	–
Mutual funds – domestic fixed income	55,638	55,638	–	–
Mutual funds – international equity	55,303	55,303	–	–
Mutual funds – international fixed income	1,933	1,933	–	–
Commingled funds	89,981	–	89,981	–
Common stock	49,125	49,125	–	–
Total assets measured at fair value on a recurring basis	325,538	\$ 195,670	\$ 129,868	\$ –
Due to broker, net	(179)			
	<u>\$ 325,359</u>			

# Spectrum Health System and Affiliates

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

### 9. Employee Benefit Plans (continued)

The following table presents the plans' financial instruments as of June 30, 2015, measured at fair value on a recurring basis within the fair value hierarchy as disclosed in Note 7:

	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Cash and cash equivalents	\$ 9,561	\$ 9,561	\$ —	\$ —
U.S. treasury securities	23,938	23,938	—	—
Corporate debt securities	10,422	—	10,422	—
Mortgage-backed securities	20,040	—	20,040	—
Mutual funds – domestic fixed income	57,010	57,010	—	—
Mutual funds – international equity	61,846	61,846	—	—
Mutual funds – international fixed income	1,694	1,694	—	—
Commingled funds	88,564	—	88,564	—
Common stock	53,017	53,017	—	—
Total assets measured at fair value on a recurring basis	326,092	\$ 207,066	\$ 119,026	\$ —
Due to broker, net	(119)			
	<u>\$ 325,973</u>			

Projected benefits to be paid in the years subsequent to June 30, 2016:

2017	\$ 26,606
2018	26,730
2019	26,909
2020	26,851
2021–2026	158,672
Contributions expected in 2017	12,334

## Spectrum Health System and Affiliates

### Notes to Consolidated Financial Statements (continued)

*(In Thousands)*

#### **10. Consent Decree**

In connection with the formation of Spectrum Health, the System agreed to be bound by the terms of a consent decree with a federal court. The consent decree contains a series of formal assurances to the West Michigan community with respect to the operation of the merged entity, Spectrum Health. Although numerous requirements were imposed by the consent decree, the most restrictive terms expired in September 2004 (including the limitations on price increases). However, the following requirements will continue in perpetuity:

- Spectrum Health will target a five-year rolling average total margin for the merged system that does not exceed the average of Moody's and Standard & Poor's upper quartile total margins for other health systems nationally.
- Spectrum Health has committed to establish a fund to provide health care programs for the underserved in the community, including services such as community-based clinics, immunization and preventive care, and health education programs. The Community Commitment fund will include a budgeted item in the amount of \$6 million per year.
- The Community Commitment also opens the budget and pricing process of Spectrum Health to the public for both input in advance of the adoption of the budget and scrutiny of past performance. A permanent Finance Advisory Committee counsels the Finance Committee of the Spectrum Health Board of Directors during the budgeting process and prior to any budgetary recommendation to the entity's Board.
- The Board of Directors of Spectrum Health will be representative of the community it serves.

As of June 30, 2016 and 2015, and for the years then ended, management believes the System is in compliance with the terms of the consent decree.

## Supplemental Information

## Report of Independent Auditors on Supplemental Information

The Board of Directors  
Spectrum Health System and Affiliates

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The community benefit expense, consolidating balance sheet, and consolidating statement of operations and changes in net assets are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information, except for that portion marked “unaudited,” has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information, except for that portion marked “unaudited,” on which we express no opinion, is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

*Ernst & Young LLP*

August 29, 2016

# Spectrum Health System and Affiliates

## Consolidating Balance Sheet (In Thousands)

June 30, 2016

	Obligated Group	Designated Affiliates	Credit Group	Spectrum Health Ludington Hospital	Spectrum Health Pennock	Other	System Total
<b>Assets</b>							
Current assets:							
Cash and cash equivalents	\$ 239,057	\$ 40,423	\$ 279,480	\$ 1,090	\$ 2,690	\$ 212,848	\$ 496,108
Short-term investments	—	—	—	—	—	256,450	256,450
Patient accounts receivable, net	218,162	38,099	256,261	11,147	5,837	47,132	320,377
Other accounts receivable, net	10,593	131	10,724	25	489	135,717	146,955
Third-party settlement receivables	137	—	137	—	—	145	282
Pledges receivable	4,193	—	4,193	—	—	8,567	12,760
Inventories	30,926	4,339	35,265	1,875	1,579	2,646	41,365
Prepaid expenses and other current assets	47,424	2,138	49,562	301	701	21,772	72,336
Total current assets	550,492	85,130	635,622	14,438	11,296	685,277	1,346,633
Investments	1,268,525	4,079	1,272,604	6,309	10,008	662,863	1,951,784
Interest in recipient organization	112,646	10,243	122,889	1,092	6,587	(130,568)	—
Property and equipment – net	1,081,218	126,714	1,207,932	34,057	18,868	232,122	1,492,979
Other assets:							
Due from unconsolidated affiliates	305,467	(6,121)	299,346	1,352	786	(301,484)	—
Investments in unconsolidated affiliates	47,856	(32)	47,824	85	85	(47,994)	—
Investments in joint ventures	7,058	2,520	9,578	—	—	—	9,578
Goodwill	8,144	—	8,144	—	—	12,027	20,171
Intangible assets and other costs	3,146	296	3,442	309	53	9,047	12,851
Pledges receivable	—	—	—	—	—	45,920	45,920
Other	102,627	1,492	104,119	—	14	8,046	112,179
	474,298	(1,845)	472,453	1,746	938	(274,438)	200,699
Total assets	\$ 3,487,179	\$ 224,321	\$ 3,711,500	\$ 57,642	\$ 47,697	\$ 1,175,256	\$ 4,992,095

## Spectrum Health System and Affiliates

### Consolidating Balance Sheet (continued) (In Thousands)

	Obligated Group	Designated Affiliates	Credit Group	Spectrum Health Ludington Hospital	Spectrum Health Pennock	Other	System Total
<b>Liabilities and net assets</b>							
Current liabilities:							
Accounts payable and accrued expenses	\$ 154,164	\$ 9,184	\$ 163,348	\$ 4,205	\$ 2,642	\$ 231,359	\$ 401,554
Salaries, wages, and related withholdings	144,394	20,990	165,384	4,194	5,429	69,191	244,198
Health plan claims payable	—	—	—	—	—	274,347	274,347
Current maturities of long-term debt	13,166	2,612	15,778	900	1,874	1,057	19,609
Short-term debt	78,400	—	78,400	—	—	—	78,400
Total current liabilities	390,124	32,786	422,910	9,299	9,945	575,954	1,018,108
Due to unconsolidated affiliates	127,414	14,335	141,749	7,095	4,578	(153,422)	—
Third-party settlement liabilities	1,454	5,503	6,957	2,990	1,295	12,445	23,687
Long-term debt, less current maturities	652,570	59,795	712,365	15,865	7,222	24,895	760,347
Professional liability accrual	41,552	—	41,552	—	—	—	41,552
Accrued pension obligation	124,227	—	124,227	—	—	4,733	128,960
Interest rate swaps	139,371	2,376	141,747	—	—	—	141,747
Other long-term liabilities	93,707	351	94,058	—	—	11,230	105,288
Total liabilities	1,570,419	115,146	1,685,565	35,249	23,040	475,835	2,219,689
Net assets:							
Controlling interest in unrestricted net assets	1,799,981	98,507	1,898,488	21,302	18,070	645,388	2,583,248
Noncontrolling interest in subsidiaries	143	—	143	—	—	38,980	39,123
Total unrestricted	1,800,124	98,507	1,898,631	21,302	18,070	684,368	2,622,371
Temporarily restricted	69,438	7,077	76,515	1,048	6,109	13,396	97,068
Permanently restricted	47,198	3,591	50,789	43	478	1,657	52,967
Total net assets	1,916,760	109,175	2,025,935	22,393	24,657	699,421	2,772,406
Total liabilities and net assets	\$ 3,487,179	\$ 224,321	\$ 3,711,500	\$ 57,642	\$ 47,697	\$ 1,175,256	\$ 4,992,095



## Spectrum Health System and Affiliates

### Consolidating Statement of Operations and Changes in Net Assets (In Thousands)

Year Ended June 30, 2016

	Obligated Group	Designated Affiliates	Credit Group	Spectrum Health Ludington Hospital	Spectrum Health Pennock	Other	System Total
<b>Operating revenue</b>							
Health plan	\$ —	\$ —	\$ —	\$ —	\$ —	2,784,764	\$ 2,784,764
Patient service revenue (net of allowances and adjustments)	1,960,340	323,106	2,283,446	77,247	73,964	(17,740)	2,416,917
Provision for bad debts	(48,423)	(12,568)	(60,991)	(5,217)	(5,763)	(21,593)	(93,564)
Net patient service revenue (expense)	1,911,917	310,538	2,222,455	72,030	68,201	(39,333)	2,323,353
Other	400,871	(36,233)	364,638	1,445	2,402	(256,087)	112,398
Total operating revenue	2,312,788	274,305	2,587,093	73,475	70,603	2,489,344	5,220,515
<b>Operating expenses</b>							
Salaries, wages, and employee benefits	1,017,055	159,043	1,176,098	35,323	41,573	366,577	1,619,571
Supplies and other	964,827	78,825	1,043,652	42,584	29,261	(16,937)	1,098,560
Health plan expense to providers	—	—	—	—	—	2,034,735	2,034,735
Depreciation and amortization	125,749	12,700	138,449	3,660	2,828	31,216	176,153
Interest	17,745	2,457	20,202	439	149	980	21,770
Total operating expenses	2,125,376	253,025	2,378,401	82,006	73,811	2,416,571	4,950,789
Total operating income (loss)	187,412	21,280	208,692	(8,531)	(3,208)	72,773	269,726
<b>Other nonoperating revenue (expenses)</b>							
Investment income (loss), net	9,966	(1,824)	8,142	(117)	(1,702)	18,420	24,743
Loss on interest rate swaps, net	(56,463)	(409)	(56,872)	—	—	(310)	(57,182)
Other (expenses) income	(18,651)	(17)	(18,668)	—	318	(1,202)	(19,552)
Total other nonoperating (expenses) revenue	(65,148)	(2,250)	(67,398)	(117)	(1,384)	16,908	(51,991)
Consolidated excess of revenue over (under) expenses	122,264	19,030	141,294	(8,648)	(4,592)	89,681	217,735
Less: Excess of revenue over expenses attributable to noncontrolling interest	112	—	112	—	—	5,579	5,691
Excess of revenue over (under) expenses	122,152	19,030	141,182	(8,648)	(4,592)	84,102	212,044

# Spectrum Health System and Affiliates

## Consolidating Statement of Operations and Changes in Net Assets (continued) (In Thousands)

Year Ended June 30, 2016

	Obligated Group	Designated Affiliates	Credit Group	Spectrum Health Ludington Hospital	Spectrum Health Pennock	Other	Total Controlling	Non- controlling	Total
<b>Unrestricted net assets</b>									
Excess of revenue over (under) expenses	\$ 122,152	\$ 19,030	\$ 141,182	\$ (8,648)	\$ (4,592)	\$ 84,102	\$ 212,044	\$ 5,691	\$ 217,735
Contributions	—	—	—	—	—	404	404	—	404
Expenditures for donor-sponsored programs	—	—	—	—	—	(280)	(280)	—	(280)
Net assets released for capital acquisitions	694	607	1,301	149	—	22	1,472	—	1,472
Pension-related changes other than net periodic pension costs	(79,388)	—	(79,388)	—	—	(2,417)	(81,805)	—	(81,805)
Other	119,515	(62,929)	56,586	(5,133)	(51,613)	2,316	2,156	—	2,156
Increase (decrease) in unrestricted net assets	162,973	(43,292)	119,681	(13,632)	(56,205)	84,147	133,991	5,691	139,682
<b>Temporarily restricted net assets</b>									
Contributions	—	—	—	—	—	12,630	12,630	—	12,630
Expenditures for donor-sponsored programs	—	—	—	—	—	(16,923)	(16,923)	—	(16,923)
Investment returns	—	—	—	—	—	(1,149)	(1,149)	—	(1,149)
Interest in recipient organization	(4,023)	(36)	(4,059)	267	5,087	(1,295)	—	—	—
Net assets released for capital acquisitions	—	—	—	—	—	(1,472)	(1,472)	—	(1,472)
Other	62	—	62	—	—	848	910	—	910
(Decrease) increase in temporarily restricted net assets	(3,961)	(36)	(3,997)	267	5,087	(7,361)	(6,004)	—	(6,004)
<b>Permanently restricted net assets</b>									
Contributions	—	—	—	—	—	6,339	6,339	—	6,339
Investment returns	—	—	—	—	—	(850)	(850)	—	(850)
Interest in recipient organization	4,954	(77)	4,877	28	24	(4,929)	—	—	—
Other	—	—	—	—	—	(716)	(716)	—	(716)
Increase (decrease) in permanently restricted net assets	4,954	(77)	4,877	28	24	(156)	4,773	—	4,773
Increase (decrease) in net assets	163,966	(43,405)	120,561	(13,337)	(51,094)	76,630	132,760	5,691	138,451
Net assets, beginning of year	1,752,651	152,580	1,905,231	35,730	75,751	583,811	2,600,523	33,432	2,633,955
Net assets, end of year	\$ 1,916,617	\$ 109,175	\$ 2,025,792	\$ 22,393	\$ 24,657	\$ 660,441	\$ 2,733,283	\$ 39,123	\$ 2,772,406

## Spectrum Health System and Affiliates

### Community Benefit Expense (Unaudited) (In Thousands)

June 30, 2016

In support of its mission, the System provides various health-related services, at a loss, to the indigent and other residents in its service area. The following is a summary of the System's community benefit expense:

	<b>Year Ended June 30</b>	
	<b>2016</b>	<b>2015</b>
Community partnership programs (Community Commitment fund)	\$ 6,882	\$ 6,804
Community partnership programs	5,279	4,360
Health clinics	3,344	3,580
Health professions education	14,857	13,309
Research	3,312	3,724
Donations/contributions	52	726
Traditional charity care	2,470	4,042
Discounted care (under 250% federal poverty level)	5,692	9,487
Unpaid costs for government program patients	236,553	193,984
Uninsured – bad debts	48,053	43,291
Total community benefit expense	<u>\$ 326,494</u>	<u>\$ 283,307</u>

*Community partnership programs (Community Commitment fund)* – Includes health care programs for the underserved in the community, including services such as community-based clinics, immunizations and preventive care, and health education programs. Examples include programs related to the poor, elderly, substance abuse, child abuse, and others with specific particular health care needs. They also include broader populations who benefit from health community initiatives, such as health promotion, education, and health screening. The Community Commitment fund relates to Spectrum Health's established \$6 million fund, as part of the Consent Decree, to provide quality health care programs for the underserved in the community. The remaining programs are funded through operations.

*Health clinics* – Includes net costs incurred to operate community clinics that are offered at no cost or subsidized cost.

*Health professions education* – Represents the cost to provide a clinical setting for undergraduate training and internships in order to help prepare future health care professionals.

## Spectrum Health System and Affiliates

### Community Benefit Expense (Unaudited) (continued)

(In Thousands)

June 30, 2016

*Research* – Includes the unpaid cost of health care research and studies.

*Donations/contributions* – Includes cash and in-kind donations that are made on behalf of the poor and needy to community agencies and to special funds for charitable activities, as well as resources contributed directly to programs, organizations, and foundations for efforts on behalf of the poor and disadvantaged.

*Traditional charity care* – Covers services provided to persons who cannot afford to pay. The amount reflects the cost of free or discounted health services, net of contributions and other revenue received as direct assistance for the provision of charity care. Charity care is determined based on established policies, using patient income and assets to determine payment ability.

*Discounted care (under 250% federal poverty level)* – Represents the amount of the state of Michigan mandated discounts provided for the uninsured based on financial need. The hospital must accept 115% Medicare rates as payments in full from an uninsured individual with an annual income level up to 250% of the federal poverty level.

*Unpaid costs for government program patients* – Represents the estimated shortfall created when a facility receives payments below the costs of treating Medicare and Medicaid beneficiaries.

*Uninsured – bad debts* – Represents the amount of uncompensated care to uninsured and underinsured patients, which is reported as bad debt.

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