

**Stanford Health Care**  
**Consolidated Financial Statements**  
**and Accompanying Consolidating Information**  
**August 31, 2017 and 2016**

**Stanford Health Care**  
**Index**  
**August 31, 2017 and 2016**

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## Report of Independent Auditors

To the Board of Directors  
Stanford Health Care

We have audited the accompanying consolidated financial statements of Stanford Health Care ("SHC"), which comprise the consolidated balance sheets as of August 31, 2017 and 2016, and the related consolidated statements of operations and changes in net assets and of cash flows for the years then ended.

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

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

### ***Auditors' Responsibility***

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

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

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Stanford Health Care as of August 31, 2017 and 2016, and the results of its operations and changes in net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*PricewaterhouseCoopers LLP*

December 5, 2017

**Stanford Health Care**  
**Consolidated Balance Sheets**  
**August 31, 2017 and 2016**  
**(in thousands of dollars)**

	<u>2017</u>	<u>2016</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 710,109	\$ 690,460
Short term investments	233,533	103,627
Patient accounts receivable, net of allowance for doubtful accounts of \$191,000 and \$161,000 at August 31, 2017 and 2016, respectively	610,734	559,933
Other receivables	71,112	92,961
Inventories	56,559	50,016
Prepaid expenses and other	42,528	36,273
Total current assets	<u>1,724,575</u>	<u>1,533,270</u>
Investments	111,664	104,038
Investments at equity	66,255	41,609
Investments in University managed pools	1,287,193	1,316,489
Assets limited as to use, held by trustee	58,134	235,788
Property and equipment, net	2,869,346	2,401,880
Other assets	112,445	124,263
Total assets	<u>\$ 6,229,612</u>	<u>\$ 5,757,337</u>
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 307,899	\$ 335,995
Accrued salaries and related benefits	255,759	236,819
Due to related parties	71,429	61,308
Third-party payor settlements	18,149	22,948
Current portion of long-term debt	13,335	13,756
Revolving line of credit	135,000	-
Debt subject to short-term remarketing arrangements	228,200	228,200
Self-insurance reserves and other	45,854	43,232
Total current liabilities	<u>1,075,625</u>	<u>942,258</u>
Self-insurance reserves and other, net of current portion	130,816	118,994
Other long-term liabilities	277,329	355,683
Pension liability	51,745	65,463
Long-term debt, net of current portion	1,189,529	1,220,789
Total liabilities	<u>2,725,044</u>	<u>2,703,187</u>
Net assets:		
Unrestricted:		
Stanford Health Care	2,871,113	2,449,037
Noncontrolling interests	22,060	20,133
Total unrestricted	<u>2,893,173</u>	<u>2,469,170</u>
Temporarily restricted	603,251	577,086
Permanently restricted	8,144	7,894
Total net assets	<u>3,504,568</u>	<u>3,054,150</u>
Total liabilities and net assets	<u>\$ 6,229,612</u>	<u>\$ 5,757,337</u>

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

**Stanford Health Care**  
**Consolidated Statements of Operations and Changes in Net Assets**  
**Years Ended August 31, 2017 and 2016**  
**(in thousands of dollars)**

	<u>2017</u>	<u>2016</u>
Operating revenues:		
Net patient service revenue	\$ 4,311,530	\$ 4,019,285
Provision for doubtful accounts	(77,004)	(126,280)
Net patient service revenue less provision for doubtful accounts	4,234,526	3,893,005
Premium revenue	80,647	72,292
Other revenue	129,324	122,996
Net assets released from restrictions used for operations	9,904	9,372
Total operating revenues	<u>4,454,401</u>	<u>4,097,665</u>
Operating expenses:		
Salaries and benefits	1,986,360	1,850,124
Professional services	42,851	49,846
Supplies	586,056	531,130
Purchased services	1,136,020	1,058,182
Depreciation and amortization	154,686	136,442
Interest	43,643	39,661
Other	384,354	389,199
Expense recoveries from related parties	(113,451)	(104,965)
Total operating expenses	<u>4,220,519</u>	<u>3,949,619</u>
Income from operations	233,882	148,046
Interest and investment income	15,325	13,635
Earnings on equity method investments	5,114	-
Increase in value of University managed pools	144,829	24,181
Interest rate swaps mark to market adjustments	85,368	(115,958)
Excess of revenues over expenses	484,518	69,904
Other changes in unrestricted net assets:		
Transfer to Stanford University, net	(69,376)	(88,944)
Transfer to Lucile Salter Packard Children's Hospital	-	(3,300)
Change in net unrealized gains on investments	1,058	1,245
Net assets released from restrictions used for:		
Purchase of property and equipment	1,320	973
Change in pension and postretirement liability	6,182	(80)
Noncontrolling capital contributions (distributions)	301	(1,000)
Increase (decrease) in unrestricted net assets	<u>424,003</u>	<u>(21,202)</u>
Changes in temporarily restricted net assets:		
Transfer from Stanford University	2,748	2,645
Contributions and other	28,541	20,717
Investment income	4,662	744
Gains on University managed pools	1,438	1,683
Net assets released from restrictions used for:		
Operations	(9,904)	(9,372)
Purchase of property and equipment	(1,320)	(973)
Increase in temporarily restricted net assets	<u>26,165</u>	<u>15,444</u>
Changes in permanently restricted net assets:		
Contributions	250	200
Increase in permanently restricted net assets	<u>250</u>	<u>200</u>
Increase (decrease) in net assets	450,418	(5,558)
Net assets, beginning of year	<u>3,054,150</u>	<u>3,059,708</u>
Net assets, end of year	<u>\$ 3,504,568</u>	<u>\$ 3,054,150</u>

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

**Stanford Health Care**  
**Consolidated Statements of Cash Flows**  
**Years Ended August 31, 2017 and 2016**  
**(in thousands of dollars)**

	<u>2017</u>	<u>2016</u>
<b>Cash flows from operating activities:</b>		
Change in Stanford Health Care net assets	\$ 448,491	\$ (2,712)
Change in noncontrolling interests	1,927	(2,846)
Total change in net assets	450,418	(5,558)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	152,840	134,502
Provision for doubtful accounts	77,004	126,280
Change in fair value of interest rate swaps	(85,368)	115,958
Increase in value of University managed pools	(144,829)	(24,181)
Unrealized gains on investments	(5,138)	(1,712)
Realized gains on investments	(22)	-
(Excess) deficit of income of equity method investees over distributions received	(12,154)	3,101
Contributions received for long lived assets or endowment and net equity transfers to/from related parties	44,639	79,767
Changes in operating assets and liabilities:		
Patient accounts receivable	(127,805)	(135,492)
Due to related parties	(24,877)	474
Other receivables, inventory, other assets, prepaid expenses and other	4,174	(34,759)
Accounts payable, accrued liabilities and pension liabilities	(22,131)	82,724
Accrued salaries and related benefits	18,940	33,960
Third-party payor settlements	(4,799)	13,930
Self-insurance reserves	14,444	6,944
Cash provided by operating activities	<u>335,336</u>	<u>395,938</u>
<b>Cash flows from investing activities:</b>		
Purchases of investments	(204,822)	(59,290)
Sales of investments	68,350	67,052
Purchases of investments at equity	(12,752)	(13,427)
Purchases of investments in University managed pools	(1,764)	(1,729)
Sales of investments in University managed pools	179,989	150,240
Decrease in assets limited as to use and other	177,654	344,913
Purchases of property and equipment	(635,550)	(619,570)
Cash used in investing activities	<u>(428,895)</u>	<u>(131,811)</u>
<b>Cash flows from financing activities:</b>		
Borrowing on revolver	135,000	-
Costs of issuance of debt	(71)	-
Payment of long-term debt and capital lease obligations	(18,708)	(15,951)
Contributions received for long lived assets or endowment and net equity transfers to/from related parties	(3,013)	(33,393)
Cash provided by (used in) financing activities	<u>113,208</u>	<u>(49,344)</u>
Net increase in cash and cash equivalents	19,649	214,783
Cash and cash equivalents, beginning of year	<u>690,460</u>	<u>475,677</u>
Cash and cash equivalents, end of year	<u>\$ 710,109</u>	<u>\$ 690,460</u>
<b>Supplemental disclosures of cash flow information:</b>		
Interest paid, net of amounts capitalized	\$ 45,439	\$ 41,427
<b>Supplemental disclosures of non cash information:</b>		
Decrease in payables for property and equipment	\$ (13,356)	\$ (8,128)
Equity transfers (to) from related parties, net	(7,690)	3,894
Assets and liabilities acquired under capital leases	1,191	1,632

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

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 1. Organization

Stanford Health Care (“SHC”) operates a licensed acute care hospital (“Stanford Hospital”) and a cancer center in Palo Alto, California, along with numerous outpatient physician clinics in the San Francisco Bay Area, in community settings, and in association with regional hospitals. Stanford Hospital is a principal teaching affiliate of the Stanford University School of Medicine (“SoM”) and provides primary and specialty health services to adults, including cardiac care, cancer treatment, solid organ transplantation services, neurosciences, and orthopedics services designated by management as SHC’s “Strategic Clinical Services”. SHC, together with Lucile Salter Packard Children’s Hospital at Stanford (“LPCH”), operates the clinical settings through which the SoM educates medical and graduate students, trains residents and clinical fellows, supports faculty and community clinicians and conducts medical and biological sciences research.

The Board of Trustees of Leland Stanford Junior University (the “University”) is the sole corporate member of SHC and LPCH. As part of their ongoing operations, SHC and LPCH engage in certain related party transactions as described further in Note 13.

The consolidated financial statements include SHC’s interest in University HealthCare Alliance (“UHA”), The Hospital Committee for the Livermore-Pleasanton Areas (dba Stanford Health Care - ValleyCare) (“SHC-VC”), Stanford Blood Center, LLC (“SBC LLC”), Stanford Emanuel Radiation Oncology Center, LLC (“SEROC”), CareCounsel, LLC (“CareCounsel”), SUMIT Holding International, LLC (“SHI”), Professional Exchange Assurance Company (“PEAC”), Stanford Health Care Advantage (“SHC Advantage”), Stanford International Medical Services RAK FZE (“SIMS RAK FZE”) and Stanford Medicine International (Hong Kong) Co., Limited (“SMI Hong Kong”) (collectively “SHC”).

UHA, a physician medical foundation, supports SHC’s mission of delivering quality care to the community and conducting research and education. In addition, UHA leads the development of a high quality clinical delivery network, built on collaboration with and sponsorship of community hospitals, on behalf of the SoM, SHC, and UHA physicians. The SoM and SHC are the members of UHA, and appoint directors to the governing board. The UHA bylaws afford control to SHC. Effective January 1, 2011, SHC entered into a sponsorship agreement with UHA whereby SHC agreed to certain funding for the development and operation of UHA and continued additional funding for future or alternative clinical sites of UHA. Additional funding by SHC to UHA for operations and capital was \$73,617 and \$60,118 for the years ended August 31, 2017 and 2016, respectively.

SHC-VC, a leading community hospital system located in the East Bay’s Tri-Valley region of Pleasanton, Livermore and Dublin, completed an affiliation agreement with SHC effective May 18, 2015. SHC is the sole corporate member of SHC-VC.

SBC LLC is a limited liability company organized effective July 31, 2015. SBC LLC serves as a community blood center and provides blood products and testing services to hospitals, clinics, companies and other clients. SHC is the sole member of SBC LLC. On September 30, 2015, SBC LLC completed the acquisition of the Stanford Blood Center from the University for \$36,000. SBC LLC paid consideration in excess of assets acquired in the amount of \$31,123, which is recorded in Transfer to Stanford University in the consolidated statements of operations and changes in net assets for the year ending August 31, 2016.

SEROC was originally formed as a joint venture between SHC and Emanuel Medical Center (“EMC”). On July 31, 2014, EMC transferred its membership interest to Doctors Medical Center of Modesto, Inc. (“DMC”). SEROC operates an outpatient clinic that provides radiation oncology services to patients in Turlock, California and surrounding communities. SHC’s interest in SEROC was 60% for the years ended August 31, 2017 and 2016. The remaining interest of 40% is recorded as a noncontrolling interest in unrestricted net assets on the consolidated balance sheets as of August 31, 2017 and 2016.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 1. Organization (Continued)

CareCounsel, a leading provider of employer-sponsored health advocacy and health care assistance services, was acquired by SHC effective July 18, 2012. The Bay Area company was founded in 1996 with a mission to help employees, retirees and their families navigate the complex health care environment through an employer-sponsored benefit that provides consumer education, advocacy and access to expert health care resources and information.

SHI is the sole owner of SUMIT Insurance Company Ltd. ("SUMIT") and Stanford University Medical Network Risk Authority, LLC (dba The Risk Authority) ("TRA"). SHC and LPCH are the owners of SHI.

SHC's share of net assets in SUMIT, a captive insurance carrier, was 79.7% and 78.4% for the years ended August 31, 2017 and 2016, respectively. LPCH's share of net assets in SUMIT was 20.3% and 21.6% for the years ended August 31, 2017 and 2016, respectively, and is recorded as a noncontrolling interest in unrestricted net assets on the consolidated balance sheets.

TRA was formed on September 19, 2012 and began operations on December 1, 2012. TRA provides risk management services to SHI, the owners of SHI and other affiliated and unaffiliated parties and serves as attorney-in-fact to PEAC. SHC's share of net assets in TRA was 82% for the years ended August 31, 2017 and 2016. The remaining interest of 18% is recorded as a noncontrolling interest in unrestricted net assets on the consolidated balance sheets as of August 31, 2017 and 2016.

PEAC, a captive insurance carrier, provides insurance coverage to UHA, Packard Children's Health Alliance and other affiliated parties. SHC's share of net assets in PEAC was 71.4% and 70.6% for the years ended August 31, 2017 and 2016, respectively. The remaining interest of 28.6% and 29.4% for the years ended August 31, 2017 and 2016, respectively, is recorded as a noncontrolling interest in unrestricted net assets on the consolidated balance sheets.

SHC Advantage, a non-profit public benefit corporation, provides comprehensive healthcare coverage options to elderly and disabled eligible Medicare populations of Santa Clara County through their Medicare Advantage Plan and is solely controlled by SHC. This service is offered to Medicare-eligible residents of Santa Clara County effective January 1, 2015.

SIMS RAK FZE was formed in January 2016 to provide consulting and project management services in the United Arab Emirates.

SMI Hong Kong was formed in May 2016, as a holding company for business activities in China.

### 2. Summary of Significant Accounting Policies

#### Principles of Consolidation

The consolidated financial statements include the accounts of SHC and its subsidiaries, which are controlled and owned more than 50% by SHC. All significant inter-company accounts and transactions are eliminated in the consolidation.



# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### Basis of Presentation

The accompanying consolidated financial statements are prepared on the accrual basis of accounting. Net assets of SHC and changes therein have been classified and are reported as follows:

- **Unrestricted net assets** — Unrestricted net assets represent those resources of SHC that are not subject to donor-imposed stipulations. The only limits on unrestricted net assets are broad limits resulting from the nature of SHC and the purposes specified in its articles of incorporation or bylaws and, limits resulting from contractual agreements, if any.
- **Temporarily restricted net assets** — Temporarily restricted net assets represent contributions, which are subject to donor-imposed restrictions that can be fulfilled by actions of SHC pursuant to those stipulations or by the passage of time.
- **Permanently restricted net assets** — Permanently restricted net assets represent contributions that are subject to donor-imposed restrictions that they be maintained permanently by SHC. Generally, the donors of these assets permit SHC to use all or part of the investment return on these assets.

Expenses are generally reported as decreases in unrestricted net assets. A restriction expires when the stipulated time period has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. Temporarily restricted contributions are recorded as restricted revenue when received and when the restriction expires, the net assets are shown as released from restriction on the consolidated statements of operations and changes in net assets. Investment income on temporarily or permanently restricted assets that is restricted by donor or law is recorded within the respective net asset category, and when the restriction expires, the net assets are shown as released from restriction.

#### Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less. Cash equivalents consist primarily of demand deposits and money market mutual funds.

#### Assets Limited as to Use, Held by Trustee

Assets limited as to use include various accounts held by a trustee in accordance with indenture requirements. The indenture terms require that the trustee control the expenditure of bond proceeds for capital projects. Assets limited as to use consist of cash and cash equivalents and short-term investments, recorded at cost, which approximates fair value. There are no amounts required to fund current liabilities of SHC, therefore the entire amount has been classified as long-term in the consolidated balance sheets at August 31, 2017 and 2016.

#### Inventories

Inventories, which consist primarily of hospital operating supplies and pharmaceuticals, are stated at the lower of cost or market value determined using the first-in, first-out method.

#### Investments

Investments held directly by SHC consist of cash and cash equivalents, mutual funds and investments in non-public entities and are stated at fair value. Fair value is determined in accordance with current accounting guidance as further described in Note 7. Investment earnings (including realized gains and losses on investments, interest, dividends and impairment loss on investment securities) are included in investment income unless the income or loss is restricted by donor or law. Income on investments of donor restricted funds is added to or deducted from the appropriate net asset category based on the donor's restriction. Unrestricted unrealized gains and losses on other than trading securities are separately reported below the excess of revenues over expenses.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### Investments at Equity

Investments at equity consist of investments in which SHC has ownership of 50% or less but is able to exercise significant influence over the investee. These investments include Stanford-StartX Fund, LLC ("StartX Fund"), Stanford PET-CT, LLC ("PET-CT") and Pleasanton Physician Affiliates II, LLC ("PPA II"). All earnings from StartX Fund and PPA II are included in earnings on equity method investments in the consolidated statements of operations and changes in net assets. Earnings from PET-CT are included in other revenue in the consolidated statements of operations and changes in net assets.

The mission of StartX, a California nonprofit public benefit corporation, is to accelerate the development of students, faculty and alumni of the University identified by StartX as high potential entrepreneurs through an experiential educational program. StartX Fund is a California limited liability company created to support the continued experiential education of participants in the StartX accelerator program. SHC's interest in StartX Fund was 33% for the years ended August 31, 2017 and 2016.

PET-CT is a California limited liability company which provides radiological services to patients of the community, including patients served by SHC and physicians affiliated with the SoM. SHC and the University each appoint one-half of the members of the governing board of PET-CT and are its only members. SHC's interest in PET-CT was 50% for the years ended August 31, 2017 and 2016.

PPA II is a California limited liability company which owns and operates a medical office building in Pleasanton. SHC-VC's interest in PPA II was 39% for the years ended August 31, 2017 and 2016.

#### Investments in University Managed Pools

Investments in University managed pools consist of funds invested in the University's Merged Pool ("MP") and Expendable Funds Pool ("EFP") (collectively the "Pools"). Under the terms of SHC's agreement with the University, the University has discretion to invest the funds in the Pools. SHC may deposit funds in the Pools at its discretion. Withdrawals from the MP and EFP require advance notice to the University. The value of its share of the Pools is determined by the University and is based on the fair value of the underlying assets in the Pools.

The University allocates investment earnings to SHC from the University managed pools based on SHC's share of the Pools. Earnings include interest, dividends, distributions, investment gains and losses, and the increases or decreases in the value of SHC's share of the pools. All investment gains and losses and increases and decreases in share value are treated as realized and included in the excess of revenues over expenses.

The increases or decreases in the value of SHC's share of the Pools are recorded as income and gains on University managed pools unless the income is restricted by donor or law. Income on investments of donor restricted funds invested in the University managed pools is added to or deducted from the appropriate net asset category based on the donor's restriction.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### Property and Equipment

Property and equipment are stated at cost except for donated assets, which are recorded at fair market value at the date of donation. Depreciation and amortization of property and equipment is determined using the straight-line method over the estimated useful lives of the assets, which are as follows:

Land improvements	10 to 25 years
Buildings and leasehold improvements	7 to 40 years
Equipment	3 to 20 years

Significant replacements and improvements are capitalized, while maintenance and repairs, which do not improve or extend the life of the respective assets, are charged to expense as incurred. Leasehold improvements are amortized over the shorter of the estimated useful life or term of the lease. Upon sale or disposal of property and equipment, the cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in the consolidated statements of operations and changes in net assets.

Equipment includes medical equipment, furniture and fixtures and computer software and hardware.

Equipment under capital leases is recorded at present value at the inception of the leases and is amortized on the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. The amortization of the assets recorded under capital leases is included in depreciation and amortization expense in the accompanying consolidated statements of operations and changes in net assets.

Interest costs incurred on borrowed funds during the period of construction of capital assets is capitalized, net of any interest earned, as a component of the cost of acquiring those assets.

#### Asset Retirement Obligations

Asset retirement obligations ("ARO") are legal obligations associated with the retirement of long-lived assets. These liabilities are initially recorded at fair value as other long-term liabilities and the related asset retirement costs are capitalized by increasing the carrying amount of the related assets by the same amount as the liability. Asset retirement costs are subsequently accreted over the useful lives of the related assets. SHC recorded current period accretion expense of \$397 and \$377 in the consolidated statements of operations and changes in net assets for the years ended August 31, 2017 and 2016, respectively. ARO liability of \$8,265 and \$7,868 is included in other long-term liabilities on the consolidated balance sheets as of August 31, 2017 and 2016, respectively.

#### Other Assets

Other assets include long-term portion of contributions receivable, intangible assets, and other long-term assets.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### **Contributions Receivable**

Unconditional promises to give (“contributions”) are recorded at fair value at the date the promise is received. Donations for specific purposes are reported as either temporarily or permanently restricted net assets. Contributions to be received after one year are discounted at an appropriate discount rate commensurate with the risks involved and applicable to the years in which the promises are received, and recorded in their respective net asset category. In accordance with current accounting guidance, the discount rates were determined using the risk free rate adjusted for the risk of donor default. Current and long-term portions of contributions receivable are included in other receivables and other assets in the consolidated balance sheets, respectively, and contribution revenue is included in the financial statements in the appropriate net asset category. Amortization of the discount is included in contributions and other in the consolidated statements of operations and changes in net assets. Conditional promises to give are recognized when the condition is substantially met.

#### **Premiums, Discounts and Deferred Financing Costs on Long-Term Debt**

Premiums and discounts arising from the original issuance of long-term debt are amortized on either the effective interest method or the straight-line basis, which approximates the effective interest method, over the life of the debt. The unamortized portion of these premiums and discounts are included in long-term debt on the consolidated balance sheets. Deferred financing costs represent costs incurred in conjunction with the issuance of SHC’s long-term debt. These costs are amortized on a straight-line basis, which approximates the effective interest method, over the life of the debt.

#### **Interest Rate Swap Agreements**

SHC has entered into several interest rate swap agreements to reduce the effect of interest rate fluctuation on its variable rate bonds. All swaps are recognized on the consolidated balance sheets at their fair value in accordance with current accounting guidance. Changes in the fair value of interest rate swaps are included in excess of revenues over expenses. The net cash payments or receipts under the interest rate swap agreements have been recorded as an increase (decrease) to interest expense.

#### **Excess of Revenues over Expenses**

The consolidated statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, include transfers of assets to and from affiliates for other than goods and services, change in unrealized gains and losses on marketable investments, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets), changes in pension and postretirement liability and other changes related to noncontrolling interests.

#### **Net Patient Service Revenue**

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers including Medicare and Medi-Cal, and others for services rendered, including estimated retroactive audit adjustments under reimbursement agreements with third-party payers. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined. Contracts, laws and regulations governing the Medicare and Medi-Cal programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates may change by a material amount in the near term.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### Net Patient Service Revenue (continued)

The provision for doubtful accounts is based upon management's assessment of expected net collections considering historical experience and other collection indicators. Throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon historical write-off experience. The results of this review are then used to make any modifications to the provision for doubtful accounts to establish an appropriate allowance for uncollectible accounts.

#### Charity Care

SHC provides either full or partial charity care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are not reported as net patient service revenue. SHC also provides services to other indigent patients under Medi-Cal and other publicly sponsored programs, which reimburse at amounts less than the cost of the services provided to the recipients. The difference between the cost of services provided to these indigent persons and the expected reimbursement is included in the estimated cost of charity care.

#### Premium Revenue

UHA has capitated agreements with various health maintenance organizations ("HMOs") to provide medical services to enrollees. Under these agreements, monthly payments are received based on the number of health plan enrollees. These receipts are recorded as premium revenue in the consolidated statements of operations and changes in net assets. Costs are accrued when services are rendered under these contracts, including cost estimates of incurred but not reported ("IBNR") claims. The IBNR accrual (which is included in accounts payable and accrued liabilities in the consolidated balance sheets) includes an estimate of the costs of services for which UHA is responsible, including referrals to outside healthcare providers.

#### Income Taxes

SHC, UHA, SHC-VC and SHC Advantage are not-for-profit corporations and tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code. SBC LLC, SEROC, CareCounsel and SHI are limited liability companies and taxable income flows through to the individual members. SUMIT is currently exempt from all taxes until March 31, 2035. TRA is a limited liability company, but has elected to be taxed as a corporation. PEAC is a taxable corporation. SHC and its subsidiaries have no uncertain tax positions pertaining to unrelated business income.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### Self-Insurance Plans

SHC and SHC-VC self-insure for professional liability risks, postretirement medical benefits, workers' compensation and health and dental benefits. These liabilities are reflected as self-insurance reserves in the consolidated balance sheets.

- **Professional Liability** — SHC and SHC-VC are self-insured through SUMIT for medical malpractice and general liability losses under claims-made coverage. SHC and SHC-VC also maintain professional liability reserves for claims not covered by SUMIT which total \$5,249 and \$817 as of August 31, 2017, respectively. As of August 31, 2016, this coverage was \$5,036 and \$1,122 for SHC and SHC-VC, respectively. Since September 1, 2005, SUMIT has retained 100% of the risk related to the first \$15,000 per occurrence. The next \$165,000 is transferred to various reinsurance companies. Prior to September 1, 2005, SHC maintained various coverage limits.
- **Postretirement Medical Benefits** — Liabilities for post-retirement medical claims for current and retired employees are actuarially determined.
- **Workers' Compensation** — SHC and SHC-VC purchase insurance for workers' compensation claims with a \$750 deductible per occurrence. Workers' compensation insurance provides statutory limits for the State of California. An actuarial estimate of retained losses (or losses retained within the deductible) has been used to record a liability.
- **Health and Dental** — Liabilities for health and dental claims for current employees are based on estimated costs.

#### Fair Value of Financial Instruments

Due to the short-term nature of cash and cash equivalents, accounts payable and accrued liabilities, and accrued salaries and related benefits, their carrying value approximates their fair value. The fair value of the amounts payable under third-party reimbursement contracts is not readily determinable. The fair value of long-term debt is estimated based on quoted market prices for the bonds or similar financial instruments.

#### Concentration of Credit Risk

Financial instruments, which potentially subject SHC to concentrations of credit risk, consist principally of cash and cash equivalents, patient accounts receivable, and investments in University managed pools.

SHC's concentration of credit risk relating to patient accounts receivable is limited by the diversity and number of patients and payers. Patient accounts receivable consist of amounts due from commercial insurance companies, governmental programs, private pay patients and other third-party payers.

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates relate to patient accounts receivable allowances, amounts due to third party payers, retirement plan obligations, and self-insurance reserves. Actual results could differ from those estimates.

#### Reclassification

Certain reclassifications have been made to the 2016 consolidated financial statements to conform to the 2017 presentation. Such reclassifications had no effect on excess of revenues over expenses as previously reported.

# Stanford Health Care

## Notes to Consolidated Financial Statements

### (in thousands of dollars)

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## 2. Summary of Significant Accounting Policies (Continued)

### Recent Pronouncements

The Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) is the sole source of authoritative non-governmental U.S. generally accepted accounting principles.

**Pension service costs** - In March 2017, the FASB issued an ASC update which requires that an employer report the service cost component of pension costs in the same line item as employee compensation costs within operating income. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, and will not be eligible for capitalization. The guidance is effective for SHC during the fiscal year ending August 31, 2020. SHC is currently evaluating the impact that this guidance will have on the consolidated financial statements.

**Consolidation** - In January 2017, the FASB issued an ASC update which reinstates the presumption that a not-for-profit (“NFP”) entity that is a general partner controls a limited partnership. The amendments in this update also add guidance on when an NFP limited partner should consolidate a for-profit limited partnership. The guidance is effective for SHC during the fiscal year ending August 31, 2018. SHC is currently evaluating the impact that this guidance will have on the consolidated financial statements.

**Debt issuance costs** - In April 2015, the FASB issued an ASC update which requires debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability, and amortization of those costs reported as interest expense. This guidance is effective for SHC during the fiscal year ending August 31, 2017, and early adoption is permitted. In August 2015, the FASB issued a supplemental ASU which allows an entity to present debt issuance costs related to a line of credit arrangement as an asset and subsequently amortize the costs ratably over the term of the line of credit arrangement. The recognition and measurement guidance for debt issuance costs is not affected. SHC has adopted the guidance on debt issuance costs in fiscal year 2017; however fiscal year 2016 amounts have not been reclassified.

**Revenue recognition** - In May 2014, the FASB issued an ASC update to improve the consistency of revenue recognition practices across industries for economically similar transactions. Subsequently, the FASB has issued several amendments and updates to the original standard. The core principle is that an entity recognizes revenue for goods or services to customers in an amount that reflects the consideration it expects to receive in return. In August 2015, the FASB voted to defer the implementation of the new guidance. The guidance is effective for SHC during the fiscal year ending August 31, 2019, and should be applied on a retrospective or modified retrospective basis. SHC is currently evaluating the impact that this guidance will have on its consolidated financial statements.

**Fair value** - In May 2015, the FASB issued an ASC update which 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 practical expedient as well as limiting disclosure requirement to investments for which the entity has elected to measure the fair value using that practical expedient. The guidance is effective for SHC during the fiscal year ending August 31, 2018, and should be applied on a retrospective basis for each period presented. SHC is currently evaluating the impact that this guidance will have on its consolidated financial statements.

**Leases** - In February 2016, the FASB issued an ASC update which requires lessees to recognize operating and financing lease liabilities and corresponding right-of-use assets on the balance sheet. The guidance is effective for SHC during the fiscal year ending August 31, 2020, and should be applied on a retrospective basis. SHC is currently evaluating the impact that this guidance will have on its consolidated financial statements.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 2. Summary of Significant Accounting Policies (Continued)

#### **Recent Pronouncements (continued)**

**Not-for-profit reporting** - In August 2016, the FASB issued an ASC update which modifies current NFP reporting requirements. The ASC update changes the way NFPs classify net assets and results in significant changes to financial reporting and disclosures for NFPs. The guidance is effective for SHC during the fiscal year ending August 31, 2019, and should be applied on a retrospective basis. SHC is currently evaluating the impact that this guidance will have on its consolidated financial statements.

**Statement of cash flows** - In August 2016, the FASB issued an ASC update which intends to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. The guidance is effective for SHC during the fiscal year ending August 31, 2020, and should be applied on a retrospective basis. SHC is currently evaluating the impact that this guidance will have on its consolidated financial statements.



# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 3. Net Patient Service Revenue

SHC has agreements with third-party payers that provide for payments at amounts different from SHC's established rates. A summary of payment arrangements with major third-party payers follows:

- **Medicare** — Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Medicare reimburses hospitals for covered outpatient services rendered to its beneficiaries by way of an outpatient prospective payment system based on ambulatory payment classifications.

Inpatient non-acute services, certain outpatient services and medical education costs related to Medicare beneficiaries are paid based, in part, on a cost reimbursement methodology. SHC is reimbursed for cost reimbursable items at a tentative rate with final settlement of such items determined after submission of annual cost reports and audits thereof by the Medicare administrative contractor. The estimated amounts due to or from the program are reviewed and adjusted annually based on the status of such audits and any subsequent appeals. Differences between final settlements and amounts accrued in previous years are reported as adjustments to net patient service revenue in the year examination is substantially completed. SHC's Medicare cost reports have been audited by the Medicare administrative contractor through August 31, 2008. Professional services are reimbursed based on a fee schedule.

- **Medi-Cal** — Inpatient services rendered to Medi-Cal program beneficiaries are reimbursed at a prospectively determined rate per discharge. Outpatient services are reimbursed based upon prospectively determined fee schedules. Professional services are reimbursed based on a fee schedule.
- **Managed Care Organizations** — SHC has entered into agreements with numerous third-party payers to provide patient care to beneficiaries under a variety of payment arrangements. These include arrangements with:
  - Commercial insurance companies, including workers' compensation plans, which reimburse SHC at negotiated charges.
  - Managed care contracts such as those with HMOs and PPOs, which reimburse SHC at contracted or per diem rates, which are usually less than full charges.
  - Counties in the State of California, which reimburse SHC for certain indigent patients covered under county contracts.
- **Uninsured** — For uninsured patients that do not qualify for charity care, SHC recognizes revenue on the basis of its standard rates for services less an uninsured discount applied to the patient's account that approximates the average discount for managed care payers.

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**3. Net Patient Service Revenue (Continued)**

Patient service revenue, net of contractual allowances (but before provision for doubtful accounts), by major payor for the years ended August 31 is as follows:

	<u>2017</u>	<u>2016</u>
Medicare	\$ 858,076	\$ 755,658
Medi-Cal	93,699	106,728
Managed Care - Discounted Fee for Services	3,108,719	2,870,437
Self pay and other	206,191	239,248
Related party	<u>44,845</u>	<u>47,214</u>
Patient service revenue, net of contractual allowances	\$ 4,311,530	\$ 4,019,285
Provision for doubtful accounts	(77,004)	(126,280)
Net patient service revenue	<u>\$ 4,234,526</u>	<u>\$ 3,893,005</u>

SHC recognized net patient service revenue adjustments of \$24,265 and \$4,303 as a result of prior years favorable developments related to reimbursement for the years ended August 31, 2017 and 2016, respectively.

Amounts due from Blue Cross, Medicare, and Blue Shield as a percentage of net patient accounts receivable at August 31 are as follows:

	<u>2017</u>	<u>2016</u>
Blue Cross	21%	18%
Medicare	14%	12%
Blue Shield	11%	11%

SHC does not believe significant credit risks exist with these payers.

**California Hospital Quality Assurance Fee Program**

The State of California enacted legislation in 2009 which established a Hospital Quality Assurance Fee ("HQAF") Program and a Hospital Fee Program. These programs imposed a provider fee on certain California general acute care hospitals that, combined with federal matching funds, would be used to provide supplemental payments to certain hospitals and support the State's effort to maintain health care coverage for children. The effective period of this Hospital Fee Program was April 1, 2009 through December 31, 2010. The State received final approval of the rates from the Centers for Medicare & Medicaid Services ("CMS") in December 2010.

Subsequent legislation extended the HQAF and Hospital Fee programs from January 1, 2011 through June 30, 2011, which was approved by CMS in December 2011.

Additional legislation extended the HQAF and Hospital Fee programs for 30 months from July 1, 2011 through December 31, 2013. CMS approved the 30 month fee-for-service ("FFS") Medi-Cal supplement in June 2012. CMS approved 24 months and 6 months of the Medi-Cal Managed Care ("MMC") supplement in June 2013 and November 2014, respectively.

State legislation Senate Bill 239 further extended the HQAF and Hospital Fee programs for another 36 months from January 1, 2014 through December 31, 2016. In December 2014, CMS approved the 36 month FFS Medi-Cal supplement. As of August 31, 2017, CMS has approved 18 months of the MMC non-expansion supplement, and 12 months of the MMC expansion supplement, which are additional funds in excess of the matching (non-expansion) funds.

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**3. Net Patient Service Revenue (Continued)**

**California Hospital Quality Assurance Fee Program (continued)**

SHC recognized \$45,616 and \$55,195 in net patient service revenue under these programs and \$41,594 and \$45,809 in other expense for HQAF to the California Department of Health Care Services for the years ended August 31, 2017 and 2016, respectively. SHC recorded \$6,230 in deferred revenue as of August 31, 2017, pending CMS approval.

**4. Charity Care and Uncompensated Costs**

SHC engages in numerous community benefit programs and services. These services include health research, education and training and other benefits for the larger communities that are excluded from the information below.

Uncompensated charity care is provided to vulnerable populations. Additionally, Medi-Cal and Medicare program reimbursements do not cover the estimated costs of services provided.

Information related to SHC's charity care for the years ended August 31 is as follows:

	<u>2017</u>	<u>2016</u>
Charity care at established rates	\$ 99,916	\$ 85,246
Estimated cost of charity care, net	\$ 21,997	\$ 19,365

The estimated cost of providing charity care is based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on SHC's total expenses divided by gross patient service charges. SHC received \$663 and \$799 during the years ended August 31, 2017 and 2016, respectively, from contributions that were restricted for the care of indigent patients.

Estimated cost of services in excess of reimbursement for the years ended August 31 is as follows:

	<u>2017</u>	<u>2016</u>
Charity care	\$ 21,997	\$ 19,365
Medi-Cal	343,594	283,260
Medicare	629,967	585,728
Total	<u>\$ 995,558</u>	<u>\$ 888,353</u>

**5. Contributions Receivable**

Contributions are recorded at the discounted net present value of the future cash flows, adjusted for the risk of donor default, using a discount rate of 2.11% for new receivables recorded in 2017 and 1.44% for receivables recorded in 2016.

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**5. Contributions Receivable (Continued)**

Contributions receivable at August 31 are expected to be realized in the following periods:

	<u>2017</u>	<u>2016</u>
In one year or less	\$ 14,772	\$ 11,531
Between one year and five years	82,647	86,428
More than five years	<u>2,750</u>	<u>11,352</u>
	100,169	109,311
Less: discount/allowance	<u>(10,161)</u>	<u>(11,558)</u>
Total contributions receivable, net	90,008	97,753
Less: current portion	<u>(13,668)</u>	<u>(10,525)</u>
Contributions receivable, net of current portion	<u>\$ 76,340</u>	<u>\$ 87,228</u>

Contributions receivable at August 31 are to be utilized for the following purposes:

	<u>2017</u>	<u>2016</u>
Plant replacement and expansion	\$ 94,517	\$ 102,142
Other patient and clinical services	<u>5,652</u>	<u>7,169</u>
Total	<u>\$ 100,169</u>	<u>\$ 109,311</u>

There were no conditional pledges at August 31, 2017 and 2016.

**6. Investments and Investments in University Managed Pools**

The composition of investments held directly by SHC at August 31 is as follows:

	<u>2017</u>		<u>2016</u>	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
Short term investments:				
Mutual funds	<u>\$ 233,463</u>	<u>\$ 233,533</u>	<u>\$ 105,025</u>	<u>\$ 103,627</u>
Investments:				
Cash and cash equivalents	\$ 44,552	\$ 44,552	\$ 44,085	\$ 44,085
Mutual funds	65,455	66,399	58,370	59,744
Other	<u>696</u>	<u>713</u>	<u>209</u>	<u>209</u>
Total	<u>\$ 110,703</u>	<u>\$ 111,664</u>	<u>\$ 102,664</u>	<u>\$ 104,038</u>

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**6. Investments and Investments in University Managed Pools (Continued)**

The composition of investments in University managed pools at August 31 is as follows:

	<u>Fair Value</u>	
	<u>2017</u>	<u>2016</u>
Investments in University managed pools:		
Merged Pool	\$1,280,875	\$1,310,047
Expendable Funds Pool	6,318	6,442
Total	<u>\$1,287,193</u>	<u>\$1,316,489</u>

The Merged Pool (“MP”) is the primary investment pool in which funds are invested. The MP is invested with the objective of maximizing long-term total return. It is a unitized pool in which the fund holders purchase investments and withdraw funds based on a monthly share value. The MP’s investments at August 31, 2017 and 2016 consist of approximately 3% and 4% cash and cash equivalents, 7% and 6% fixed income, 27% and 27% public equity securities, 8% and 9% real estate, 9% and 9% natural resources, 20% and 20% absolute returns, and 26% and 25% private equity securities, respectively.

**7. Fair Value Measurements**

Fair value is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability.

The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk.

Accounting guidance expands the disclosure requirements around fair value and establishes a fair value hierarchy for valuation inputs. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which are determined by the lowest level input that is significant to the fair value measurement in its entirety.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

### 7. Fair Value Measurements (Continued)

These levels are:

Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the measurement date. Financial assets and liabilities in Level 1 include U.S. Treasury securities and listed equities.

Level 2: Pricing inputs are based on quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in inactive markets, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Financial assets and liabilities in this category generally include asset-backed securities, corporate bonds and loans, municipal bonds and interest rate swap instruments.

Level 3: Pricing inputs are generally unobservable for the assets or liabilities and include situations where there is little, if any, market activity for the investment. The inputs into the determination of the fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using factors that involve considerable judgment and interpretations, including but not limited to private and public comparables, third party appraisals, discounted cash flow models, and fund manager estimates.

The following table summarizes SHC's assets and liabilities measured at fair value on a recurring basis as of August 31, based on the inputs used to value them:

	2017			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Cash and cash equivalents	\$ 710,109	\$ -	\$ -	\$ 710,109
Short term investments:				
Mutual funds	-	233,533	-	233,533
Assets limited as to use, held by trustee:				
Cash and cash equivalents	58,134	-	-	58,134
Investments:				
Cash and cash equivalents	44,552	-	-	44,552
Mutual funds	-	66,399	-	66,399
Other	-	-	713	713
Investments	44,552	66,399	713	111,664
Investments in University managed pools	-	1,287,193	-	1,287,193
Total assets	<u>\$ 812,795</u>	<u>\$ 1,587,125</u>	<u>\$ 713</u>	<u>\$ 2,400,633</u>
<b>Liabilities</b>				
Interest rate swap instruments	\$ -	\$ 245,966	\$ -	\$ 245,966
	2016			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Cash and cash equivalents	\$ 690,460	\$ -	\$ -	\$ 690,460
Short term investments:				
Mutual funds	-	103,627	-	103,627
Assets limited as to use, held by trustee:				
Cash and cash equivalents	235,788	-	-	235,788
Investments:				
Cash and cash equivalents	44,085	-	-	44,085
Mutual funds	-	59,744	-	59,744
Other	-	-	209	209
Investments	44,085	59,744	209	104,038
Investments in University managed pools	-	1,316,489	-	1,316,489
Total assets	<u>\$ 970,333</u>	<u>\$ 1,479,860</u>	<u>\$ 209</u>	<u>\$ 2,450,402</u>
<b>Liabilities</b>				
Interest rate swap instruments	\$ -	\$ 331,334	\$ -	\$ 331,334

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**7. Fair Value Measurements (Continued)**

The table below sets forth a summary of the changes in the fair value of the level 3 investments for the year ended August 31:

	<u>2017</u>	<u>2016</u>
Balance, beginning of year	\$ 209	\$ -
Purchases	504	209
Balance, end of year	<u>\$ 713</u>	<u>\$ 209</u>

**8. Property and Equipment**

Property and equipment consist of the following as of August 31:

	<u>2017</u>	<u>2016</u>
Land and improvements	\$ 68,885	\$ 67,816
Buildings and leasehold improvements	1,446,312	1,321,441
Equipment	<u>1,052,857</u>	<u>944,194</u>
	2,568,054	2,333,451
Less: Accumulated depreciation	(1,467,545)	(1,314,850)
Construction-in-progress	<u>1,768,837</u>	<u>1,383,279</u>
Property and equipment, net	<u>\$ 2,869,346</u>	<u>\$ 2,401,880</u>

Depreciation and amortization expense totaled \$154,686 and \$136,442 for the years ending August 31, 2017 and 2016, respectively, and is included in the consolidated statements of operations and changes in net assets.

Medical equipment acquired under capital leases totaled \$9,294 and \$8,104 as of August 31, 2017 and 2016, respectively, and building improvements acquired under capital leases totaled \$1,970 as of August 31, 2017 and 2016, and are included in property and equipment in the consolidated balance sheets. Amortization expense under capital leases is included in depreciation expense in the consolidated statements of operations and changes in net assets. Accumulated amortization was \$8,608 and \$7,741 as of August 31, 2017 and 2016, respectively.

Interest expense on debt issued for construction projects and income earned on the funds held pending use are capitalized until the projects are placed in service and depreciated over the estimated useful life of the asset. Capitalized interest expense net of capitalized investment income was \$25,815 and \$24,190 for the years ended August 31, 2017 and 2016, respectively.

Certain land and building, with a carrying value of \$9,729 at August 31, 2016 was used as collateral on notes payable (see Note 9).

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

### 9. Debt Obligations

SHC's outstanding debt at August 31 is summarized below:

	Years of Maturity	Effective Interest Rates	Outstanding Principal	
			2017	2016
<b>Fixed Rate Obligations</b>				
2008 Series A-1 Refunding Revenue Bonds	2017-2040	5.14%	\$ 67,410	\$ 67,835
2008 Series A-2 Refunding Revenue Bonds	2017-2040	5.32%/5.25%	99,725	100,350
2008 Series A-3 Refunding Revenue Bonds	2017-2040	5.29%/5.49%	80,615	81,140
2010 Series A Refunding Revenue Bonds	2017-2031	4.66%/5.46%	119,315	124,875
2010 Series B Refunding Revenue Bonds	2023-2036	4.95%/5.20%	146,710	146,710
2012 Series A Revenue Bonds	2028-2051	3.98%/5.00%	340,000	340,000
2012 Series B Refunding Revenue Bonds	2018-2023	2.30%/4.71%	41,340	47,445
2015 Series A Revenue Bonds	2052-2054	4.10%/4.82%	100,000	100,000
Note payable, collateralized by certain land and building	2024	4.25%	-	4,870
<b>Variable Rate Obligations</b>				
2008 Series B Refunding Revenue Bonds	2041-2045	0.84%/0.55%	168,200	168,200
2012 Series C Revenue Bonds	2039-2051	1.04%/0.78%	60,000	60,000
2012 Series D Revenue Bonds	2024-2051	1.23%/0.75%	100,000	100,000
2015 Series B Revenue Bonds	2052-2054	1.38%/0.90%	75,000	75,000
Revolving Line of Credit	2020	1.53%	135,000	-
Total principal amounts			1,533,315	1,416,425
Unamortized original issue premiums/discounts, net			43,606	46,320
Unamortized costs of issuance			(10,857)	-
Current portion of long-term debt			(13,335)	(13,756)
Revolving line of credit, current			(135,000)	-
Debt subject to short-term remarketing arrangements			(228,200)	(228,200)
Long-term portion, net of current portion			<u>\$ 1,189,529</u>	<u>\$ 1,220,789</u>

In June 2008, the California Health Facilities Financing Authority ("CHFFA"), on behalf of SHC, issued Variable Rate Demand Bonds ("VRDB's") in the aggregate principal amount of \$428,500 (the "2008 Bonds") to refund its previously issued 2006 Bonds. The 2008 Bonds were comprised of \$260,300 of 2008 Series A VRDB's that were issued as Series A-1, Series A-2, and Series A-3; and \$168,200 of 2008 Series B VRDB's that were issued as Series B-1 and Series B-2.

In June 2009, SHC remarketed the 2008 Series A-1 bonds in the aggregate principal amount of \$70,500. In June 2010, SHC converted the 2008 Series A-1 bonds from an annual put mode to a long-term fixed interest rate mode. The remarketing of the 2008 Series A-1 bonds generated an original issue premium of approximately \$140; that, pursuant to the requirements of the underlying documents, was used to reduce the principal amount of the bonds from \$70,500 to \$70,360.

In June 2010, CHFFA, on behalf of SHC, issued fixed rate revenue bonds in the aggregate principal amount of \$296,055 (the "2010 Bonds"). The 2010 Bonds were comprised of \$149,345 of 2010 Series A bonds, proceeds of which were used to refund the 1998B bonds, and \$146,710 of 2010 Series B bonds, proceeds of which were used to refund the 2003 Series B, C and D bonds. The issuance of the 2010 Series A and Series B bonds generated original issue premiums of \$10,944 and \$3,292, respectively.



# Stanford Health Care

## Notes to Consolidated Financial Statements

### (in thousands of dollars)

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#### 9. Debt Obligations (Continued)

In June 2011, SHC remarketed the 2008 Series A-2, A-3 and B-2 bonds in the aggregate principal amount of \$272,365. SHC converted the 2008 Series A-2 bonds from a weekly interest rate mode and the 2008 Series A-3 bonds from a multi-annual put mode to a long-term fixed interest rate mode. The remarketing of the 2008 Series A-3 bonds generated an original issue premium of approximately \$1,535; that, pursuant to the requirements of the underlying documents, was used to reduce the principal amount of the bonds from \$85,700 to \$84,165. SHC converted the 2008 Series B-2 bonds from a weekly interest rate mode to a commercial paper mode. As a part of the conversion, the 2008 Series B-2 bonds were split into two sub-series in the amount of \$42,050 each. Bonds in a commercial paper mode are remarketed for various periods that can be no longer than 270 days and are established at the beginning of each commercial paper rate period. Bondholders in a commercial paper mode have the option to tender their bonds only at the end of the commercial paper rate period.

In May 2012, CHFFA, on behalf of SHC, issued four series of revenue bonds in the aggregate principal amount of \$568,320 (the "2012 Bonds"). The 2012 Bonds were comprised of \$340,000 of 2012 Series A bonds, \$68,320 of Series B bonds, \$60,000 of Series C bonds and \$100,000 of Series D bonds. The issuance of the 2012 Series A and Series B bonds generated original issue premiums of \$29,097 and \$10,877, respectively. Proceeds of the 2012 Series A, C and D bonds will be used to finance a portion of the New Stanford Hospital. Proceeds of the 2012 Series B bonds were used to advance refund the 2003 Series A bonds.

In June 2015, CHFFA, on behalf of SHC, issued two series of revenue bonds in the aggregate principal amount of \$175,000 (the "2015 Bonds"). The 2015 Bonds were comprised of \$100,000 of 2015 Series A bonds, and \$75,000 of Series B bonds. The 2015 Series A bonds generated an original issue premium of \$5,627. Proceeds of the 2015 Series A and B bonds will be used to finance a portion of the New Stanford Hospital.

In May 2017, SHC entered into a \$200,000 revolving credit facility. Drawdowns from the revolving credit facility bear interest at a floating rate equal to the applicable London Interbank Offered Rate ("LIBOR") plus a specified margin. The amount outstanding on this credit facility was \$135,000 as of August 31, 2017.

The 2008 Series B-1 bonds are in a weekly interest rate mode and are remarketed every 7 days at the then prevailing interest rate. Bondholders in a weekly interest rate mode have the option of tendering their bonds on a weekly basis. The 2012 Series C bonds are in a Windows weekly floating index mode and cannot be tendered for 180 days after a 30 day notice and remarketing period. The 2008 Series B bonds and the 2012 Series C bonds are supported by SHC's self-liquidity and are classified as current liabilities. The 2012 Series D and 2015 Series B bonds are also in a floating index mode with monthly interest rate resets and were directly placed with U.S. Bank. The 2012 Series D and 2015 Series B bonds are not subject to remarketing or tender until May 13, 2020 and June 28, 2024, respectively. Both series of bonds are classified as long-term liabilities.

The 2015 Bonds, together with the 2012, 2010, and 2008 Bonds are collectively referred to as the "Revenue Bonds". The Revenue Bonds are limited obligations of CHFFA and are payable solely from payments made by SHC. Payments of principal and interest on the Revenue Bonds are collateralized by a pledge against the revenues of SHC secured under a master trust indenture between SHC and the master trustee. The master trust indenture includes, among other things, limitations on additional indebtedness, liens on property, restrictions on the disposition or transfer of assets, and maintenance of certain financial ratios. SHC may redeem the Revenue Bonds, in whole or in part, prior to the stated maturities. Total debt outstanding under the master trust indenture is in the aggregate principal amounts of \$1,533,315 and \$1,411,555 as of August 31, 2017 and 2016, respectively.

**Stanford Health Care**  
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**9. Debt Obligations (Continued)**

Scheduled principal payments on long-term debt are summarized below:

	<u>Scheduled Maturities</u>	<u>Revolving Line of Credit</u>	<u>Bonds Supported by SHC Liquidity</u>	<u>Total</u>
2018	\$ 13,335	\$ 135,000	\$ 228,200	\$ 376,535
2019	14,505	-	-	14,505
2020	14,235	-	-	14,235
2021	16,045	-	-	16,045
2022	15,775	-	-	15,775
Thereafter	1,096,220	-	-	1,096,220
	<u>\$ 1,170,115</u>	<u>\$ 135,000</u>	<u>\$ 228,200</u>	<u>\$ 1,533,315</u>

The scheduled principal payments above represent the annual payments required under debt repayment schedules. The current portion of long-term obligations, including debt subject to short term remarketing arrangements, includes payments scheduled to be made in 2018, pay down of the balance outstanding under the revolving line of credit, and the VRDB's supported by SHC's liquidity. The VRDB's supported by self-liquidity provide the bondholder with an option to tender the bonds to SHC. Generally accepted accounting principles require that bonds supported by SHC's liquidity be classified as current liabilities.

In the event SHC receives notice of any optional tender of the 2008 Series B-1 bonds or the 2012 Series C bonds, or if any bonds become subject to mandatory tender, the purchase price of the bonds will be paid from the remarketing of such bonds. However, if the remarketing proceeds are insufficient, SHC will have a current obligation to purchase any remaining bonds. SHC maintains sufficient liquidity to provide for the full and timely purchase price of any bonds tendered in the event of a failed remarketing.

The estimated fair value of the Revenue Bonds as of August 31, 2017 and 2016 was \$1,517,350 and \$1,585,366, respectively, and is considered level 2 based on the inputs used to value the Revenue Bonds as defined in Note 7.

In 1998, SHC advance refunded its 1993 bonds in the amount of \$89,520 by issuing the 1998 Series B bonds. As of August 31, 2017 and 2016, \$12,095 and \$17,490, respectively, of advance refunded bonds, which are considered extinguished, remain outstanding.

**Interest Rate Swap Agreements**

SHC entered into various interest rate swap agreements to manage fluctuations in cash flows resulting from variable rate debt interest risk. Under the terms of the current agreements, SHC pays a fixed interest rate, determined at inception, and receives a variable rate on the underlying notional principal amount based on a percentage of the One Month LIBOR.

SHC currently has nine outstanding interest rate exchange agreements that were originally entered into in 2003, 2006 and 2008 with maturities through November 2051. Various agreements were amended and restated to forward interest rate swaps in 2010 and 2012. The effective dates of these amended agreements became 2012 and 2016, respectively. As a result, cash flows on these agreements did not commence until 2012 and 2016.

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**9. Debt Obligations (Continued)**

**Interest Rate Swap Agreements (continued)**

The following is a summary of the outstanding positions under these interest rate swap agreements at August 31, 2017:

<u>Description</u>	<u>Current Notional</u>	<u>Maturity Date</u>	<u>Rate Paid</u>	<u>Rate Received</u>
2003 Series B	\$ 48,800	11/15/2036	3.365%	70% 1-month LIBOR
2003 Series C	48,700	11/15/2036	3.365%	70% 1-month LIBOR
2003 Series D	52,500	11/15/2036	3.365%	70% 1-month LIBOR
Subtotal LIBOR Swaps	150,000			
2008 Series A-1	67,550	11/01/2040	3.693%	70% 1-month LIBOR
2008 Series A-2	102,775	11/15/2051	3.999%	67% 1-month LIBOR
2008 Series A-3	84,600	11/15/2051	3.902%	67% 1-month LIBOR
Subtotal LIBOR Swaps	254,925			
2012 Series A	68,350	11/15/2045	4.081%	67% 1-month LIBOR
2012 Series B	68,375	11/15/2045	4.077%	67% 1-month LIBOR
2012 Series C	34,175	11/15/2045	4.008%	67% 1-month LIBOR
Subtotal Forward Swaps	170,900			
Total	\$ 575,825			

SHC designates its interest rate swaps that are used to minimize the variability in cash flows of interest-bearing liabilities or forecasted transactions caused by changes in interest rates as hedging instruments at the inception of each contract, with the intention of maintaining hedge accounting treatment over the term of the agreement. However, circumstances may arise whereby the representations made at the inception of the agreement became invalid, or the structure of the bonds is changed, resulting in de-designation of the hedge. In June 2008, the underlying bonds that were being hedged were refinanced and as a result, none of the swap agreements are treated as a hedge for accounting purposes.

The fair value of interest rate swaps (all of which are designated as non-hedging instruments) is shown on the balance sheets as of August 31 as follows:

<u>Description</u>	<u>Fair Value</u>		<u>Balance Sheet Location</u>
	<u>2017</u>	<u>2016</u>	
Fixed Payment Swaps	\$ 245,966	\$ 331,334	Other long-term liabilities

The change in fair value of the interest rate swaps (all of which are designated as non-hedging instruments) is shown on the consolidated statements of operations and changes in net assets for the years ended August 31 as follows:

<u>Description</u>	<u>Unrealized Gains (Losses)</u>		<u>Statement of Operations Location</u>
	<u>2017</u>	<u>2016</u>	
Fixed Payment Swaps	\$ 85,368	\$ (115,958)	Interest rate swap mark to market adjustments

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**9. Debt Obligations (Continued)**

**Interest Rate Swap Agreements (continued)**

SHC has two swap agreements which require mutual posting of collateral by SHC and the counterparties if the termination values exceed a predetermined threshold dollar amount. There was \$10,090 and \$36,230 of cash collateral posted by SHC at August 31, 2017 and 2016, respectively.

Upon the occurrence of certain events of default or termination events identified in the derivative contracts, either SHC or the counterparty could terminate the contracts in accordance with their terms. Termination results in the payment of a termination amount by one party that attempts to compensate the other party for its economic losses. If interest rates at the time of termination are lower than those specified in the derivatives contract, SHC will make a payment to the counterparty. Conversely, if interest rates at such time are higher, the counterparty will make a payment to SHC.

**Bond Interest Expense**

The components of bond interest expense for the years ended August 31 are as follows:

	<u>2017</u>	<u>2016</u>
Interest and fees	\$ 25,976	\$ 25,678
Swap settlements	<u>17,195</u>	<u>13,497</u>
Bond interest expense	<u>\$ 43,171</u>	<u>\$ 39,175</u>
Interest capitalized as a cost of construction	\$ 25,815	\$ 24,190

**10. Retirement Plans**

SHC provides retirement benefits through defined benefit and defined contribution retirement plans covering substantially all benefit eligible employees.

**Defined Contribution Retirement Plan**

Employer contributions to the defined contribution retirement plan are based on a percentage of participant annual compensation. Employer contributions to this plan for SHC employees, excluding LPCH employees (see Note 13), totaling \$83,262 and \$69,180, UHA employer contributions totaling \$3,485 and \$2,526, and SHC-VC employer contributions totaling \$3,737 and \$7,479, for the years ended August 31, 2017 and 2016, respectively, are included in salaries and benefits expense in the consolidated statements of operations and changes in net assets.

# Stanford Health Care

## Notes to Consolidated Financial Statements

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#### 10. Retirement Plans (Continued)

##### **Defined Benefit Pension Plan**

Certain employees of SHC are covered by a noncontributory defined benefit pension plan (the "Staff Pension Plan"). Benefits are based on years of service and the employee's compensation. Contributions to the plans are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants.

As of August 31, 2004, SHC assumed the pension liability of the LPCH employees. SHC received \$187 and \$193 in cash for the years ending August 31, 2017 and 2016, respectively, which represented the current year pension expense related to LPCH employees.

The valuation of the Staff Pension Plan uses assumptions for future mortality improvements. For the fiscal year ending August 31, 2017, these assumptions were updated to include four additional years of Social Security Administration data resulting in a small decrease to the benefit obligation.

For the fiscal year ending August 31, 2017, the valuation of the Staff Pension Plan reflects updated demographic assumptions for retirement, withdrawal, and benefit commencement age for terminated vested participants. These assumptions were developed from the results of the 2017 experience study, which was based on census data for the Staff Pension Plan for the 2014 through 2017 plan years, and slightly decreased the benefit obligation.

During the fiscal year ending August 31, 2016, the Staff Pension Plan was amended to allow for a temporary lump sum window for deferred vested participants. During the window, eligible participants were contacted and offered an opportunity to take the lump sum value of their benefit, resulting in \$17,217 in lump sum paid from the plan. This large lump sum payment triggered settlement accounting which required a \$6,079 recognition of the plan's deferred losses, and also reduced the projected benefit obligation and assets by \$17,217.

##### **Postretirement Medical Benefit Plan**

SHC currently provides health insurance coverage for SHC employees upon retirement as early as age 55, with years of service as defined by specific criteria. The health insurance coverage for retirees who are under age 65 is the same as that provided to active employees. A Medicare supplement option is provided for retirees over age 65.

During the fiscal year ending August 31, 2016, the demographic assumptions used in the valuation of the Postretirement Medical Benefit Plan were reviewed and updated, resulting in a \$17,600 decrease in the accumulated postretirement benefit obligation. The decrease was primarily due to lower expectation of plan utilization in the future.

The following tables present information on plan assets and obligations, costs, and actuarial assumptions for the Staff Pension Plan and the Postretirement Medical Benefit Plan for the years ended August 31, 2017 and 2016, respectively.

The tables for the Postretirement Medical Benefit Plan include SHC and LPCH employees. The total postretirement medical benefit liability was \$84,179 and \$76,644 as of August 31, 2017 and 2016, respectively. SHC recorded a liability within self-insurance reserves in the consolidated balance sheets of \$65,823 and \$59,895 as of August 31, 2017 and 2016, respectively, which represents the liability for SHC employees excluding LPCH employees.

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**10. Retirement Plans (Continued)**

The change in pension and other post-retirement plan assets and the related change in benefit obligations, using a measurement date of August 31, as of and for the years ended August 31 are as follows:

	<b>Staff Pension Plan Obligations</b>		<b>Postretirement Medical Benefits Net of Medicare Part D Subsidy</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
<b>Change in plan assets:</b>				
Fair value of plan assets at beginning of year	\$ 191,021	\$ 197,889	\$ -	\$ -
Actual return on plan assets	13,794	24,034	-	-
Employer contributions	3,207	-	6,439	6,029
Participants contributions	-	-	925	1,043
Plan settlements	-	(17,217)	-	-
Benefits paid	(12,811)	(11,989)	(7,524)	(7,234)
Medicare subsidies received	-	-	160	162
Expenses paid	(1,735)	(1,696)	-	-
Fair value of plan assets at end of year	<u>\$ 193,476</u>	<u>\$ 191,021</u>	<u>\$ -</u>	<u>\$ -</u>
<b>Change in benefit obligation:</b>				
Benefit obligation at beginning of year	\$ 256,484	\$ 249,109	\$ 76,644	\$ 84,751
Service cost	2,842	1,644	2,317	2,052
Interest cost	8,296	9,806	2,422	3,295
Participants contributions	-	-	925	1,043
Plan settlements	-	(17,217)	-	-
Benefits paid	(12,811)	(11,989)	(7,524)	(7,234)
Medicare subsidies received	-	-	160	162
Expenses paid	(1,735)	(1,696)	-	-
Plan amendments	-	-	5,136	2,289
Actuarial (gain) loss	(7,855)	26,827	4,099	(9,714)
Benefit obligation at end of year	<u>\$ 245,221</u>	<u>\$ 256,484</u>	<u>\$ 84,179</u>	<u>\$ 76,644</u>
<b>Amounts recognized in consolidated balance sheets:</b>				
Plan assets minus benefit obligation	<u>\$ (51,745)</u>	<u>\$ (65,463)</u>	<u>\$ (84,179)</u>	<u>\$ (76,644)</u>
Net benefit liability recognized	<u>\$ (51,745)</u>	<u>\$ (65,463)</u>	<u>\$ (84,179)</u>	<u>\$ (76,644)</u>
<b>Amounts recognized in consolidated balance sheets:</b>				
Current liabilities	\$ -	\$ -	\$ (7,063)	\$ (5,485)
Noncurrent liabilities	(51,745)	(65,463)	(77,116)	(71,159)
Net benefit liability recognized	<u>\$ (51,745)</u>	<u>\$ (65,463)</u>	<u>\$ (84,179)</u>	<u>\$ (76,644)</u>
<b>Amounts recognized in unrestricted net assets:</b>				
Prior service cost	\$ -	\$ -	\$ (7,636)	\$ (4,102)
Net (loss) gain	(77,362)	(91,341)	9,117	14,131
Unrestricted net assets	<u>\$ (77,362)</u>	<u>\$ (91,341)</u>	<u>\$ 1,481</u>	<u>\$ 10,029</u>

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**10. Retirement Plans (Continued)**

The estimated net loss for the Staff Pension Plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year is \$2,605.

The estimated net gain and prior service cost for the Postretirement Medical Benefit Plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year are \$580 and \$1,602, respectively.

Total benefit obligation at the end of the year for the Postretirement Medical Benefit Plan excluding Medicare Part D subsidy increased to \$85,723.

The accumulated benefit obligation for the Staff Pension Plan was \$243,235 and \$254,108 as of August 31, 2017 and 2016, respectively.

Net benefit expense related to the plans for the years ended August 31 includes the following components:

	<b>Staff Pension Plan Obligations</b>	
	<b>2017</b>	<b>2016</b>
	<b>2017</b>	<b>2016</b>
Service cost	\$ 2,842	\$ 1,644
Interest cost	8,296	9,806
Expected return on plan assets	(10,682)	(11,909)
Amortization of net actuarial loss	3,012	2,272
Settlement loss recognized	-	6,079
Total net periodic benefit cost	<u>\$ 3,468</u>	<u>\$ 7,892</u>

	<b>Postretirement Medical Benefits</b>			
	<b>Net of Medicare Part D Subsidy</b>		<b>Excluding Medicare Part D Subsidy</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Service cost	\$ 2,317	\$ 2,052	\$ 2,317	\$ 2,052
Interest cost	2,422	3,295	2,512	3,415
Amortization of prior service cost	1,602	773	1,602	773
Amortization of net actuarial gain	(915)	(313)	(1,123)	(537)
Total net periodic benefit cost	<u>\$ 5,426</u>	<u>\$ 5,807</u>	<u>\$ 5,308</u>	<u>\$ 5,703</u>

Changes recognized in unrestricted net assets for the years ended August 31 include the following components:

	<b>Staff Pension Plan Obligations</b>		<b>Postretirement Medical Benefits Net of Medicare Part D Subsidy</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Net (gain) loss arising during period	\$ (10,967)	\$ 14,702	\$ 4,099	\$ (9,714)
New prior service cost	-	-	5,136	2,289
Amortizations				
Prior service cost	-	-	(1,602)	(773)
(Loss) gain	(3,012)	(2,272)	915	313
Settlement loss recognized	-	(6,079)	-	-
Total recognized in unrestricted net assets	<u>\$ (13,979)</u>	<u>\$ 6,351</u>	<u>\$ 8,548</u>	<u>\$ (7,885)</u>
Total recognized in net periodic benefit cost and unrestricted net assets	<u>\$ (10,511)</u>	<u>\$ 14,243</u>	<u>\$ 13,974</u>	<u>\$ (2,078)</u>

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**10. Retirement Plans (Continued)**

**Actuarial Assumptions**

The weighted-average assumptions used to determine benefit obligations are as follows for the years ended August 31:

	<b>Staff Pension Plan Obligations</b>		<b>Postretirement Medical Benefits</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Weighted-average assumptions				
Discount rate	3.56%	3.32%	3.33%	3.07%
Rate of compensation increase	3.00%	3.00%	N/A	N/A

The discount rate, expected rate of return on plan assets, and the projected covered payroll growth rates used in determining the above net benefit expense are as follows for the years ended August 31:

	<b>Staff Pension Plan Obligations</b>		<b>Postretirement Medical Benefits</b>	
	<b>2017</b>	<b>2016</b>	<b>2017</b>	<b>2016</b>
Weighted-average assumptions				
Discount rate	3.32%	4.20%	3.07%	4.01%
Expected return on plan assets	6.00%	6.50%	N/A	N/A
Rate of compensation increase	3.00%	3.00%	N/A	N/A

To develop the assumption for the expected rate of return on plan assets, SHC considered the historical and future expected returns. An independent investment consulting firm provided SHC with an estimate of the future expected returns for each asset class based on SHC's asset allocation targets. The evaluation of the historical returns and the future expected returns resulted in the use of 6.00% as the assumption for the expected return on plan assets.

To determine the accumulated post-retirement benefit obligation as of August 31, 2017, a 6.75% annual rate of increase in the per capita cost of covered health care was assumed for calendar year 2017, declining gradually to 4.50% by 2038, and remaining at this rate thereafter.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the post-retirement medical benefit plan. Increasing the health care cost trend rate by 1% in each future year would increase the accumulated post-retirement benefit obligation by \$1,937 and the aggregate service and interest cost by \$101. Decreasing the health care cost trend rate by 1% in each future year would decrease the accumulated post-retirement benefit obligation by \$1,754 and the aggregate service and interest cost by \$91.

**Plan Assets**

SHC's Staff Pension Plan weighted-average asset allocations as of the measurement date August 31, 2017 and 2016, respectively, by asset category are as follows:

<b><u>Asset Category</u></b>	<b><u>August 31, 2017</u></b>	<b><u>August 31, 2016</u></b>
Debt securities	50%	50%
Equity securities	50%	49%
Other	0%	1%
Total	100%	100%



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**10. Retirement Plans (Continued)**

**Plan Assets (continued)**

The following table summarizes SHC's Staff Pension Plan assets measured at fair value on a recurring basis as of August 31, based on the inputs used to value them as defined in Note 7:

	2017			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$ 1,247	\$ -	\$ -	\$ 1,247
Mutual funds	192,229	-	-	192,229
Total assets	<u>\$ 193,476</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 193,476</u>

  

	2016			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$ 1,075	\$ -	\$ -	\$ 1,075
Mutual funds	189,946	-	-	189,946
Total assets	<u>\$ 191,021</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 191,021</u>

**Plan Investments**

The investment objective of the Staff Pension Plan funds is to maximize the total rate of return (income and appreciation) within the limits of prudent risk taking and Section 404 of the Employee Retirement Income Security Act. The funds are diversified across asset classes to achieve an optimal balance between risk and return and between income and capital appreciation. Many of the pension liabilities are long-term. The investment horizon is also long-term; however, the investment plan also ensures adequate near-term liquidity to meet benefit payments.

The allowable asset mix range and target asset allocations are:

<u>Asset Category</u>	<u>Acceptable Range</u>	<u>Target Allocation</u>
Equity securities	36% to 60%	50%
Debt securities	20% to 80%	50%

Appropriate investments include common, preferred and convertible equities of domestic and foreign companies, mutual and commingled trust funds, top tier commercial paper, certificates of deposit, and fixed income securities whose assets are rated investment grade or better.

Financial futures and options on futures traded on exchanges are also permitted for hedging purposes. Prohibited investments include commodities, unregistered securities and short sales. Derivative products may not be used to leverage a portfolio or to speculate. All assets must have readily ascertainable market value and be easily marketable.

Portfolios are expected to be well diversified with respect to industry and economic sectors. Equity investments in any one company shall be limited to the greater of 5% of the market value of the portfolio at time of purchase or twice the applicable benchmark weighting of the security. The investment manager shall not hold more than 15% of any company's outstanding equity.

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**10. Retirement Plans (Continued)**

**Plan Investments (continued)**

Fixed income investments may consist of U.S. government, U.S. government guaranteed, and U.S. government agency securities. Corporate bond holdings must have an investment grade credit rating at the time of purchase and during the holding period. No single issuer of fixed income or cash equivalent securities (with the exception of the U.S. Government and its Agencies) will account for more than 10% of the market value of the fixed income securities in a manager's portfolio.

**Concentration of Risk**

SHC manages a variety of risks, including market, credit, and liquidity risks, across plan assets through investment managers. Concentration of risk is defined as an undiversified exposure to one of the above-mentioned risks that increases the exposure of the loss of plan assets unnecessarily. Risk is minimized by diversifying our exposure to such risks across a variety of instruments, markets, and counterparties. As of August 31, 2017, SHC did not have concentrations of risk in any single entity, manager, counterparty, sector, industry or country.

**Expected Contributions**

SHC expects to make \$34,800 to its Staff Pension Plan for both SHC and LPCH employees during the fiscal year ending August 31, 2018. SHC expects to contribute \$5,687 to its Postretirement Medical Benefit Plan for only SHC employees during the fiscal year ending August 31, 2018.

**Expected Benefit Payments**

The following benefit payments, which reflect expected future service, are expected to be paid for the fiscal years ending August 31:

	<b>Pension Benefits</b>	<b>Postretirement Medical Benefits</b>	
		<b>Net of Medicare Part D Subsidy</b>	<b>Excluding Medicare Part D Subsidy</b>
2018	\$ 13,748	\$ 7,063	\$ 7,212
2019	14,133	6,980	7,127
2020	14,463	7,009	7,152
2021	14,758	7,055	7,194
2022	14,986	7,079	7,214
2023 - 2027	75,373	32,976	33,554

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**11. Unrestricted Net Assets**

The changes in consolidated unrestricted net assets attributable to the controlling financial interest of SHC and the noncontrolling interests, for the years ended August 31, are as follows:

	<b>Total</b>	<b>Controlling Interest</b>	<b>Noncontrolling Interests</b>
Balance as of September 1, 2015	\$ 2,490,372	\$ 2,467,393	\$ 22,979
Excess of revenues over expenses	69,904	71,864	(1,960)
Noncontrolling capital distribution	(1,000)	-	(1,000)
Other changes in unrestricted net assets	(90,106)	(90,220)	114
Balance as of August 31, 2016	2,469,170	2,449,037	20,133
Excess of revenues over expenses	484,518	482,781	1,737
Noncontrolling capital contributions	301	-	301
Other changes in unrestricted net assets	(60,816)	(60,705)	(111)
Balance as of August 31, 2017	<u>\$ 2,893,173</u>	<u>\$ 2,871,113</u>	<u>\$ 22,060</u>

**12. Temporarily and Permanently Restricted Net Assets**

**Temporarily Restricted Net Assets**

Temporarily restricted net assets consist of the following at August 31:

	<b>2017</b>	<b>2016</b>
Plant replacement and expansion	\$ 540,785	\$ 513,585
Other patient services	42,520	41,382
Clinical services	8,342	11,098
Indigent care	7,314	6,953
Education	4,290	4,068
Total	<u>\$ 603,251</u>	<u>\$ 577,086</u>

**Permanently Restricted Net Assets**

In 2009, California adopted a version of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). SHC has interpreted UPMIFA as requiring the preservation of the original gift as of the gift date of donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, SHC classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure in a manner consistent with the standard of prudence prescribed by UPMIFA.

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

**12. Temporarily and Permanently Restricted Net Assets (Continued)**

**Permanently Restricted Net Assets (continued)**

In accordance with UPMIFA, SHC considers the following factors in making a determination to appropriate or accumulate endowment funds:

1. The duration and preservation of the fund.
2. The purposes of SHC and the donor restricted endowment fund.
3. General economic conditions.
4. The possible effect of inflation and deflation.
5. The expected total return from income and the appreciation of investments.
6. Other resources of the organization.
7. The investment policies of the organization.

Endowment funds by net asset classification as of August 31, 2017 and 2016 are as follows:

	2017			2016		
	Temporarily Restricted	Permanently Restricted	Total	Temporarily Restricted	Permanently Restricted	Total
Donor restricted endowment	\$ 12,567	\$ 8,144	\$ 20,711	\$ 10,723	\$ 7,894	\$ 18,617
Total endowment	\$ 12,567	\$ 8,144	\$ 20,711	\$ 10,723	\$ 7,894	\$ 18,617

Changes in SHC's endowment for the years ended August 31, 2017 and 2016 are as follows:

	2017			2016		
	Temporarily Restricted	Permanently Restricted	Total	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 10,723	\$ 7,894	\$ 18,617	\$ 10,666	\$ 7,694	\$ 18,360
Investment return:						
Investment income	491	-	491	491	-	491
Mark to market adjustments	1,717	-	1,717	(21)	-	(21)
Total investment return	2,208	-	2,208	470	-	470
Contributions	-	250	250	-	200	200
Expenditures	(364)	-	(364)	(413)	-	(413)
Endowment net assets, end of year	\$ 12,567	\$ 8,144	\$ 20,711	\$ 10,723	\$ 7,894	\$ 18,617

The following provides descriptions of amounts classified as permanently restricted net assets and temporarily restricted net assets (endowment only). The portion of endowment funds that is required to be retained permanently or temporarily, either by explicit donor stipulation or by California UPMIFA, as of August 31, 2017 and 2016 is as follows:

	2017			2016		
	Temporarily Restricted	Permanently Restricted	Total	Temporarily Restricted	Permanently Restricted	Total
Clinical services	\$ 1,302	\$ 4,250	\$ 5,552	\$ 958	\$ 4,000	\$ 4,958
Education	4,975	1,435	6,410	4,274	1,435	5,709
Indigent care and other	6,290	2,459	8,749	5,491	2,459	7,950
Total endowment classified as net assets	\$ 12,567	\$ 8,144	\$ 20,711	\$ 10,723	\$ 7,894	\$ 18,617

# Stanford Health Care

## Notes to Consolidated Financial Statements

### (in thousands of dollars)

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#### 12. Temporarily and Permanently Restricted Net Assets (Continued)

##### Permanently Restricted Net Assets (continued)

All of SHC's endowment, totaling \$20,711 and \$18,617 at August 31, 2017 and 2016, respectively, are invested in the MP. The funds are held in perpetuity and invested to generate income to support operating and strategic initiatives.

##### Return Objectives and Risk Parameters

The return objective for the endowment assets is to generate optimal total return while maintaining an appropriate level of risk established by the University.

##### Strategies Employed for Achieving Investment Objectives

SHC relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized gain) and current yield (interest and dividend) managed by the MP.

#### 13. Related-Party Transactions

##### Transactions with the University and SoM

SHC has various transactions with the University and the SoM. SHC records expense transactions where direct and incremental economic benefits are received by SHC.

Expenses paid to the University and the SoM are reported as operating expenses in the consolidated statements of operations and changes in net assets and are management's best estimates of SHC's arms-length payments of such amounts for its market specific circumstances. To the extent that payments to the University and the SoM exceed an arms-length estimated amount relative to the benefits received by SHC, they are recorded as transfers to the University and the SoM in other changes in net assets.

SHC purchases certain services from the University and the SoM. Payment for these services is based on management's best estimate of its market specific circumstances.

Services provided by the SoM include physician services that benefit SHC, such as emergency room coverage, physicians providing medical direction to SHC, and physicians providing service to the clinical practice, which are covered by the Professional Services Agreement ("PSA"). Such expenses are reflected as purchased services in the consolidated statements of operations and changes in net assets, and total \$678,239 and \$607,274 for the years ended August 31, 2017 and 2016, respectively.

Services provided by the University and other SoM non-physician services include telecommunications, transportation, utilities, and certain administrative services, such as legal and internal audit. Total costs incurred by SHC were \$99,616 and \$104,044 for the years ended August 31, 2017 and 2016, respectively, and are reflected in various categories in the consolidated statements of operations and changes in net assets.

SHC paid service fees to the University in the amount of \$2,211 for the years ended August 31, 2017 and 2016. The service fees represent costs for the utilization of infrastructure owned by the University such as road improvements, parking garages and generators and are reflected in the consolidated statements of operations and changes in net assets as other expense. Expected payments over the next 16 years total \$19,437. Annual service fees range from approximately \$2,369 for the year ending August 31, 2018 to \$690 for the year ending August 31, 2033.

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 13. Related-Party Transactions (Continued)

#### Transactions with the University and SoM (continued)

SHC also received payment for services provided to the University including primarily building maintenance, housekeeping, and security. Costs incurred by SHC in providing these services are reflected in the respective categories in the consolidated statements of operations and changes in net assets. Reimbursement from the University totaled \$38,088 and \$37,844 for the years ended August 31, 2017 and 2016, respectively, and is reflected in the consolidated statements of operations and changes in net assets as expense recoveries.

In addition, SHC received certain grant monies for clinical trials from the University. Grant revenue totaled \$6,767 and \$5,748 for the years ended August 31, 2017 and 2016, respectively, and is reflected in the consolidated statements of operations and changes in net assets as net patient service revenue and recoveries.

During the year ended August 31, 2004, SHC paid \$5,500 to the University. The amount represented a prepayment of a 51 year lease for property owned by the University. The short term portion of \$108 is included in prepaid expenses and other in the consolidated balance sheets as of August 31, 2017 and 2016. The remaining amount included in other assets in the consolidated balance sheets is \$3,702 and \$3,810 as of August 31, 2017 and 2016, respectively.

For the years ended August 31, 2017 and 2016, SHC transferred \$69,071 and \$57,821, respectively, to the University. These funds are used by the University to support the academic mission of the SoM and its initiatives as well as the general support of the academic community and physical plant. For the years ended August 31, 2017 and 2016, SHC also transferred \$305 and \$31,123, respectively, to the University which represents excess consideration paid in the acquisition of the Stanford Blood Center. Total transfers of \$69,376 and \$88,944 for the years ended August 31, 2017 and 2016, respectively, are included in other changes in unrestricted net assets in the consolidated statements of operations and changes in net assets.

SHC also received equity transfers of \$2,748 and \$2,645 during the years ended August 31, 2017 and 2016, respectively, which represented restricted gifts originally donated to the University. These gifts were subsequently re-designated mostly for SHC patient care services and the New Stanford Hospital and are included in changes in temporarily restricted net assets in the consolidated statements of operations and changes in net assets.

#### Transactions with LPCH

SHC and LPCH share certain departments, including facilities design and construction, materials management, managed care contracting, compliance and general services. Shared service costs are included in the respective categories on the consolidated statements of operations and changes in net assets, and are allocated between SHC and LPCH based on negotiated rates. Reimbursement received from LPCH totaled \$31,360 and \$30,340 for the years ended August 31, 2017 and 2016, respectively, and is reflected in the consolidated statements of operations and changes in net assets as expense recoveries.

SHC provides various services to LPCH. These services include operating room, cardiac catheterization, interventional radiology, radiation oncology and laboratory. The cost of these services is charged back to LPCH based on a percentage of charges intended to approximate cost or a cost per procedure. Costs of these purchased services are reflected in the appropriate category in the consolidated statements of operations and changes in net assets. Reimbursement of purchased services from LPCH totaled \$44,845 and \$47,214 for the years ended August 31, 2017 and 2016, respectively, and is reflected in the consolidated statements of operations and changes in net assets as net patient service revenue.

**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**13. Related-Party Transactions (Continued)**

**Transactions with LPCH (continued)**

Other services provided by SHC include services provided by interns and residents, building maintenance, IT and utilities. Reimbursement of these services totaled \$40,681 and \$33,448 for the years ended August 31, 2017 and 2016, respectively, and is reflected in the consolidated statements of operations and changes in net assets as expense recoveries.

During the year ended August 31, 2016, SHC transferred \$3,300 to LPCH which represented a partial reimbursement of prior year transfers due to revised estimate on capital projects.

**14. Operating and Capital Leases**

SHC leases various equipment and facilities under non-cancelable lease agreements expiring at various dates. Total rental expense (included in other expense in the consolidated statements of operations and changes in net assets) under these leases for the years ended August 31, 2017 and 2016 was \$97,667 and \$89,951, respectively.

Net minimum future lease payments under all non-cancelable operating leases and capital lease obligations for periods subsequent to August 31, 2017 are as follows:

Year Ending August 31,	<u>Operating</u>	<u>Capital</u>
2018	\$ 87,336	\$ 398
2019	84,232	98
2020	72,137	82
2021	62,857	66
2022	59,218	-
Thereafter	<u>128,886</u>	<u>-</u>
	<u>\$ 494,666</u>	644
Less amount representing interest		(41)
Subtotal		<u>603</u>
Current portion		(378)
Long-term portion, net of current portion		<u>\$ 225</u>

Capital lease obligations totaled \$603 of which \$378 is included in accounts payable and accrued liabilities on the consolidated balance sheets. The remaining capital lease obligation of \$225 is included in other long term liabilities on the consolidated balance sheets.

SHC leases space in its medical office buildings to others under non-cancelable operating lease arrangements. Future minimum base rentals to be received under these leases in place as of August 31, 2017 are as follows:

Year Ending August 31,	
2018	\$ 4,926
2019	2,260
2020	1,349
2021	876
2022	902
Thereafter	<u>9,607</u>
	<u>\$ 19,920</u>

# Stanford Health Care

## Notes to Consolidated Financial Statements

(in thousands of dollars)

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### 15. Commitments and Contingencies

SHC is aware of certain asserted and unasserted legal claims. While the outcome cannot be determined at this time, management is of the opinion that the liability, if any, from these actions will not have a material effect on SHC's financial position.

SHC has irrevocable standby letters of credit in the amount of \$21,583, which are required as security for the workers' compensation self-insurance arrangements and \$2,130 to serve as a security deposit for certain construction projects being undertaken by SHC. No amounts have been drawn on these letters of credit as of August 31, 2017.

At August 31, 2017, SHC had contractual obligations of approximately \$309,432 primarily related to the construction of the new hospital and other capital projects and approximately \$342,918 to support SHC's operations, such as maintenance, food services, valet services and other purchased services.

Effective December 23, 2014, SHC entered into a five year agreement with a global technology services and outsourcing company, pursuant to which SHC will receive certain information technology services. Under the terms of the agreement, SHC will be charged fixed fees for one-time transition services, ongoing recurring and event-based fees for information technology services, and additional fees plus expenses for project work agreed upon pursuant to work orders. SHC has the right to extend the agreement for up to two consecutive one-year periods. SHC anticipates that it will spend approximately \$36,000 over the initial term of the agreement. SHC has certain rights to reduce the scope of services to be purchased and to terminate the agreement early for a termination fee. The amount of the termination fee depends on when the right to terminate is exercised, what services are terminated, and changes monthly from \$1,136 to terminate all services in the month ending September 30, 2017 and decreasing gradually to \$459 for the month ending December 31, 2019.

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation, as well as to regulatory actions unknown or unasserted at this time. Government activity with respect to investigations and allegations concerning possible violations of regulations by healthcare providers could result in the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. SHC is subject to similar regulatory reviews, and while such reviews may result in repayments and/or civil remedies that could have a material effect on SHC's financial results of operations in a given period, management believes that such repayments and/or civil remedies would not have a material effect on SHC's financial position.

As with many medical centers across the country, information security and privacy is a growing risk area based on developments in the law and expanding mobile technology practices. SHC has policies, procedures, and training in place to safeguard protected information, but select incidents have occurred in the past and may occur in the future involving potential or actual disclosure of such information (including, for example, certain identifiable information relating to patients or research participants). In most cases, there has been no evidence of unauthorized access to, or use/disclosure of, such information, yet laws may require reporting to potentially affected individuals and federal and state governmental agencies. Governmental agencies have the authority to investigate and request further information about an incident or safeguards, to cite SHC for a deficiency or regulatory violation, and/or require payment of fines, corrective action, or both. California law also allows a private right to sue for a breach of medical information. The cost of such possible consequences has not been material to date to SHC, and management does not believe that any future consequences of these incidents will be material to the consolidated financial statements.

The percentage of SHC employees that are covered by collective bargaining arrangements is approximately 31%. There are currently no expired agreements.



**Stanford Health Care**  
**Notes to Consolidated Financial Statements**  
**(in thousands of dollars)**

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**15. Commitments and Contingencies (Continued)**

California's Hospital Seismic Safety Act requires licensed acute care functions to be conducted only in facilities that meet specified seismic safety standards. Facilities classified by the State of California as non-compliant in the event of an earthquake must be retrofitted, replaced or removed from acute-care service by applicable deadlines in 2020 or 2030.

The California Office of Statewide Health Planning and Development has classified a substantial portion of Stanford Hospital as compliant with seismic safety structural standards until 2030 and beyond. Certain patient care activities are located in existing buildings that are structurally compliant until 2030. However, these facilities have utility system configurations that must be modified no later than January 1, 2020 in order to remain in use for acute patient care. SHC is constructing a new hospital facility to address seismic safety requirements, which will also enable retrofit work of the existing hospital facility utility infrastructure.

Amendments of the Hospital Seismic Safety Act, through Senate Bill ("SB") 90 and SB 499, allow extensions to compliance timelines for hospitals that meet certain eligibility requirements. SHC has received approval from the State to extend the compliance deadline through 2019 for all buildings subject to the requirement. These extensions will allow sufficient time to construct the new hospital and mitigate the deficiencies of the existing facility.

In June 2011, the Palo Alto City Council certified the Final Environmental Impact Report, land use changes, permits and a Development Agreement with SHC, LPCH and the University as part of a Renewal Project. In July 2011, the Palo Alto City Council provided final approval for the Renewal Project at the second reading of the Development Agreement. The Renewal Project will rebuild Stanford Hospital and expand LPCH to assure adequate capacity, meet State-mandated earthquake safety standards, and provide modern, technologically-advanced hospital facilities. The Renewal Project also includes replacement of outdated laboratory facilities at the SoM and remodeling of Hoover Pavilion. SHC's share of the estimated cost is approximately \$2.1 billion. As of August 31, 2017, SHC has capitalized \$1,520 million, inclusive of \$124 million in capitalized interest, related to this project.

Based on current estimated schedules, management projects that the Renewal Project construction will be complete in 2019.

**16. Functional Expenses**

Expenses are categorized on a functional basis for the years ended August 31:

	<u>2017</u>	<u>2016</u>
Patient services	\$ 3,811,682	\$ 3,553,997
Management and general	396,871	384,711
Fundraising	11,966	10,911
Total functional expenses	<u>\$ 4,220,519</u>	<u>\$ 3,949,619</u>

**17. Subsequent Events**

SHC has evaluated subsequent events occurring between the end of the most recent fiscal year and December 5, 2017, the date the financial statements were issued.

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**Report of Independent Auditors  
On Accompanying Consolidating Information**

To the Board of Directors  
Stanford Health Care

We have audited the consolidated financial statements of Stanford Health Care (“SHC”) as of August 31, 2017 and for the year then ended and our report thereon appears on page one of this document. That audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of the individual companies and is not a required part of the consolidated financial statements. Accordingly, we do not express an opinion on the financial position, results of operations and changes in net assets and cash flows of the individual companies.

*PricewaterhouseCoopers LLP*

December 5, 2017

**Stanford Health Care**  
**Consolidating Balance Sheet**  
**August 31, 2017**  
(in thousands of dollars)

	SHC	UHA	SHC-VC	SBC LLC	SHI	SEROC	PEAC	Care Counsel	SHC Advantage	Eliminations	Total
<b>Assets</b>											
Current assets:											
Cash and cash equivalents	\$ 603,771	\$ 2,688	\$ 49,963	\$ 11,694	\$ 23,416	\$ 6,100	\$ 6,578	\$ 278	\$ 5,621	\$ -	\$ 710,109
Short term investments	233,533	-	-	-	-	-	-	-	-	-	233,533
Patient accounts receivable, net of allowance for doubtful accounts	541,297	32,047	31,844	-	-	2,046	-	-	-	3,500	610,734
Other receivables	61,768	3,922	4,108	709	62	1,725	253	234	547	(2,216)	71,112
Inventories	47,723	1,083	5,983	1,770	-	-	-	-	-	-	56,559
Prepaid expenses and other	32,561	7,107	1,750	65	278	143	634	27	6	(43)	42,528
Due from related parties	9,163	19,622	2,720	3,887	47	-	-	-	-	(35,439)	-
<b>Total current assets</b>	<b>1,529,816</b>	<b>66,469</b>	<b>96,368</b>	<b>18,125</b>	<b>23,803</b>	<b>10,014</b>	<b>7,465</b>	<b>539</b>	<b>6,174</b>	<b>(34,198)</b>	<b>1,724,575</b>
Investments	45,265	-	-	-	59,837	-	6,562	-	-	-	111,664
Investments at equity	59,103	-	7,152	-	-	-	-	-	-	-	66,255
Investments in University managed pools	1,246,102	-	-	-	41,091	-	-	-	-	-	1,287,193
Assets limited as to use, held by trustee	58,134	-	-	-	-	-	-	-	-	-	58,134
Property and equipment, net	2,701,461	29,679	134,952	2,155	-	1,099	-	-	-	-	2,869,346
Other assets	152,958	18,022	3,425	-	-	831	144	17	311	(63,263)	112,445
Investments in related entities	292,172	3,273	-	-	-	-	-	-	-	(295,445)	-
<b>Total assets</b>	<b>\$ 6,085,011</b>	<b>\$ 117,443</b>	<b>\$ 241,897</b>	<b>\$ 20,280</b>	<b>\$ 124,731</b>	<b>\$ 11,944</b>	<b>\$ 14,171</b>	<b>\$ 556</b>	<b>\$ 6,485</b>	<b>\$ (392,906)</b>	<b>\$ 6,229,612</b>
<b>Liabilities and Net Assets</b>											
Current liabilities:											
Accounts payable and accrued liabilities	\$ 257,239	\$ 22,221	\$ 18,599	\$ 3,361	\$ 399	\$ 389	\$ 2,073	\$ 97	\$ 3,710	\$ (189)	\$ 307,899
Accrued salaries and related benefits	207,896	27,219	20,610	-	-	-	-	34	-	-	255,759
Due to related parties	97,263	2,720	4,872	144	788	74	47	374	586	(35,439)	71,429
Third-party payor settlements	18,294	-	(145)	-	-	-	-	-	-	-	18,149
Current portion of long-term debt	13,335	-	2,070	-	-	-	-	-	-	(2,070)	13,335
Revolving line of credit	135,000	-	-	-	-	-	-	-	-	-	135,000
Debt subject to short-term remarketing arrangements	228,200	-	-	-	-	-	-	-	-	-	228,200
Self-insurance reserves and other	27,233	2,131	2,263	165	14,062	-	-	-	-	-	45,854
<b>Total current liabilities</b>	<b>984,460</b>	<b>54,291</b>	<b>48,269</b>	<b>3,670</b>	<b>15,249</b>	<b>463</b>	<b>2,120</b>	<b>505</b>	<b>4,296</b>	<b>(37,698)</b>	<b>1,075,625</b>
Self-insurance reserves and other, net of current portion	87,351	-	6,141	64	29,791	-	7,469	-	-	-	130,816
Other long-term liabilities	273,446	1,769	65,377	-	-	-	-	-	-	(63,263)	277,329
Pension liability	51,745	-	-	-	-	-	-	-	-	-	51,745
Long-term debt, net of current portion	1,189,529	-	-	-	-	-	-	-	-	-	1,189,529
<b>Total liabilities</b>	<b>2,586,531</b>	<b>56,060</b>	<b>119,787</b>	<b>3,734</b>	<b>45,040</b>	<b>463</b>	<b>9,589</b>	<b>505</b>	<b>4,296</b>	<b>(100,961)</b>	<b>2,725,044</b>
Net assets:											
Unrestricted											
Stanford Health Care	2,887,352	61,383	121,781	16,546	63,532	6,889	3,273	51	2,189	(291,883)	2,871,113
Noncontrolling interests	-	-	-	-	16,159	4,592	1,309	-	-	-	22,060
<b>Total unrestricted</b>	<b>2,887,352</b>	<b>61,383</b>	<b>121,781</b>	<b>16,546</b>	<b>79,691</b>	<b>11,481</b>	<b>4,582</b>	<b>51</b>	<b>2,189</b>	<b>(291,883)</b>	<b>2,893,173</b>
Temporarily restricted	602,984	-	329	-	-	-	-	-	-	(62)	603,251
Permanently restricted	8,144	-	-	-	-	-	-	-	-	-	8,144
<b>Total net assets</b>	<b>3,498,480</b>	<b>61,383</b>	<b>122,110</b>	<b>16,546</b>	<b>79,691</b>	<b>11,481</b>	<b>4,582</b>	<b>51</b>	<b>2,189</b>	<b>(291,945)</b>	<b>3,504,568</b>
<b>Total liabilities and net assets</b>	<b>\$ 6,085,011</b>	<b>\$ 117,443</b>	<b>\$ 241,897</b>	<b>\$ 20,280</b>	<b>\$ 124,731</b>	<b>\$ 11,944</b>	<b>\$ 14,171</b>	<b>\$ 556</b>	<b>\$ 6,485</b>	<b>\$ (392,906)</b>	<b>\$ 6,229,612</b>

The supplemental information has been prepared in a manner consistent with generally accepted accounting principles and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The supplemental combining information is presented only for purposes of additional analysis and not as a presentation of the financial position and results of the individual entities.

**Stanford Health Care**  
**Consolidating Statement of Operations and Changes in Net Assets**  
**Year Ended August 31, 2017**  
**(in thousands of dollars)**

	SHC	UHA	SHC-VC	SBC LLC	SHI	SEROC	PEAC	Care Counsel	SHC Advantage	Eliminations	Total
<b>Operating revenues:</b>											
Net patient service revenue	\$ 3,785,780	\$ 251,887	\$ 272,909	\$ -	\$ -	\$ 9,187	\$ -	\$ -	\$ -	\$ (8,233)	\$ 4,311,530
Provision for doubtful accounts	(61,731)	(3,519)	(11,711)	-	-	(36)	-	-	(7)	-	(77,004)
Net patient service revenue less provision for doubtful accounts	3,724,049	248,368	261,198	-	-	9,151	-	-	(7)	(8,233)	4,234,526
Premium revenue	959	70,627	-	-	-	-	-	-	14,457	(5,396)	80,647
Other revenue	41,450	12,323	7,609	71,704	25,916	109	4,580	2,020	-	(36,387)	129,324
Net assets released from restrictions used for operations	9,869	-	35	-	-	-	-	-	-	-	9,904
<b>Total operating revenues</b>	<b>3,776,327</b>	<b>331,318</b>	<b>268,842</b>	<b>71,704</b>	<b>25,916</b>	<b>9,260</b>	<b>4,580</b>	<b>2,020</b>	<b>14,450</b>	<b>(50,016)</b>	<b>4,454,401</b>
<b>Operating expenses:</b>											
Salaries and benefits	1,717,071	111,219	153,416	22	-	1,802	-	2,978	-	(148)	1,986,360
Professional services	37,280	890	3,355	102	1,126	731	578	26	599	(1,836)	42,851
Supplies	493,900	59,496	38,261	16,468	-	82	-	17	2,125	(24,293)	586,056
Purchased services	975,403	199,637	32,334	33,793	10,601	1,057	-	213	20,829	(137,847)	1,136,020
Depreciation and amortization	134,810	7,974	10,722	840	-	340	-	-	-	-	154,686
Interest	43,519	54	2,234	5	-	15	-	-	-	(2,184)	43,643
Other	318,413	23,978	38,978	5,272	14,699	1,479	3,407	318	670	(22,860)	384,354
Expense recoveries from related parties	(175,259)	(20,345)	(3,027)	(203)	-	-	-	(1,151)	-	86,534	(113,451)
<b>Total operating expenses</b>	<b>3,545,137</b>	<b>382,903</b>	<b>276,273</b>	<b>56,299</b>	<b>26,426</b>	<b>5,506</b>	<b>3,985</b>	<b>2,401</b>	<b>24,223</b>	<b>(102,634)</b>	<b>4,220,519</b>
<b>Income (loss) from operations</b>	<b>231,190</b>	<b>(51,585)</b>	<b>(7,431)</b>	<b>15,405</b>	<b>(510)</b>	<b>3,754</b>	<b>595</b>	<b>(381)</b>	<b>(9,773)</b>	<b>52,618</b>	<b>233,882</b>
Interest and investment income	17,089	43	402	-	1,101	-	42	-	4	(3,356)	15,325
Earnings on equity method investments	5,114	-	-	-	-	-	-	-	-	-	5,114
Increase (decrease) in value of University Managed pools	144,020	-	-	-	4,615	-	-	-	-	(3,806)	144,829
Interest rate swap mark to market adjustments	85,368	-	-	-	-	-	-	-	-	-	85,368
<b>Excess (deficiency) of revenues over expenses</b>	<b>482,781</b>	<b>(51,542)</b>	<b>(7,029)</b>	<b>15,405</b>	<b>5,206</b>	<b>3,754</b>	<b>637</b>	<b>(381)</b>	<b>(9,769)</b>	<b>45,456</b>	<b>484,518</b>
<b>Other changes in unrestricted net assets:</b>											
Transfer to Stanford University, net	(69,071)	-	-	(305)	-	-	-	-	-	-	(69,376)
Transfer between SHC and SHC-VC	(10,544)	-	10,544	-	-	-	-	-	-	-	-
Change in net unrealized gains on investments	1,148	18	-	-	(456)	-	26	-	-	322	1,058
Net assets released from restrictions used for:											
Purchase of property and equipment	762	-	558	-	-	-	-	-	-	-	1,320
Change in pension and postretirement liability	6,182	-	-	-	-	-	-	-	-	-	6,182
Noncontrolling capital contribution (distribution), net	-	73,617	-	(15,000)	4	-	1,001	250	9,000	(68,571)	301
<b>Increase (decrease) in unrestricted net assets</b>	<b>411,258</b>	<b>22,093</b>	<b>4,073</b>	<b>100</b>	<b>4,754</b>	<b>3,754</b>	<b>1,664</b>	<b>(131)</b>	<b>(769)</b>	<b>(22,793)</b>	<b>424,003</b>
<b>Changes in temporarily restricted net assets:</b>											
Transfer from Stanford University	2,748	-	-	-	-	-	-	-	-	-	2,748
Contributions and other	28,196	-	345	-	-	-	-	-	-	-	28,541
Investment income	4,662	-	-	-	-	-	-	-	-	-	4,662
Gains on University managed pools	1,438	-	-	-	-	-	-	-	-	-	1,438
Net assets released from restrictions used for:											
Operations	(9,869)	-	(35)	-	-	-	-	-	-	-	(9,904)
Purchase of property and equipment	(762)	-	(558)	-	-	-	-	-	-	-	(1,320)
<b>Increase (decrease) in temporarily restricted net assets</b>	<b>26,413</b>	<b>-</b>	<b>(248)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>26,165</b>
<b>Changes in permanently restricted net assets:</b>											
Contributions	250	-	-	-	-	-	-	-	-	-	250
<b>Increase in permanently restricted net assets</b>	<b>250</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>250</b>
Increase (decrease) in net assets	437,921	22,093	3,825	100	4,754	3,754	1,664	(131)	(769)	(22,793)	450,418
Net assets, beginning of year	3,060,559	39,290	118,285	16,446	74,937	7,727	2,918	182	2,958	(269,152)	3,054,150
<b>Net assets, end of year</b>	<b>\$ 3,498,480</b>	<b>\$ 61,383</b>	<b>\$ 122,110</b>	<b>\$ 16,546</b>	<b>\$ 79,691</b>	<b>\$ 11,481</b>	<b>\$ 4,582</b>	<b>\$ 51</b>	<b>\$ 2,189</b>	<b>\$ (291,945)</b>	<b>\$ 3,504,568</b>

The supplemental information has been prepared in a manner consistent with generally accepted accounting principles and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The supplemental combining information is presented only for purposes of additional analysis and not as a presentation of the financial position and results of the individual entities.