

CONSOLIDATED FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION

The Cleveland Clinic Foundation
d.b.a. Cleveland Clinic Health System
Years Ended December 31, 2018 and 2017
With Report of Independent Auditors

Ernst & Young LLP



Cleveland Clinic Health System
Consolidated Financial Statements
and Supplementary Information
Years Ended December 31, 2018 and 2017

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Report of Independent Auditors

The Board of Directors
The Cleveland Clinic Foundation

We have audited the accompanying consolidated financial statements of The Cleveland Clinic Foundation and controlled affiliates, d.b.a. Cleveland Clinic Health System, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Cleveland Clinic Foundation and controlled affiliates, d.b.a. Cleveland Clinic Health System, at December 31, 2018 and 2017, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Adoption of ASU No. 2014-09, *Revenue from Contracts with Customers*

As discussed in Note 3 to the consolidated financial statements, the System changed its method for recognizing revenue as a result of the adoption of the amendments to the FASB Accounting Standards Codification resulting from Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, effective January 1, 2018. Our opinion is not modified with respect to this matter.

March 14, 2019

Cleveland Clinic Health System

Consolidated Balance Sheets (In Thousands)

	December 31	
	2018	2017
Assets		
Current assets:		
Cash and cash equivalents	\$ 444,763	\$ 241,227
Patient receivables, net of allowances for uncollectible accounts of \$194,159 in 2017	1,122,918	1,012,903
Investments for current use	53,841	154,971
Other current assets	426,465	374,726
Total current assets	2,047,987	1,783,827
Investments:		
Long-term investments	7,533,668	7,729,697
Funds held by trustees	49,377	69,234
Assets held for self-insurance	106,966	159,802
Donor-restricted assets	744,851	717,410
	8,434,862	8,676,143
Property, plant, and equipment, net	5,072,464	4,699,697
Other assets:		
Pledges receivable, net	152,448	151,019
Trusts and interests in foundations	87,606	80,643
Other noncurrent assets	411,762	475,010
	651,816	706,672
Total assets	\$ 16,207,129	\$ 15,866,339

	December 31	
	2018	2017
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 527,672	\$ 503,691
Compensation and amounts withheld from payroll	359,342	345,446
Current portion of long-term debt	191,350	457,813
Variable rate debt classified as current	407,776	573,270
Other current liabilities	493,453	438,662
Total current liabilities	<u>1,979,593</u>	<u>2,318,882</u>
Long-term debt	3,558,911	2,996,278
Other liabilities:		
Professional and general liability insurance reserves	141,182	147,327
Accrued retirement benefits	465,527	492,833
Other noncurrent liabilities	542,029	567,566
	<u>1,148,738</u>	<u>1,207,726</u>
Total liabilities	<u>6,687,242</u>	<u>6,522,886</u>
Net assets:		
Without donor restrictions	8,465,468	8,346,649
With donor restrictions	1,054,419	996,804
Total net assets	<u>9,519,887</u>	<u>9,343,453</u>
Total liabilities and net assets	<u><u>\$ 16,207,129</u></u>	<u><u>\$ 15,866,339</u></u>

See accompanying notes.

Cleveland Clinic Health System

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

Operations

	Year Ended December 31	
	2018	2017
Unrestricted revenues		
Net patient service revenue	\$ 8,031,799	\$ 7,794,551
Provision for uncollectible accounts	–	(296,469)
	8,031,799	7,498,082
Other	895,758	908,920
Total unrestricted revenues	8,927,557	8,407,002
Expenses		
Salaries, wages, and benefits	4,857,426	4,565,140
Supplies	864,870	793,365
Pharmaceuticals	1,090,981	957,045
Purchased services and other fees	563,770	533,045
Administrative services	222,116	198,863
Facilities	353,478	334,371
Insurance	71,584	61,060
	8,024,225	7,442,889
Operating income before interest, depreciation, amortization, and special charges	903,332	964,113
Interest	138,844	140,824
Depreciation and amortization	495,636	487,240
Operating income before special charges	268,852	336,049
Special charges (Note 20)	2,419	5,491
Operating income	266,433	330,558
Nonoperating gains and losses		
Investment return	(191,190)	896,139
Derivative losses	(186)	(2,305)
Other, net	28,862	(74,078)
Net nonoperating (losses) gains	(162,514)	819,756
Excess of revenues over expenses	103,919	1,150,314

(continued on next page)

Changes in Net Assets

	Year Ended December 31	
	2018	2017
Changes in net assets without donor restrictions:		
Excess of revenues over expenses	\$ 103,919	\$ 1,150,314
Donated capital	603	-
Net assets released from restriction for capital purposes	12,159	81,871
Retirement benefits adjustment	24,589	(3,373)
Foreign currency translation	(23,332)	29,301
Other	881	327
Increase in net assets without donor restrictions	<u>118,819</u>	<u>1,258,440</u>
Changes in net assets with donor restrictions:		
Gifts and bequests	121,814	120,671
Net investment (loss) income	(9,005)	55,112
Net assets released from restrictions used for operations included in other unrestricted revenues	(51,886)	(41,675)
Net assets released from restriction for capital purposes	(12,159)	(81,871)
Change in interests in foundations	(3,300)	5,047
Change in value of perpetual trusts	(984)	2,335
Union Hospital member substitution contribution	13,180	-
Other	(45)	(405)
Increase in net assets with donor restrictions	<u>57,615</u>	<u>59,214</u>
Increase in net assets	176,434	1,317,654
Net assets at beginning of year	9,343,453	8,025,799
Net assets at end of year	<u>\$ 9,519,887</u>	<u>\$ 9,343,453</u>

See accompanying notes.

Cleveland Clinic Health System

Consolidated Statements of Cash Flows

(In Thousands)

	Year Ended December 31	
	2018	2017
Operating activities and net nonoperating gains and losses		
Increase in net assets	\$ 176,434	\$ 1,317,654
Adjustments to reconcile increase in net assets to net cash provided by operating activities and net nonoperating gains and losses:		
Loss on extinguishment of debt	–	46,159
Retirement benefits adjustment	(24,589)	3,373
Net realized and unrealized losses (gains) on investments	249,359	(897,841)
Depreciation and amortization	497,357	490,663
Foreign currency translation loss (gain)	23,332	(29,301)
Donated capital	(603)	–
Restricted gifts, bequests, investment income, and other	(108,525)	(183,165)
Amortization of bond premiums and debt issuance costs	(6,046)	(3,106)
Net gain in value of derivatives	(15,701)	(26,509)
Union Hospital member substitution contribution	(64,876)	–
Changes in operating assets and liabilities:		
Patient receivables	(89,108)	46,268
Other current assets	(27,394)	10,173
Other noncurrent assets	65,984	(66,487)
Accounts payable and other current liabilities	80,075	16,404
Other liabilities	(10,213)	92,395
Net cash provided by operating activities and net nonoperating gains and losses	745,486	816,680
Financing activities		
Proceeds from long-term borrowings	556,864	1,118,137
Payments for advance refunding and redemption of long-term debt	(420,030)	(1,110,120)
Principal payments on long-term debt	(88,437)	(84,257)
Debt issuance costs	(6,417)	(8,173)
Change in pledges receivable, trusts, and interests in foundations	(16,300)	(1,206)
Restricted gifts, bequests, investment income, and other	108,525	183,165
Net cash provided by financing activities	134,205	97,546
Investing activities		
Expenditures for property, plant, and equipment	(804,515)	(607,720)
Proceeds from sale of property, plant, and equipment	165	1,486
Cash acquired through member substitution	1,515	–
Net change in cash equivalents reported in long-term investments	68,265	(362,513)
Purchases of investments	(3,683,770)	(2,441,368)
Sales of investments	3,747,101	2,215,234
Net cash used in investing activities	(671,239)	(1,194,881)
Effect of exchange rate changes on cash	(4,916)	1,254
Increase (decrease) in cash and cash equivalents	203,536	(279,401)
Cash and cash equivalents at beginning of year	241,227	520,628
Cash and cash equivalents at end of year	\$ 444,763	\$ 241,227
Supplemental disclosure of noncash activity		
Assets acquired through capital leases and other financing agreements	\$ 40,185	\$ 28,062
Accounts payable accruals for property, plant, and equipment	\$ 86,804	\$ 82,206

See accompanying notes.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

1. Organization and Consolidation

The Cleveland Clinic Foundation (Clinic) is a nonprofit, tax-exempt, Ohio corporation organized and operated to provide medical and hospital care, medical research, and education. The accompanying consolidated financial statements include the accounts of the Clinic and its controlled affiliates, d.b.a. Cleveland Clinic Health System (System).

The System is the leading provider of healthcare services in northeast Ohio. As of December 31, 2018, the System operates 14 hospitals with approximately 4,200 staffed beds. Thirteen of the hospitals are operated in the Northeast Ohio area, anchored by the Clinic. The System operates 21 outpatient Family Health Centers, 11 ambulatory surgery centers, as well as numerous physician offices, which are located throughout northeast Ohio, and specialized cancer centers in Sandusky and Mansfield, Ohio. In Florida, the System operates a hospital and a clinic in Weston, an outpatient family health and surgery center in Coral Springs, an outpatient family health center in West Palm Beach and numerous physician offices located throughout southeast Florida. In addition, the System operates a health and wellness center and a sports medicine clinic in Toronto, Canada and a specialized neurological clinical center in Las Vegas, Nevada. Pursuant to agreements, the System also provides management services for Ashtabula County Medical Center, located in Ashtabula, Ohio, with approximately 180 staffed beds, and Cleveland Clinic Abu Dhabi, a multispecialty hospital offering critical and acute care services that is part of Mubadala Development Company's network of healthcare facilities located in Abu Dhabi, United Arab Emirates with approximately 364 staffed beds.

All significant intercompany balances and transactions have been eliminated in consolidation.

2. Business Combinations

Effective April 1, 2018, the Clinic through a subsidiary became the sole member of The Union Hospital Association (Union Hospital) through a non-cash business combination transaction. The business combination was recorded under the acquisition method of accounting. The System recorded the fair value of the assets acquired of \$122.8 million and the liabilities assumed of \$57.9 million as of April 1, 2018. The fair value of net assets of \$64.9 million was recognized in the consolidated statement of operations and changes in net assets for the year ended December 31, 2018 as a member substitution contribution of \$51.7 million included in other nonoperating gains and losses and contributions of net assets with donor restrictions of \$13.2 million. There was no goodwill or identifiable intangible assets recorded as a result of the member substitution.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

2. Business Combinations (continued)

The results of operations for Union Hospital are included in the consolidated statements of operations and changes in net assets beginning on April 1, 2018. For the nine months ended December 31, 2018, Union Hospital had total unrestricted revenues of \$92.8 million, operating loss of \$11.1 million and a deficiency of revenues over expenses of \$11.4 million. The operations of Union Hospital did not have a material impact on net assets with donor restrictions.

Pro forma results of operations and changes in net assets of Union Hospital for the years ended December 31, 2018 and 2017, as though the business combination transaction had occurred on January 1, 2017, are not material and accordingly, are not provided.

3. Accounting Policies

Recent Accounting Pronouncements

Adopted

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance, and requires expanded disclosures about revenue recognition. The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The System adopted ASU 2014-09 on January 1, 2018 using the modified retrospective method of transition. The System performed an analysis of revenue streams and transactions under ASU 2014-09. In particular, for net patient service revenue, the System performed an analysis into the application of the portfolio approach as a practical expedient to group patient contracts with similar characteristics, such that revenue for a given portfolio would not be materially different than if it were evaluated on a contract-by-contract basis. Upon adoption, the majority of what was previously classified as provision for uncollectible accounts and presented as a reduction to net patient service revenue on the consolidated statements of operations and changes in net assets is treated as a price concession that reduces the transaction price, which is reported as net patient service revenue. The new standard also requires enhanced disclosures related to the disaggregation of revenue and significant judgments made in measurement and recognition. The impact of adopting ASU 2014-09 was not material to total unrestricted revenues, excess of revenues over expenses or total net assets.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements for Not-for-Profit Entities*. This ASU intends to make certain improvements to the current reporting requirements for not-for-profit entities. This standard sets forth changes to net asset classification requirements and the information presented about a not-for-profit entity's liquidity, financial performance and cash flows. The System adopted ASU 2016-14 in its consolidated financial statements effective December 31, 2018, applying retrospectively to all periods presented. The impact of adoption changes the classification of net assets on the consolidated balance sheets and consolidated statements of operations and changes in net assets from three classes of net assets to two classes of net assets. The System also added disclosure for the liquidity and availability of financial assets at the balance sheet date to meet cash needs for general expenditures within one year and disaggregated functional expense classifications by their natural expense classification. The impact of adopting ASU 2016-14 had no impact to total unrestricted revenues, excess of revenues over expenses or total net assets.

Not Yet Adopted

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU requires lessees to recognize assets and liabilities on the balance sheet for leases with lease terms greater than twelve months. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. This amends current guidance that requires only capital leases to be recognized on the lessee balance sheet. ASU 2016-02 will also require additional disclosures on the amount, timing and uncertainty of cash flows arising from leases. The System adopted ASU 2016-02 on January 1, 2019 using a modified retrospective approach. The impact of adoption on the consolidated financial statements will be an increase in other current and noncurrent assets to record right-of-use assets and an increase in other current and noncurrent liabilities to record lease obligations for current operating leases of approximately \$350 million representing the present value of remaining lease payments for operating leases.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

In June 2018, the FASB issued ASU No. 2018-08, *Not-for-Profit Entities, Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. This ASU intends to clarify and improve current accounting guidance to determine when a transaction should be accounted for as a contribution or as an exchange transaction and provides additional guidance about how to determine whether a contribution is conditional. The ASU is effective for the System for annual reporting periods beginning after June 15, 2018 for contributions received and after December 15, 2018 for contributions made, and interim periods beginning after December 31, 2019 with early adoption permitted. The System is currently assessing the impact that ASU 2018-08 will have on its consolidated financial statements and will adopt the provisions upon the effective date.

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement, Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU intends to improve the effectiveness of disclosures in the notes to financial statements by modifying disclosure requirements for fair value measurements. The ASU is effective for the System for annual and interim reporting periods beginning after December 15, 2019 with early adoption permitted. The System is currently assessing the impact that ASU 2018-13 will have on its consolidated financial statements and will adopt the provisions upon the effective date.

In August 2018, the FASB issued ASU No. 2018-14, *Compensation – Retirement Benefits – Defined Benefit Plans – General, Disclosure Framework – Changes to the Disclosure Requirements for Defined Benefit Plans*. This ASU intends to improve the effectiveness of disclosures in the notes to financial statements by modifying disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The ASU is effective for the System for annual reporting periods ending after December 15, 2021 with early adoption permitted. The System is currently assessing the impact that ASU 2018-14 will have on its consolidated financial statements and will adopt the provisions upon the effective date.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

In August 2018, the FASB issued ASU No. 2018-15, *Intangibles – Goodwill and Other – Internal-Use Software, Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*. This ASU aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The ASU is effective for the System for annual reporting periods beginning after December 15, 2020, and interim periods beginning after December 15, 2021 with early adoption permitted. The System is currently assessing the impact that ASU 2018-15 will have on its consolidated financial statements and will adopt the provisions upon the effective date.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Net Patient Service Revenue and Patient Receivables

Net patient service revenue is reported at the amount that reflects the consideration to which the System expects to be entitled for providing patient care. These amounts are due from patients, third-party payors, and others and includes variable consideration for retroactive revenue adjustments due to settlement of reviews and audits. Generally, the System bills the patients and third-party payors several days after the services are performed or shortly after discharge. Revenue is recognized as performance obligations are satisfied.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Performance obligations are determined based on the nature of the services provided by the System. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred in relation to total expected or actual charges. The System believes that this method provides a reasonable depiction of the transfer of services over the term of the performance obligation based on the inputs needed to satisfy the obligation. Generally, performance obligations satisfied over time relate to patients receiving inpatient acute care services. The System measures the performance obligation from admission into the hospital to the point when it is no longer required to provide services to that patient, which is generally at the time of discharge. These services are considered to be a single performance obligation. Revenue for performance obligations satisfied at a point in time is recognized when services are provided and the System does not believe it is required to provide additional services to the patient.

Because all of its performance obligations relate to contracts with a duration of less than one year, the System has elected to apply the optional exemption provided in FASB ASC 606-10-50-14(a) and, therefore, is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The unsatisfied or partially unsatisfied performance obligations referred to above are primarily related to inpatient acute care services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period.

The System is utilizing the portfolio approach practical expedient in ASC 606 for contracts related to net patient service revenue. The System accounts for the contracts within each portfolio as a collective group, rather than individual contracts, based on the payment pattern expected in each portfolio category and the similar nature and characteristics of the patients within each portfolio. The portfolios consist of major payor classes for inpatient revenue and outpatient revenue. Based on historical collection trends and other analyses, the System has concluded that revenue for a given portfolio would not be materially different than if accounting for revenue on a contract-by-contract basis.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

The System has agreements with third-party payors that generally provide for payments to the System at amounts different from its established rates. For uninsured patients who do not qualify for charity care, the System recognizes revenue based on established rates, subject to certain discounts and implicit price concessions as determined by the System. The System determines the transaction price based on standard charges for services provided, reduced by explicit price concessions provided to third-party payors, discounts provided to uninsured patients in accordance with the System's policy, and implicit price concessions provided to uninsured patients. Explicit price concessions are based on contractual agreements, discount policies and historical experience. Implicit price concessions represent differences between amounts billed and the estimated consideration the System expects to receive from patients, which are determined based on historical collection experience, current market conditions and other factors.

Generally, patients who are covered by third-party payors are responsible for patient responsibility balances, including deductibles and coinsurance, which vary in amount. The System estimates the transaction price for patients with deductibles and coinsurance based on historical experience and current market conditions. The initial estimate of the transaction price is determined by reducing the standard charge by any explicit price concessions, discounts, and implicit price concessions. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change. Adjustments arising from a change in the transaction price were not significant in 2018 or 2017.

The System is paid a prospectively determined rate for the majority of inpatient acute care and outpatient, skilled nursing, and rehabilitation services provided (principally Medicare, Medicaid, and certain insurers). These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Payments for capital are received on a prospective basis for Medicare and on a cost reimbursement methodology for Medicaid. Payments are received on a prospective basis for the System's medical education costs, subject to certain limits. The System is paid for cost reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare Administrative Contractor.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation as well as significant regulatory action, and, in the normal course of business, the System is subject to contractual reviews and audits, including audits initiated by the Medicare Recovery Audit Contractor program. As a result, there is at least a reasonable possibility that recorded estimates will change in the near term. The System believes it is in compliance with applicable laws and regulations governing the Medicare and Medicaid programs and that adequate provisions have been made for any adjustments that may result from final settlements.

Settlements with third-party payors for retroactive adjustments due to reviews and audits are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care in the period the related services are provided. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor and the System's historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known or as years are settled or are no longer subject to such reviews and audits. Adjustments arising from a change in estimated settlements increased net patient service revenue by \$16.7 million and \$5.9 million in 2018 and 2017, respectively.

As part of integration efforts involving Akron General Health System (Akron General) and through review of contractual relationships between Akron General and some of its independent physician practice groups, the System identified possible violations to the Federal Anti-Kickback Statute and Limitations on Certain Physician Referrals regulation (commonly referred to as the "Stark Law"), which may have resulted in false claims to federal and/or state healthcare programs and may result in liability under the Federal Anti-Kickback Statute, Stark Law, False Claims Act and/or other laws and regulations. Akron General is cooperating with the appropriate government authorities on such possible violations. The resolution of this matter is not expected to be material to the System's consolidated financial statements.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Charity Care

The System provides care to patients who do not have the ability to pay and who qualify for charity care pursuant to established policies of the System. Charity care is defined as services for which patients have the obligation and willingness to pay but do not have the ability to do so. The System does not report charity care as net patient service revenue. The cost of charity care provided in 2018 and 2017 approximated \$107 million and \$91 million, respectively. The System estimated these costs by calculating a ratio of cost to gross charges and then multiplying that ratio by the gross uncompensated charges associated with providing care to charity patients.

The System participates in the Hospital Care Assurance Program (HCAP). Ohio created HCAP to financially support those hospitals that service a disproportionate share of low-income patients unable to pay for care. HCAP funds basic, medically necessary hospital services for patients whose family income is at or below the federal poverty level, which includes Medicaid patients and patients without health insurance. The System recorded HCAP expenses of \$6.2 million and \$8.3 million for the years ended December 31, 2018 and 2017, respectively, which are reported in net patient service revenue.

Management Service Agreements

The System has management service agreements with regional, national and international organizations to provide advisory services for various healthcare ventures. The scope of these services range from managing current healthcare operations that are designed to improve clinical quality, innovation, patient care, medical education and research at other healthcare organizations and educational institutions to managing the construction, training, organizational infrastructure, and operational management of healthcare entities. The System recognizes revenues related to management service agreements on a pro rata basis over the term of the agreements as services are provided. Payments received in advance are recorded as deferred revenue until the services have been provided. The System has recorded deferred revenue related to management service agreements, included in other current liabilities, of \$8.8 million and \$15.7 million at December 31, 2018 and 2017, respectively. Revenue related to management service agreements for 2018 and 2017 was \$108.9 million and \$113.9 million, respectively, and is included in other unrestricted revenues.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Cash and Cash Equivalents

The System considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents. Cash equivalents are recorded at fair value in the consolidated balance sheets and exclude amounts included in long-term investments and investments for current use.

Inventories

Inventories (primarily supplies and pharmaceuticals) are stated at an average cost or the lower of cost (first-in, first-out method) or market and are recorded in other current assets.

Property, Plant, and Equipment

Property, plant, and equipment purchased by the System are recorded at cost. Donated property, plant, and equipment are recorded at fair value at the date of donation. Expenditures that substantially increase the useful lives of existing assets are capitalized. Routine maintenance and repairs are expensed as incurred. Depreciation, including amortization of capital leased assets, is computed by the straight-line method using the estimated useful lives of individual assets. Buildings are assigned useful lives ranging from five years to forty years. Equipment is assigned a useful life ranging from three to twenty years. Interest cost incurred on borrowed funds during the period of construction of capital assets and interest income on unexpended project funds are capitalized as a component of the cost of acquiring those assets. The System records costs and legal obligations associated with long-lived asset retirements. Assets acquired through capital lease arrangements are excluded from the consolidated statements of cash flows.

Impairment of Long-Lived Assets

The System evaluates the recoverability of long-lived assets and the related estimated remaining lives when indicators of impairment are present. For purposes of impairment analysis, assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. The System records an impairment charge or changes the useful life if events or changes in circumstances indicate that the carrying amount may not be recoverable or the useful life has changed.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Investments and Investment Income

Investments in equity securities with readily determinable fair values and all investments in debt securities are recorded at fair value in the consolidated balance sheets. Investments, excluding alternative investments, are primarily classified as trading. Investment transactions are recorded on a settlement date basis. Realized gains and losses are determined using the average cost method.

Commingled investment funds are valued using, as a practical expedient, the net asset value as provided by the respective investment companies and partnerships. There are no significant redemption restrictions on the commingled investment funds.

Investments in alternative investments, which include hedge funds, private equity/venture funds and real estate funds, are primarily limited partnerships that invest in marketable securities, privately held securities, real estate, and derivative products and are reported using the equity method of accounting based on net asset value information provided by the respective partnership or third-party fund administrators. Investments held by the partnerships consist of marketable securities as well as securities that do not have readily determinable values. The values of the securities held by the limited partnerships that do not have readily determinable values are determined by the general partner and are based on historical cost, appraisals, or other valuation estimates that require varying degrees of judgment. There is inherent uncertainty in such valuations, and the estimated fair values may differ from the values that would have been used had a ready market for the securities existed. Generally, the equity method investment balance of the System's holdings in alternative investments reflects net contributions to the partnerships and the System's share of realized and unrealized investment income and expenses. The investments may individually expose the System to securities lending, short sales, and trading in futures and forward contract options and other derivative products. The System's risk is limited to its carrying value. The financial statements of the limited partnerships are audited annually.

Alternative investments can be divested only at specified times in accordance with terms of the partnership agreements. Hedge fund redemptions typically contain restrictions that allow for a portion of the withdrawal proceeds to be held back from distribution while the underlying investments are liquidated. These redemptions are subject to lock-up provisions that are generally imposed upon initial investment in the fund. Private equity/venture funds and real estate funds are generally closed-end funds and have significant redemption restrictions that prohibit redemptions during the fund's life.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Investment return, including equity method income on alternative investments, is reported as nonoperating gains and losses, except for earnings on funds held by bond trustees and interest and dividends earned on assets held for self-insurance, which are included in other unrestricted revenues. Donor-restricted investment return on restricted investments is included in net assets with donor restrictions.

Certain of the System's assets and liabilities are exposed to various risks, such as interest rate, market, and credit risks.

Fair Value Measurements

Fair value measurements are defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Authoritative guidance provides an option to elect fair value as an alternative measurement for selected financial assets and liabilities not previously recorded at fair value. The System did not elect fair value accounting for any assets or liabilities that are not currently required to be measured at fair value.

The framework for measuring fair value is comprised of a three-level hierarchy based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Goodwill and Other Intangibles

Goodwill has resulted from business combinations, primarily physician practice acquisitions, and is based on the purchase price in excess of the fair values of assets acquired and liabilities assumed at the acquisition date. Annually, or when indicators of impairment exist, the System evaluates goodwill for impairment to determine whether there are events or circumstances that indicate it is more likely than not that the fair value of a reporting unit is less than its carrying amount.

Intangible assets other than goodwill are recorded at fair value in the period of acquisition. Intangible assets with finite lives, which consist primarily of patient medical records and non-compete agreements, are amortized over their estimated useful lives, ranging from three to five years, with a weighted-average amortization period of approximately three years.

Derivative Instruments

The System's derivative financial instruments consist of interest rate swaps and foreign currency forward contracts (*Note 13*), which are recognized as assets or liabilities in the consolidated balance sheets at fair value.

The System accounts for changes in the fair value of derivative instruments depending on whether they are designated and qualified as part of a hedging relationship and further, on the type of hedging relationship. The System has not designated any derivative instruments as hedges. Accordingly, the changes in fair value of derivative instruments and the related cash payments are recorded in derivative losses in the consolidated statements of operations and changes in net assets.

Foreign Currency Translation

The statements of operations of foreign subsidiaries whose functional currencies are other than the U.S. dollar are translated into U.S. dollars using average exchange rates for the period. The assets and liabilities of foreign subsidiaries whose functional currencies are other than the U.S. dollar are translated into U.S. dollars using exchange rates as of the consolidated balance sheet date. The U.S. dollar effects that arise from translating the net assets of these subsidiaries at changing rates are recorded as foreign currency translation gains and losses in the consolidated statements of operations and changes in net assets. Cumulative foreign currency translation losses included in net assets without donor restrictions were \$65.4 million and \$42.1 million at December 31, 2018 and 2017, respectively.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Debt Issuance Costs

Debt issuance costs are amortized over the period the obligation is outstanding using the straight-line method, which approximates the interest method.

Contributions

Unconditional donor pledges to give cash, marketable securities, and other assets are reported at fair value at the date the pledge is made to the extent estimated to be collectible by the System. Conditional donor promises to give and indications of intentions to give are not recognized until the condition is satisfied. Pledges received with donor restrictions that limit the use of the donated assets are reported as donor restricted support. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, net assets with donor restrictions are transferred to net assets without donor restrictions and reported in the consolidated statements of operations and changes in net assets as other unrestricted revenues if the purpose relates to operations or reported as a change in net assets without donor restrictions if the purpose relates to capital.

No amounts have been reflected in the consolidated financial statements for donated services. The System pays for most services requiring specific expertise. However, many individuals volunteer their time and perform a variety of tasks that assist the System with various programs.

Grants

Grant revenue is recognized in the period it is earned based on when the applicable project expenses are incurred and project milestones are achieved. Grant payments received in advance of related project expenses are deferred until the expenditure has been incurred and recorded as deferred revenue and included in other current liabilities. The System recorded research grant revenue, included in other unrestricted revenues, of \$212.8 million and \$195.7 million in 2018 and 2017, respectively.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

3. Accounting Policies (continued)

Net Assets With Donor Restrictions

Net assets with donor restrictions are used to differentiate resources, the use of which is restricted by donors or grantors to a specific time period or purpose, from resources on which no restrictions have been placed or that arise from the general operations of the System. Donor-restricted gifts and bequests are recorded as an addition to net assets with donor restrictions in the period received. Donor-restricted gifts include amounts held in perpetuity or for terms designated by donors, including the fair value of several charitable and perpetual trusts for which the System is an income or remainder beneficiary. Earnings on donor-restricted gifts are recorded as investment income in net assets with donor restrictions and subsequently used in accordance with the donor's designation. Net assets with donor restrictions are primarily restricted for research, education, and strategic capital projects.

Excess of Revenues Over Expenses

The consolidated statements of operations and changes in net assets include excess of revenues over expenses. Changes in net assets without donor restrictions, which are excluded from excess of revenues over expenses, consistent with industry practice, include retirement benefits adjustments, foreign currency translation gains and losses and contributions of long-lived assets (including assets acquired using grants or contributions that by donor restriction were to be used for the purpose of acquiring such assets).

4. Net Patient Service Revenue and Patient Receivables

Net patient service revenue by major payor source, net of price concessions, for the year ended December 31, 2018, is as follows (in thousands):

	<u>2018</u>	
Medicare	\$ 2,871,709	36%
Medicaid	649,428	8
Managed care and commercial	4,465,582	55
Self-pay	45,080	1
Net patient service revenue	<u>\$ 8,031,799</u>	<u>100%</u>

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

4. Net Patient Service Revenue and Patient Receivables (continued)

Net patient service revenue by major payor source, net of contractual adjustments and before the provision for uncollectible accounts, for the year ended December 31, 2017, is as follows (in thousands):

	2017	
Medicare	\$ 2,584,950	33%
Medicaid	646,934	8
Managed care and commercial	4,400,325	57
Self-pay	162,342	2
Net patient service revenue	\$ 7,794,551	100%

The System's concentration of credit risk relating to patient receivables is limited due to the diversity of patients and payors. Patient receivables consist of amounts due from government programs, commercial insurance companies, other group insurance programs, and private pay patients. Patient receivables due from Medicare, Medicaid, and one commercial payor account for approximately 26%, 7%, and 23% at December 31, 2018, and 27%, 9%, and 23% at December 31, 2017, respectively, of the System's total patient receivables. Revenues from the Medicare and Medicaid programs and one commercial payor account for approximately 36%, 8%, and 15% for 2018, and 33%, 8%, and 17% for 2017, respectively, of the System's net patient service revenue. Excluding these payors, no one payor represents more than 10% of the System's patient receivables or net patient service revenue.

As a result of certain changes required by ASU 2014-09, the majority of the System's provision for uncollectible accounts is recorded as a direct reduction to net patient service revenue instead of being presented as a separate line item on the consolidated statements of operations and changes in net assets. The adoption of ASU 2014-09 has no impact on the System's patient receivables as it was historically recorded net of allowance for uncollectible accounts and contractual adjustments on the consolidated balance sheets.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

5. Cash, Cash Equivalents, and Investments

The composition of cash, cash equivalents, and investments at December 31, 2018 and 2017, is as follows (in thousands):

	2018	2017
Cash and cash equivalents	\$ 911,877	\$ 770,654
Fixed income securities:		
U.S. treasuries	1,385,156	1,075,486
U.S. government agencies	20,889	18,964
U.S. corporate	108,240	83,383
U.S. government agencies asset-backed securities	94,399	25,139
Corporate asset-backed securities	31,477	4,895
Foreign	54,132	21,267
Fixed income mutual funds	122,034	391,971
Commingled fixed income funds	692,830	791,372
Common and preferred stocks:		
U.S.	425,269	475,141
Foreign	292,635	297,573
Equity mutual funds	97,932	262,991
Commingled equity funds	1,772,594	2,029,255
Commingled commodity funds	188,769	127,690
Alternative investments:		
Hedge funds	1,357,553	1,142,932
Private equity/venture funds	1,007,692	854,632
Real estate	369,988	483,996
Pending purchases of investments	–	215,000
Total cash, cash equivalents, and investments	\$ 8,933,466	\$ 9,072,341

Pending purchases of investments of \$215.0 million at December 31, 2017 were invested as hedge funds on January 1, 2018.

Investments are primarily maintained in a master trust fund administered using a bank as trustee. The management of the majority of the System's investments is conducted by numerous external investment management organizations that are monitored by the System. The alternative investments have separate administrators and custodian arrangements. Alternative investments also include five holdings in which the System invests directly.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

5. Cash, Cash Equivalents, and Investments (continued)

Total investment return is comprised of the following for the years ended December 31, 2018 and 2017 (in thousands):

	2018	2017
Other unrestricted revenues:		
Interest income and dividends	\$ 2,108	\$ 2,909
Nonoperating gains, net:		
Interest income and dividends	73,101	70,135
Net realized gains on sales of investments	171,240	177,901
Net change in unrealized (losses) gains on investments	(553,824)	518,861
Equity method income on alternative investments	148,278	152,178
Investment management fees	(29,985)	(22,936)
	(191,190)	896,139
Other changes in net assets:		
Investment income on restricted investments and other	(9,005)	54,250
Total investment return	\$ (198,087)	\$ 953,298

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

6. Liquidity and Availability

Financial assets available for general expenditure within one year of December 31, 2018 include the following (in thousands):

	<u>2018</u>
Cash and cash equivalents	\$ 444,763
Patient receivables	1,122,918
Long-term investments	5,579,202
	<u>\$ 7,146,883</u>

The System has assets limited to use held by trustees, set aside for the System's captive insurance subsidiary and held for donor-restricted purposes. These investments are not reflected in the amounts above.

The System invests in alternative investments to increase the investment portfolio's diversification. The asset allocation of the portfolio is broadly diversified across global equity and global fixed income asset classes and alternative investment strategies and is designed to maximize the probability of achieving the System's long-term investment objectives at an appropriate level of risk while maintaining a level of liquidity to meet the needs of ongoing portfolio management. The nature of alternative investments generally restricts the liquidity and availability of these investments to be available for the general expenditures of the System within one year of the consolidated balance sheet. As such, these investments have been excluded from the amounts above.

As part of the System's liquidity management plan, cash in excess of daily requirements for general expenditures is invested in long-term investments. The System's long-term investment portfolio contains money market funds and other liquid investments that can be drawn upon, if necessary, to meet the liquidity needs of the System.

The System maintains a \$300 million revolving credit facility as discussed in Note 12. As of December 31, 2018, \$195 million was available under the credit facility.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

7. Other Current Assets and Liabilities and Other Noncurrent Assets and Liabilities

Other current and noncurrent assets at December 31, 2018 and 2017, consist of the following (in thousands):

	2018	2017
Current:		
Inventories	\$ 162,198	\$ 143,437
Prepaid expenses	73,511	57,010
Pledges receivable, current (<i>Note 11</i>)	66,674	45,657
Research receivables	37,024	36,143
Estimated amounts due from third-party payors	13,447	9,397
Other	73,611	83,082
Total other current assets	\$ 426,465	\$ 374,726
Noncurrent:		
Deferred compensation plan assets	\$ 211,345	\$ 206,085
Goodwill and other intangible assets (<i>Note 8</i>)	102,857	101,999
Investments in affiliates	35,436	33,921
Note receivable	–	37,204
Other	62,124	95,801
Total other noncurrent assets	\$ 411,762	\$ 475,010

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

7. Other Current Assets and Liabilities and Other Noncurrent Assets and Liabilities (continued)

Other current and noncurrent liabilities at December 31, 2018 and 2017 consist of the following (in thousands):

	2018	2017
Current:		
Interest payable	\$ 63,046	\$ 52,236
Research deferred revenue	61,591	67,492
Current portion of professional and general liability insurance reserves (<i>Note 14</i>)	53,841	51,051
Estimated amounts due to third-party payors	31,910	40,053
Management contracts and other deferred revenue	31,821	38,026
Employee benefit related liabilities	30,804	29,211
Current portion of pledges payable	1,255	15,460
Other	219,185	145,133
Total other current liabilities	\$ 493,453	\$ 438,662
Noncurrent:		
Employee benefit related liabilities	\$ 259,341	\$ 256,797
Derivative liabilities (<i>Note 13</i>)	110,863	123,989
Pledge liabilities	21,603	20,328
Estimated amounts due to third-party payors	12,799	18,665
Gift annuity liabilities	11,688	12,120
Other	125,735	135,667
Total other noncurrent liabilities	\$ 542,029	\$ 567,566

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

8. Goodwill and Other Intangible Assets

The System recorded goodwill of \$1.7 million and \$10.9 million in 2018 and 2017, respectively, related to the acquisitions of various physician practices. Goodwill is recorded in other noncurrent assets in the consolidated balance sheets.

The changes in the carrying amount of goodwill for the years ended December 31, 2018 and 2017 are as follows (in thousands):

	Year Ended December 31	
	2018	2017
Balance, beginning of year	\$ 69,420	\$ 58,497
Goodwill acquired	1,726	10,978
Foreign currency translation	(726)	(55)
Balance, end of year	\$ 70,420	\$ 69,420

The System acquired other intangible assets of \$0.5 million and \$0.2 million in 2018 and 2017, respectively, related to the acquisitions of various physician practices. Other intangible assets are recorded in other noncurrent assets in the consolidated balance sheets.

Other intangible assets at December 31, 2018 and 2017 consist of the following (in thousands):

	2018		2017	
	Historical Cost	Accumulated Amortization	Historical Cost	Accumulated Amortization
Trade name	\$ 31,700	\$ —	\$ 31,700	\$ —
Finite-lived intangible assets	6,786	6,049	6,261	5,382
Total	\$ 38,486	\$ 6,049	\$ 37,961	\$ 5,382

Amortization related to finite-lived intangible assets was \$0.7 million and \$1.7 million in 2018 and 2017, respectively, and is included in depreciation and amortization in the consolidated statements of operations and changes in net assets. Future amortization is as follows (in thousands): 2019 – \$394; 2020 – \$234; and 2021 – \$109.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

9. Fair Value Measurements

The following tables present the financial instruments measured at fair value on a recurring basis as of December 31, 2018 and 2017, based on the valuation hierarchy (in thousands):

December 31, 2018	Level 1	Level 2	Level 3	Total
Assets				
Cash and investments:				
Cash and cash equivalents	\$ 911,624	\$ 253	\$ –	\$ 911,877
Fixed income securities:				
U.S. treasuries	1,385,156	–	–	1,385,156
U.S. government agencies	–	20,889	–	20,889
U.S. corporate	–	108,240	–	108,240
U.S. government agencies asset-backed securities	–	94,399	–	94,399
Corporate asset-backed securities	–	31,477	–	31,477
Foreign	–	54,132	–	54,132
Fixed income mutual funds	122,034	–	–	122,034
Common and preferred stocks:				
U.S.	425,269	–	–	425,269
Foreign	288,773	3,862	–	292,635
Equity mutual funds	97,932	–	–	97,932
Total cash and investments	3,230,788	313,252	–	3,544,040
Perpetual and charitable trusts	–	63,991	–	63,991
Total assets at fair value	\$ 3,230,788	\$ 377,243	\$ –	\$ 3,608,031
Liabilities				
Interest rate swaps	\$ –	\$ 101,444	\$ –	\$ 101,444
Foreign currency forward contracts	–	9,419	–	9,419
Total liabilities at fair value	\$ –	\$ 110,863	\$ –	\$ 110,863

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

9. Fair Value Measurements (continued)

December 31, 2017	Level 1	Level 2	Level 3	Total
Assets				
Cash and investments:				
Cash and cash equivalents	\$ 770,609	\$ 45	\$ –	\$ 770,654
Fixed income securities:				
U.S. treasuries	1,075,486	–	–	1,075,486
U.S. government agencies	–	18,964	–	18,964
U.S. corporate	–	83,383	–	83,383
U.S. government agencies asset-backed securities	–	25,139	–	25,139
Corporate asset-backed securities	–	4,895	–	4,895
Foreign	–	21,267	–	21,267
Fixed income mutual funds	391,971	–	–	391,971
Common and preferred stocks:				
U.S.	473,420	1,721	–	475,141
Foreign	296,025	1,548	–	297,573
Equity mutual funds	262,991	–	–	262,991
Total cash and investments	3,270,502	156,962	–	3,427,464
Perpetual and charitable trusts	–	53,728	–	53,728
Total assets at fair value	<u>\$ 3,270,502</u>	<u>\$ 210,690</u>	<u>\$ –</u>	<u>\$ 3,481,192</u>
Liabilities				
Interest rate swaps	\$ –	\$ 123,989	\$ –	\$ 123,989
Total liabilities at fair value	<u>\$ –</u>	<u>\$ 123,989</u>	<u>\$ –</u>	<u>\$ 123,989</u>

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

9. Fair Value Measurements (continued)

Financial instruments at December 31, 2018 and 2017 are reflected in the consolidated balance sheets as follows (in thousands):

	2018	2017
Cash, cash equivalents, and investments measured at fair value	\$ 3,544,040	\$ 3,427,464
Commingled funds measured at net asset value	2,654,193	2,948,317
Alternative investments accounted for under the equity method	2,735,233	2,481,560
Pending purchases of investments	–	215,000
Total cash, cash equivalents, and investments	\$ 8,933,466	\$ 9,072,341
Perpetual and charitable trusts measured at fair value	\$ 63,991	\$ 53,728
Interests in foundations	23,615	26,915
Trusts and interests in foundations	\$ 87,606	\$ 80,643

Interest rate swaps and forward currency forward contracts (*Note 13*) are reported in other noncurrent liabilities in the consolidated balance sheets.

The following is a description of the System's valuation methodologies for assets and liabilities measured at fair value. Fair value for Level 1 is based upon quoted market prices. Fair value for Level 2 is determined as follows:

Investments classified as Level 2 are primarily determined using techniques that are consistent with the market approach. Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, 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. Inputs, which include broker/dealer quotes, reported/comparable trades, and benchmark yields, are obtained from various sources, including market participants, dealers, and brokers.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

9. Fair Value Measurements (continued)

The fair value of perpetual and charitable trusts in which the System receives periodic payments from the trust is determined based on the present value of expected cash flows to be received from the trust using discount rates ranging from 2.8% to 5.0%, which are based on Treasury yield curve interest rates or the assumed yield of the trust assets. The fair value of charitable trusts in which the System is a remainder beneficiary is based on the System's beneficial interest in the investments held in the trust, which are measured at fair value.

The fair value of interest rate swaps is determined based on the present value of expected future cash flows using discount rates appropriate with the risks involved. The valuations include a credit spread adjustment to market interest rate curves to appropriately reflect nonperformance risk. The credit spread adjustment is derived from other comparably rated health care entities' bonds. The System manages credit risk based on the net portfolio exposure with each counterparty.

The fair value of foreign currency forward contracts is based on the difference between the contracted exchange rate and current market foreign currency exchange rates adjusted for forward points, which are differences in prevailing deposit interest rates between each currency through the remaining term of the contract.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

10. Property, Plant, and Equipment

Property, plant, and equipment at December 31, 2018 and 2017 consist of the following (in thousands):

	2018	2017
Land and improvements	\$ 438,577	\$ 406,463
Buildings	6,021,391	5,657,283
Leasehold improvements	30,237	30,832
Equipment	1,732,114	1,671,465
Computer hardware and software	1,074,167	855,524
Construction-in-progress	617,055	754,564
Leased facilities and equipment	194,421	158,785
	10,107,962	9,534,916
Accumulated depreciation and amortization	(5,035,498)	(4,835,219)
	\$ 5,072,464	\$ 4,699,697

Included in the preceding table is unamortized computer software of \$212.6 million and \$193.2 million at December 31, 2018 and 2017, respectively. Amortization of computer software totaled \$46.3 million and \$47.9 million in 2018 and 2017, respectively. Amortization of computer software for the five years subsequent to December 31, 2018, is as follows (in millions): 2019 – \$40.6; 2020 – \$31.6; 2021 – \$26.4; 2022 – \$23.2; and 2023 – \$23.0.

Accumulated amortization of leased facilities and equipment was \$79.1 million and \$70.4 million at December 31, 2018 and 2017, respectively.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

11. Pledges Receivable

Outstanding pledges receivable from various corporations, foundations, and individuals at December 31, 2018 and 2017, are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Pledges due:		
In less than one year	\$ 85,918	\$ 61,439
In one to five years	116,240	115,638
In more than five years	<u>79,200</u>	<u>81,429</u>
	281,358	258,506
Allowance for uncollectible pledges and discounting	(62,236)	(61,830)
Current portion (net of allowance for uncollectible		
pledges of \$19.2 million in 2018 and \$15.6 million		
in 2017)	<u>(66,674)</u>	<u>(45,657)</u>
	\$ 152,448	\$ 151,019

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

12. Long-Term Debt

Long-term debt at December 31, 2018 and 2017 consists of the following (in thousands):

	Interest Rate(s)	Final Maturity	Amount Outstanding at December 31	
			2018	2017
Series 2018 Sterling Notes	2.90% to 3.08%	2068	\$ 509,476	\$ —
Series 2017A Bonds	0.83% to 3.48%	2043	818,775	818,775
Series 2017B Bonds	1.56% to 3.70%	2043	169,255	169,255
Series 2017C Bonds	2.24%	2032	8,945	9,305
Series 2016, Private Placement	3.35%	2046	325,000	325,000
Series 2016, Term Loan	Variable rate	2026	15,170	16,270
Series 2014 Bonds	4.86%	2114	400,000	400,000
Series 2014A CP Notes	Variable rate	2044	70,955	70,955
Series 2013A Bonds	3.62% to 4.04%	2042	62,650	73,150
Series 2013B Bonds	Variable rate	2039	201,160	201,160
Series 2013, Keep Memory Alive	Variable rate	2037	59,115	61,165
Series 2012A Bonds	1.80% to 4.07%	2039	439,925	451,135
Series 2011A Bonds	3.15% to 4.83%	2032	148,645	160,605
Series 2011B Bonds	2.56%	2031	26,380	27,785
Series 2011C Bonds	3.40% to 4.72%	2032	157,945	157,945
Series 2009B Bonds	4.21%	2039	16,135	31,640
Series 2008A Bonds	4.39%	2043	—	7,930
Series 2008B Bonds	Variable rate	2043	327,575	327,575
Series 2003C Bonds	Variable rate	2035	41,905	41,905
Revolving credit facility	Variable rate	2019	105,000	60,000
Notes payable	Varies	Varies	106	376,521
Capital leases	Varies	Varies	121,589	93,986
City of Lakewood lease	6.00%	2018	—	513
			4,025,706	3,882,575
Net unamortized premium			160,044	167,451
Unamortized debt issuance costs			(27,713)	(22,665)
Current portion			(191,350)	(457,813)
Long-term variable rate debt classified as current			(407,776)	(573,270)
			\$ 3,558,911	\$ 2,996,278

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

12. Long-Term Debt (continued)

The majority of the System's outstanding bonds are limited obligations of various issuing authorities payable solely by the System pursuant to loan agreements between the borrowing entities and the issuing authorities. The Series 2018 Sterling Notes, Series 2016 private placement, Series 2016 term loan, Series 2014 bonds and Series 2013 Keep Memory Alive bonds are issued directly by the Clinic or its subsidiaries. Under various financing agreements, the System must meet certain operating and financial performance covenants.

In August 2018, the System through a UK subsidiary entered into a private placement agreement to issue Guaranteed Senior Notes (Series 2018 Sterling Notes) totaling £665 million. The subsidiary received proceeds of £300 million and £100 million in August 2018 and November 2018, respectively, and will receive additional proceeds of £265 million in August 2019. The 2018 Sterling Notes are guaranteed by the Cleveland Clinic obligated group and another UK subsidiary, mature at various dates through 2068 and bear interest at an average fixed rate of 2.99%. The proceeds of the 2018 Sterling Notes repaid a \$375.0 million term loan used to acquire a long-term leasehold interest in a building in London, England and have been or will be used to partially fund the construction and conversion of the building into a healthcare facility.

In August 2017, pursuant to certain agreements between the System and the State of Ohio (State) acting by and through the Ohio Higher Education Facility Commission, the State issued \$818.8 million of fixed-rate Hospital Refunding Revenue Bonds (Series 2017A Bonds) and \$169.3 million of fixed-rate Taxable Hospital Refunding Revenue Bonds (Series 2017B Bonds) for the benefit of the System. Proceeds from the sale of the Series 2017A Bonds and Series 2017B Bonds were used to refund all or a portion of the outstanding Series 2008A, 2008B, 2009A, 2009B and 2012A Bonds and to pay the cost of issuance. The System recorded a loss on extinguishment of debt of \$46.2 million related to this transaction, which is recorded in other nonoperating gains and losses in the consolidated statements of operations and changes in net assets.

In December 2017, pursuant to certain agreements between the System and the State of Ohio (State) acting by and through the Ohio Higher Education Facility Commission, the State issued \$9.3 million of Hospital Refunding Revenue Bonds (Series 2017C Bonds) for the benefit of the System. Proceeds from the sale of the Series 2017C Bonds were used to refund all of the outstanding Series 2002 Bonds. The Series 2017C Bonds were purchased by a financial institution and are scheduled to be tendered to the System on December 1, 2027. During this term, the bonds bear interest at 2.24% plus an applicable credit spread. The tender date may be extended subject to the consent of the financial institution.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

12. Long-Term Debt (continued)

The System maintains the Cleveland Clinic Health System Obligated Group Commercial Paper Program (CP Program), which provides for the issuance of the Series 2014A CP Notes. The CP Program was established in November 2014 and will terminate no later than January 2044. The Series 2014A CP Notes may be issued from time to time in a maximum outstanding face amount of \$100 million and are supported by the System's self-liquidity program. The System has \$71.0 million of outstanding Series 2014A CP Notes at both December 31, 2018 and 2017.

Certain of the System's current outstanding bonds bear interest at a variable rate. During 2018 and 2017, the rates for the System's variable rate long-term debt series ranged from 0.49% to 3.14% (average rate 1.56%) and 0.47% to 2.18% (average rate 0.91%), respectively.

Certain variable rate bonds are secured by irrevocable direct pay letters of credit and standby bond purchase agreements totaling \$352.2 million at December 31, 2018. Long-term variable rate debt is classified as current in the consolidated balance sheets if it is supported by lines of credit or standby bond purchase agreements that expire within one year, require repayment of a remarketing draw within one year or contain a subjective clause that, if declared by the lender, could cause immediate repayment of the bonds.

The System provides self-liquidity on the Series 2003C Bonds, certain sub-series of the Series 2008B Bonds and the Series 2014A CP Notes. These bonds are classified as current liabilities in the consolidated balance sheets.

During the term of agreements with the issuing authorities, the System is required to make specified deposits with trustees to fund principal and interest payments when due. Also, unexpended bond proceeds are held by the trustee and released to the System for approved requisition requests for capital projects. There were no unexpended bond proceeds at December 31, 2018 and 2017. The current portion of the funds held by trustees, which consists of deposits with the trustees to fund current principal and interest payments, was \$103.9 million at December 31, 2017 and is included in investments for current use. There was no current portion of funds held by trustees at December 31, 2018.

The System is subject to certain restrictive covenants, including provisions relating to certain debt ratios, days cash on hand, and other matters. The System was in compliance with these covenants at December 31, 2018 and 2017.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

12. Long-Term Debt (continued)

The System executed a \$375.0 million term loan agreement with a financial institution in 2015. The proceeds of the term loan were used to finance the System's international business strategy. The term loan was paid in 2018 using proceeds from the issuance of the 2018 Sterling Notes. The interest rate on the term loan was a variable rate based on the London Interbank Offered Rate (LIBOR) plus an applicable spread and ranged from 1.85% to 2.69% in 2018 (average rate 2.37%) and from 01.11% to 1.85% in 2017 (average rate 1.59%).

The System has a \$300 million revolving credit facility with multiple financial institutions. The revolving credit facility expires in 2019 with provisions allowing the System to extend the term for one-year periods. The facility allows the System to enter into short-term loans that automatically renew throughout the term of the facility. The revolving credit facility bears interest at a variable rate based on the London Interbank Offered Rate (LIBOR) plus an applicable spread. Amounts outstanding on the revolving credit facility as of December 31, 2018 and 2017 totaled \$105.0 million and \$60.0 million, respectively. The interest rate on the revolving credit facility ranged from 2.09% to 3.10% in 2018 (average rate 2.58%) and from 1.52% to 2.09% in 2017 (average rate 1.70%).

Combined current aggregate scheduled maturities of long-term debt, excluding capital leases and assuming the remarketing of the variable rate demand bonds, for the five years subsequent to December 31, 2018, are as follows (in thousands): 2019 – \$169,141; 2020 – \$66,020; 2021 – \$68,870; 2022 – \$71,825; and 2023 – \$75,130.

The System has various capital leases for facilities and equipment. Future minimum capital lease payments, including total interest of \$24.5 million, are as follows (in thousands): 2019 – \$27,363; 2020 – \$23,280; 2021 – \$19,227; 2022 – \$14,488; and 2023 – \$11,569; and thereafter – \$50,114. Assets acquired through capital lease arrangements are included in property, plant, and equipment.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

12. Long-Term Debt (continued)

The City of Lakewood, Ohio (the City) leased real and personal property to Lakewood Hospital Association (LHA) for the purpose of enabling the operation of certain healthcare services at Lakewood Hospital. In connection with executing an Amended Lease with the City, LHA had agreed to make additional payments to the City. In 2015, under the terms of an agreement between the Clinic, LHA and the City, the Amended Lease was further amended to shorten the lease term and to reduce the total payments due under the lease. The payments under the amended lease ranged in annual amounts up to \$1.2 million through 2018, or until certain provisions in the lease were satisfied. The lease terminated in 2018, and the property was returned to the City. The net present value of the additional payments discounted at an interest rate of 6% was \$0.5 million at December 31, 2017.

Total interest paid approximated \$128.5 million and \$153.4 million in 2018 and 2017, respectively. Capitalized interest cost approximated \$0.4 million and \$0.6 million in 2018 and 2017, respectively.

13. Derivative Instruments

The System has entered into various derivative financial instruments to manage interest rate risk and foreign currency exposures.

The System's objective with respect to interest rate risk is to manage the risk of rising interest rates on the System's variable rate debt and certain variable rate operating lease payments. Consistent with its interest rate risk management objective, the System entered into various interest rate swap agreements with a total outstanding notional amount of \$618.2 million and \$615.0 million at December 31, 2018 and 2017, respectively. During the term of these transactions, the System pays interest at a fixed rate and receives interest at a variable rate based on the London Interbank Offered Rate (LIBOR) or the Securities Industry and Financial Markets Association Index (SIFMA). The swap agreements are not designated as hedging instruments. Net interest paid or received under the swap agreements is included in derivative losses in the consolidated statements of operations and changes in net assets.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

13. Derivative Instruments (continued)

The following table summarizes the System's interest rate swap agreements (in thousands):

Swap Type	Expiration Date	System Pays	System Receives	Notional Amount at December 31	
				2018	2017
Fixed	2021	3.21%	68% of LIBOR	\$ 30,145	\$ 31,725
Fixed	2024	3.42%	68% of LIBOR	26,500	27,200
Fixed	2027	3.56%	68% of LIBOR	120,113	124,303
Fixed	2028	5.12%	100% of LIBOR	36,605	37,730
Fixed	2028	3.51%	68% of LIBOR	28,285	29,125
Fixed	2030	5.07%	100% of LIBOR	57,250	59,075
Fixed	2030	5.06%	100% of LIBOR	57,225	59,050
Fixed	2031	3.04%	68% of LIBOR	46,975	49,850
Fixed	2032	4.32%	79% of LIBOR	2,189	2,279
Fixed	2032	4.33%	70% of LIBOR	4,377	4,557
Fixed	2032	3.78%	70% of LIBOR	2,189	2,279
Fixed	2036	4.90%	100% of LIBOR	49,125	49,700
Fixed	2036	4.90%	100% of LIBOR	76,950	76,950
Fixed	2037	4.62%	100% of SIFMA	59,115	61,165
Fixed	2039	4.62%	68% of LIBOR	21,170	—
				\$ 618,213	\$ 614,988

The System is exposed to fluctuations in various foreign currencies against its functional currency, the U.S. dollar (USD). The System uses foreign currency forward contracts to manage its exposure to fluctuations in the USD – British Pound (GBP) exchange rate. Currency forward contracts involve fixing the USD – GBP exchange rate for delivery of a specified amount of foreign currency on a specified date. The currency forward contracts are typically cash settled in USD for their fair value at or close to their settlement date.

In November 2018, the System entered into three foreign currency forward contracts, expiring between May 2020 and April 2021, with a total outstanding notional amount of \$336.2 million at December 31, 2018. The System had no outstanding foreign currency forward contracts at December 31, 2017. The foreign currency forward contracts are not designated as hedging instruments.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

13. Derivative Instruments (continued)

The following table summarizes the location and fair value for the System's derivative instruments (in thousands):

	Derivatives Liability			
	December 31, 2018		December 31, 2017	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments				
Interest rate swap agreements	Other noncurrent liabilities	\$ 101,444	Other noncurrent liabilities	\$ 123,989
Foreign currency contracts	Other noncurrent liabilities	\$ 9,419		\$ –

The following table summarizes the location and amounts of derivative losses on the System's interest rate swap agreements (in thousands):

	Location of Loss Recognized	Year Ended December 31	
		2018	2017
Derivatives not designated as hedging instruments			
Interest rate swap agreements	Derivative gains (losses)	\$ 9,233	\$ (5,309)
Foreign currency contracts	Derivative (losses) gains	\$ (9,419)	\$ 3,004

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

13. Derivative Instruments (continued)

The System has used various derivative contracts in connection with certain prior obligations and investments. Although minimum credit ratings are required for counterparties, this does not eliminate the risk that a counterparty may fail to honor its obligations. Derivative contracts are subject to periodic “mark-to-market” valuations. A derivative contract may, at any time, have a positive or negative value to the System. In the event that the negative value reaches certain thresholds established in the derivative contracts, the System is required to post collateral, which could adversely affect its liquidity. At December 31, 2018 and 2017, the System posted \$49.0 million and \$69.2 million, respectively, of collateral with counterparties that is included in funds held by trustees in the consolidated balance sheets. In addition, if the System were to choose to terminate a derivative contract or if a derivative contract were terminated pursuant to an event of default or a termination event as described in the derivative contract, the System could be required to pay a termination payment to the counterparty.

14. Professional and General Liability Insurance

The System manages its professional and general liability insurance program through a captive insurance arrangement.

In the ordinary course of business, professional and general liability claims have been asserted against the System by various claimants. These claims are in various stages of processing or, in certain instances, are in litigation. In addition, there are known incidents, and there also may be unknown incidents, which may result in the assertion of additional claims. The System has accrued its best estimate of both asserted and unasserted claims based on actuarially determined amounts. These estimates are subject to the effects of trends in loss severity and frequency, and ultimate settlement of professional and general liability claims may vary significantly from the estimated amounts.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

14. Professional and General Liability Insurance (continued)

The System's professional and general liability insurance reserves of \$195.0 million and \$198.4 million at December 31, 2018 and 2017, respectively, are recorded as current and noncurrent liabilities and include discounted estimates of the ultimate costs for both asserted claims and unasserted claims. Asserted claims for the System's reserves were discounted at 3.25% and 2.25% at December 31, 2018 and 2017, respectively. Unasserted claims were discounted at 3.50% and 2.50% at December 31, 2018 and 2017, respectively. Through the captive insurance subsidiary, the System has set aside investments of \$160.8 million (\$53.8 million included in investments for current use) and \$210.9 million (\$51.1 million included in investments for current use) at December 31, 2018 and 2017, respectively, of which \$38.2 million and \$37.6 million at December 31, 2018 and 2017, respectively, are restricted in accordance with reinsurance trust agreements related to coverage of the Florida operations and other reinsurance programs provided by the captive insurance subsidiary.

Activity in the professional and general liability insurance reserves is summarized as follows (in thousands):

	2018	2017
Balance at beginning of year	\$ 198,378	\$ 198,234
Incurred related to:		
Current period	62,320	65,901
Prior period	(4,095)	(14,288)
Total incurred	58,225	51,613
Paid related to:		
Current period	6,481	5,219
Prior period	54,747	44,828
Total paid	61,228	50,047
Total incurred less total paid	(3,003)	1,566
Decrease in unasserted claims	(320)	(1,414)
Decrease in reinsurance recoverable	(32)	(8)
Balance at end of year	\$ 195,023	\$ 198,378

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

14. Professional and General Liability Insurance (continued)

The foregoing reconciliation shows \$4.1 million and \$14.3 million of favorable development in 2018 and 2017, respectively, due to changes in actuarial estimates as a result of lower claim activity, closed claims, and expedited settlement of claims, which has reduced claim expenses and resulted in more favorable settlements. The System utilizes a combination of actual and industry statistics to estimate loss and loss adjustment expense reserves.

15. Pensions and Other Postretirement Benefits

The System maintains four defined benefit pension plans, including two plans related to Akron General. The CCHS Retirement Plan is a tax-qualified defined benefit pension plan that provides benefits to substantially all employees of the System, except those employed by Akron General or Union Hospital. All benefit accruals under the CCHS Retirement Plan ceased as of December 31, 2012. Akron General has a tax-qualified defined benefit plan covering substantially all of its employees that were hired before 2004 who meet certain eligibility requirements. All benefit accruals under the Akron General defined benefit plan ceased as of December 31, 2017. The benefits for the System's tax-qualified defined benefit pension plans are provided based on age, years of service, and compensation. The System's policy for its tax-qualified defined benefit pension plans is to fund at least the minimum amounts required by the Employee Retirement Income Security Act. The System also maintains two unfunded, nonqualified defined benefit supplemental retirement plans, which cover certain professional staff and administrative employees.

The System sponsors two noncontributory, defined contribution plans, and three contributory, defined contribution plans covering System and Akron General employees. The System also assumed three additional contributory, defined contribution plans from the Union Hospital member substitution. The Cleveland Clinic Investment Pension Plan (IPP) is a noncontributory, defined contribution plan, which covers substantially all of the System's employees, except employees covered by the Cleveland Clinic Cash Balance Plan and those employed by Akron General or Union Hospital. The System's contribution to the IPP for participants is based upon a percentage of employee compensation that is based on years of service. The Cleveland Clinic Cash Balance Plan (CBP) is a noncontributory, defined contribution plan that covers certain professional and administrative employees not covered by the IPP. The System's contribution to the CBP is a percentage of employee compensation that is determined according to age. The System sponsors six tax-qualified contributory, defined contribution plans, which cover substantially all employees. The plans permit employees to make pretax employee deferrals and to become entitled to certain employer matching contributions that are based on employee contributions.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

The System provides healthcare benefits upon retirement for substantially all of its employees who meet certain minimum age and years of service provisions at retirement. The System's healthcare plans generally provide for cost-sharing, in the form of retiree contributions, deductibles, and coinsurance. The System's policy is to fund the annual cost of healthcare benefits from the general assets of the System. The estimated cost of these postretirement benefits is actuarially determined and accrued over the employees' service periods.

The mortality tables used to calculate the defined benefit obligation for the System's defined benefit and postretirement health benefit plans are based on the RP-2014 "Employees" table unadjusted, with generational projection for non-annuitants and the RP-2014 "Healthy Annuitants" table unadjusted, with generational projection for annuitants. In 2017, the System updated the generational mortality projections scale from Scale MP-2016 to Scale MP-2017. In 2018, the System updated the generational mortality projections scale from Scale MP-2017 to Scale MP-2018. The System believes that the updated mortality rates are the best estimate of future experience.

The System expects to make contributions of \$9.5 million to the defined benefit pension plans in 2019. Pension benefit payments over the next ten years are estimated as follows: 2019 – \$114.4 million; 2020 – \$115.6 million; 2021 – \$119.2 million; 2022 – \$116.7 million; 2023 – \$117.1 million; and in the aggregate for the five years thereafter – \$548.3 million.

The System expects to make contributions of \$3.8 million to other postretirement benefit plans in 2019. Other postretirement benefit payments over the next ten years, net of the average annual Medicare Part D subsidy of approximately \$0.9 million, are estimated as follows: 2019 – \$3.8 million; 2020 – \$3.8 million; 2021 – \$3.6 million; 2022 – \$3.3 million; 2023 – \$3.0 million; and in the aggregate for the five years thereafter – \$10.8 million.

No plan assets are expected to be returned to the employer during 2019.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

The System is required to recognize the funded status, which is the difference between the fair value of plan assets and the projected benefit obligations, of its pension and other postretirement benefit plans in the consolidated balance sheets, with a corresponding adjustment to net assets without donor restrictions. Amounts recorded in net assets without donor restrictions consist of actuarial gains and losses and prior service credits and costs. Actuarial gains and losses recorded in net assets outside of the corridor, which is 10% of the greater of the projected benefit obligation or the fair value of the plan assets, will be recognized as a component of net periodic benefit cost immediately in the current period. Prior service credits and costs will be amortized over future periods, pursuant to the System's accounting policy.

Unrecognized prior service credits and costs are amortized on a straight-line basis over the estimated life of the plan participants. In 2019, the System is expected to amortize \$2.9 million of unrecognized prior service credits in net periodic benefit costs.

Included in net assets without donor restrictions at December 31, 2018 and 2017 are the following amounts that have not yet been recognized in net periodic benefit cost (in thousands):

	Defined Benefit Pension Plans		Other Postretirement Benefits	
	2018	2017	2018	2017
Unrecognized actuarial losses (gains)	\$ 144,463	\$ 173,279	\$ (8,189)	\$ (9,553)
Unrecognized prior service credit	(13,711)	(15,621)	(7,041)	(7,994)
Total	\$ 130,752	\$ 157,658	\$ (15,230)	\$ (17,547)

Unrecognized actuarial losses (gains) included in net assets without donor restrictions represent amounts within the corridor that do not require recognition in net periodic benefit cost for each respective year.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

Changes in plan assets and benefit obligations recognized in net assets without donor restrictions for the years ended December 31, 2018 and 2017 are as follows (in thousands):

	Defined Benefit Pension Plans		Other Postretirement Benefits	
	2018	2017	2018	2017
Current year actuarial (loss) gain	\$ (5,114)	\$ (45,990)	\$ 13,870	\$ 5,674
Recognition of actuarial loss (gain) in excess of corridor	33,930	41,048	(15,234)	(6,011)
Current year prior service credit	–	4,538	–	–
Amortization of prior service credit	(1,910)	(1,680)	(953)	(952)
Total	\$ 26,906	\$ (2,084)	\$ (2,317)	\$ (1,289)

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

The following table sets forth the funded status of the System's pensions and other postretirement benefit plans and the amounts recognized in the System's December 31, 2018 and 2017 consolidated balance sheets (in thousands):

	Defined Benefit Pension Plans		Other Postretirement Benefits	
	2018	2017	2018	2017
Change in projected benefit obligation:				
Projected benefit obligation at beginning of year	\$ 1,785,443	\$ 1,736,681	\$ 95,533	\$ 98,900
Service (credit) cost	(1,513)	196	1,068	1,313
Interest cost	64,712	71,493	3,622	4,273
Actuarial (gain) loss	(104,647)	89,403	(13,870)	(5,674)
Participant contributions	-	-	15,254	13,437
Plan amendments	-	(4,538)	-	-
Curtailment	-	(62)	-	-
Settlement payments	(68,676)	(68,248)	-	-
Benefits paid	(44,736)	(39,482)	(20,478)	(17,606)
Federal subsidy	-	-	760	890
Projected benefit obligation at end of year	1,630,583	1,785,443	81,889	95,533
Change in plan assets:				
Fair value of plan assets at beginning of year	1,375,159	1,342,970	-	-
Actual return on plan assets	(34,975)	128,022	-	-
Participant contributions	-	-	15,254	13,437
System contributions	7,647	11,897	5,224	4,169
Benefits paid	(113,412)	(107,730)	(20,478)	(17,606)
Fair value of plan assets at end of year	1,234,419	1,375,159	-	-
Accrued retirement benefits	\$ (396,164)	\$ (410,284)	\$ (81,889)	\$ (95,533)
Current liabilities	\$ (8,680)	\$ (8,882)	\$ (3,846)	\$ (4,102)
Noncurrent liabilities	(387,484)	(401,402)	(78,043)	(91,431)
Net liability recognized in consolidated balance sheets	\$ (396,164)	\$ (410,284)	\$ (81,889)	\$ (95,533)

The accumulated benefit obligation for all defined benefit pension plans was \$1.6 billion and \$1.8 billion at December 31, 2018 and 2017, respectively.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

The CCHS Retirement Plan paid \$68.7 million and \$68.2 million in lump-sum payments in accordance with plan terms in 2018 and 2017, respectively, which exceeded the sum of the service cost and interest cost components of net periodic benefit cost for each year. As a result, the System recorded a settlement charge of \$8.0 million and \$7.6 million for the years ended December 31, 2018 and 2017, respectively.

In 2017, the System amended the Akron General primary defined benefit pension plan to offer a lump sum option to all non-bargained active and terminated vested participants, effective January 1, 2018. As a result of this amendment, the projected benefit obligation decreased \$4.5 million in 2017.

The components of net periodic benefit cost (credit) are as follows (in thousands):

	Defined Benefit Pension Plans		Other Postretirement Benefits	
	2018	2017	2018	2017
Components of net periodic benefit cost:				
Service (credit) cost	\$ (1,513)	\$ 196	\$ 1,068	\$ 1,313
Interest cost	64,712	71,493	3,622	4,273
Expected return on plan assets	(74,786)	(84,670)	-	-
Recognition of actuarial loss (gain) in excess of corridor	25,901	33,471	(15,234)	(6,011)
Settlement charge	8,029	7,577	-	-
Amortization of unrecognized prior service credit	(1,910)	(1,680)	(953)	(952)
Net periodic benefit cost (credit)	20,433	26,387	(11,497)	(1,377)
Defined contribution plans	238,129	224,769	-	-
Total	\$ 258,562	\$ 251,156	\$ (11,497)	\$ (1,377)

The service (credit) cost component of net periodic benefit cost (credit) is included in salaries, wages, and benefits in the consolidated statements of operations and changes in net assets. The components of net periodic benefit cost (credit) other than the service (credit) cost component are included in other nonoperating gains and losses in the consolidated statements of operations and changes in net assets.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

Weighted-average assumptions used to determine pension and postretirement benefit obligations and net periodic benefit cost are as follows:

	Defined Benefit Pension Plans		Other Postretirement Benefits	
	2018	2017	2018	2017
Weighted-average assumptions:				
Discount rates:				
Used for benefit obligations	4.37%	3.74%	4.38%	3.83%
Used for net periodic benefit cost	3.74%	4.24%	3.83%	4.36%
Expected rate of return on plan assets	5.65%	6.53%	–	–
Rate of compensation increase:				
Used for benefit obligations	2.25%	2.25%	–	–
Used for net periodic benefit cost	2.25%	2.25%	–	–

The System uses a direct cost approach to estimate its postretirement benefit obligation for healthcare services provided by the System (internally provided services). Healthcare services provided by non-System entities (externally provided services) are based on the System's historical cost experience.

The annual assumed healthcare cost trend rates for the next year and the assumed trend thereafter is as follows:

	2018	2017
Internally provided services:		
Initial rate	5.75%	6.00%
Ultimate rate	4.50%	4.50%
Year ultimate reached	2024	2024
Externally provided services:		
Initial rate	6.75%	7.00%
Ultimate rate	5.50%	5.50%
Year ultimate reached	2024	2024

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

A one-percentage-point increase or decrease in the healthcare cost trend rate would have increased or decreased service and interest costs in 2018 by \$2.1 million and \$1.4 million, respectively, and service and interest costs in 2017 by \$2.4 million and \$1.4 million, respectively.

The System's weighted-average asset allocation of pension plan assets at December 31, 2018 and 2017, by asset category, are as follows:

Asset category	Percentage of Plan Assets		
	2018	2017	Target Allocation
Interest-bearing cash	4.1%	6.4%	1%–6%
Fixed income securities	49.7	45.8	41%–65%
Common and preferred stocks	27.6	31.1	16%–36%
Alternative investments	18.6	16.7	7%–28%
Total	100.0%	100.0%	

The System's investment strategy for its pension assets balances the liquidity needs of the pension plans with the long-term return goals necessary to satisfy future pension obligations. The target allocation ranges of the investment pool to various asset classes are designed to diversify the portfolio in a way that achieves an efficient trade-off between long-term return and risk while providing adequate liquidity to meet near-term expenses and obligations.

The System's weighted-average pension portfolio return assumption of 5.65% and 6.53% in 2018 and 2017, respectively, is based on the targeted assumed rate of return through its asset mix at the beginning of each year, which is designed to mitigate short-term return volatility and achieve an efficient trade-off between return and risk. Expected returns and risk for each asset class are formed using a global capital asset pricing model framework in which the expected return is the compensation earned from taking risk. Forward-looking adjustments are made to expected return, volatility, and correlation estimates as well. Additionally, constraints such as permissible asset classes, portfolio guidelines, and liquidity considerations are included in the model.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

The System implemented an investment strategy for the CCHS Retirement Plan over the last few years based on the current funded status of the plan that has reduced the asset allocation for common and preferred stocks with a corresponding increase in fixed income securities. The updated investment strategy was implemented because of the funded status of the pension plan and the anticipation that such changes in investment strategy will result in lower volatility of future changes in funded status. Additional revisions in asset allocations and expected rate of return on plan assets may occur based on future changes in the funded status of the pension plans. Once the new investment strategy is fully implemented, it is anticipated that the duration of the investment assets will match the liabilities of the pension plan over time.

The following tables present the financial instruments in the System's defined benefit pension plans measured at fair value on a recurring basis as of December 31, 2018 and 2017, based on the valuation hierarchy (in thousands):

December 31, 2018	Level 1	Level 2	Level 3	Total
Assets				
Cash and investments:				
Cash and cash equivalents	\$ 49,767	\$ 367	\$ —	\$ 50,134
Fixed income securities:				
U.S. treasuries	297,780	—	—	297,780
U.S. government agencies	—	—	—	—
U.S. corporate	—	144,345	—	144,345
Foreign	—	17,437	—	17,437
Fixed income mutual funds	—	—	—	—
Common and preferred stocks:				
U.S.	60,750	—	—	60,750
Foreign	14,924	1,174	—	16,098
Equity mutual funds	19,927	—	—	19,927
Total assets at fair value	\$ 443,148	\$ 163,323	\$ —	\$ 606,471

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

December 31, 2017	Level 1	Level 2	Level 3	Total
Assets				
Cash and investments:				
Cash and cash equivalents	\$ 87,571	\$ 5	\$ –	\$ 87,576
Fixed income securities:				
U.S. treasuries	360,138	–	–	360,138
U.S. government agencies	–	5,045	–	5,045
U.S. corporate	–	62,672	–	62,672
Foreign	–	7,513	–	7,513
Fixed income mutual funds	73,016	–	–	73,016
Common and preferred stocks:				
U.S.	69,804	–	–	69,804
Foreign	20,342	654	–	20,996
Equity mutual funds	92,189	–	–	92,189
Total assets at fair value	<u>\$ 703,060</u>	<u>\$ 75,889</u>	<u>\$ –</u>	<u>\$ 778,949</u>

Total plan assets in the System's defined benefit pension plans at December 31, 2018 and 2017 are comprised of the following (in thousands):

	2018	2017
Plan assets measured at fair value	\$ 606,471	\$ 778,949
Commingled funds measured at net asset value	398,884	367,089
Alternative investments measured at net asset value	229,064	196,121
Pending purchases of alternative investments	–	33,000
Total fair value of plan assets at end of year	<u>\$ 1,234,419</u>	<u>\$ 1,375,159</u>

Fair value methodologies for Level 1 and Level 2 are consistent with the inputs described in Note 9.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

15. Pensions and Other Postretirement Benefits (continued)

Fixed income securities include debt obligations of the U.S. government and various agencies, U.S. corporations, and other fixed income instruments such as mortgage-backed and asset-backed securities. The composition of these securities represents an expected return and risk profile that is commensurate with broadly defined fixed income indexes such as the Barclays Capital U.S. Aggregate Index. Additionally, investments include mutual funds and commingled fixed-income funds that may also invest in opportunistic as well as non-U.S. and high-yield debt instruments. Commingled fixed-income funds are valued using net asset value as a practical expedient.

Common and preferred stocks include investments of publicly traded common stocks of both U.S. and international corporations, the majority of which represent actively traded and liquid securities that are traded on many of the world's major exchanges and include large-, mid-, and small-capitalization securities. The composition of these securities represents an expected return and risk profile that is commensurate with broadly defined equity indexes such as the Russell 3000 Index and the Morgan Stanley Capital International (MSCI) All Country World ex-U.S. Index. Investments also include equity mutual funds and commingled equity funds whose underlying assets may include publicly traded equity securities. Commingled equity funds are valued using net asset value as a practical expedient.

Alternative investments include hedge funds and private equity funds that are valued using net asset value as a practical expedient. Hedge funds are meant to provide returns between those expected from stocks and fixed income investments with commensurate levels of risk and lower correlation relative to traditional investments. Included in this category are investments that are well diversified across various strategies and may consist of absolute return funds, long/short funds, and other opportunistic/multi-strategy funds. The underlying investments in such funds may include publicly traded and privately held equity and debt instruments issued by U.S. and international corporations as well as various derivatives based on these securities. Hedge fund redemptions typically contain restrictions that allow for a portion of the withdrawal proceeds to be held back from distribution while the underlying investments are liquidated. Private equity investments make up a smaller portion of the alternative investments and generally consist of limited partnerships formed to invest in equity and debt investments in operating companies that are not publicly traded. Investment strategies in this category may include buyouts, distressed debt, and venture capital. Private equity funds are closed-end funds and have significant redemption restrictions that prohibit redemptions during the fund's life.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

16. Income Taxes

The Clinic and most of its controlled affiliates are tax-exempt organizations as described in Section 501(c)(3) of the Internal Revenue Code. These organizations are subject to income tax on any income from unrelated business activities. The System also owns or controls certain domestic and international taxable affiliates.

The System files income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. With few exceptions, the System is no longer subject to U.S. federal, state, and local or non-U.S. income tax examinations by tax authorities for years before 2015.

At December 31, 2018 and 2017, the liability for uncertainty in income taxes was \$0.9 million and \$0.6 million, respectively. The System does not expect a significant increase or decrease in unrecognized tax benefits within the next 12 months. The System recognizes interest and penalties accrued related to the liability for unrecognized tax benefits in the consolidated statements of operations and changes in net assets.

The System has gross deferred tax assets of \$201.9 million and \$210.7 million at December 31, 2018 and 2017, respectively. The gross deferred tax assets primarily relate to net operating losses available for income tax purposes. The majority of these losses expire in varying amounts from 2019 through 2037. A deferred tax asset of \$40.9 million and \$45.2 million has been recorded at December 31, 2018 and 2017, respectively. A valuation allowance of \$40.9 million and \$45.1 million has been recorded at December 31, 2018 and 2017, respectively, against the deferred tax assets due to the uncertainty regarding their use.

The Tax Cuts and Jobs Act (Act) was enacted on December 22, 2017. The Act reduces the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that was previously tax deferred and creates new taxes on certain foreign sourced earnings. For tax-exempt entities, the Act also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on remuneration above certain thresholds that is paid to executives by the organization, and report income or loss from unrelated business activities on an activity-by-activity basis, among other provisions. The System has adopted the relevant provisions of the Act. At December 31, 2017, the System recorded a tax benefit of \$6.2 million for the remeasurement of the deferred tax balances at the new tax rate. The System will continue to revise and refine calculations as additional IRS guidance is issued.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

17. Commitments and Contingent Liabilities

The System leases various equipment and facilities under operating lease arrangements. Total rental expense in 2018 and 2017 was \$71.2 million and \$66.2 million, respectively. Minimum operating lease payments over the next five years are as follows (in thousands): 2019 – \$46,394; 2020 – \$41,711; 2021 – \$37,958; 2022 – \$34,318; and 2023 – \$30,502.

Included in the System's operating lease payments are the following off-balance-sheet financing agreements:

In 2003, the System entered into an operating lease agreement for the purpose of leasing a genetics and stem cell research building (Stem Cell Building Lease). Under the terms of the Stem Cell Building Lease, the System began to lease the facility upon the issuance of the certificate of occupancy in December 2004 and is required to lease the facility for 29 years. At December 31, 2018, total remaining minimum operating lease payments were \$26.5 million.

In 2006, the System entered into an operating lease agreement for the purpose of leasing a parking garage and service center building (Service Center Lease). Under the terms of the Service Center Lease, the System began to lease the facility upon issuance of a certificate of occupancy in October 2008 and is required to lease the facility for 21 years with an option (by the System) to extend the lease an additional five years. At December 31, 2018, total remaining minimum operating lease payments were \$67.0 million.

In 2007, the System entered into two operating lease agreements to lease an office complex comprised of five buildings primarily used for administrative services, totaling approximately 707,000 square feet. The System is required to lease the facilities for 22 years with an option (by the System) to extend the leases an additional five years. At December 31, 2018, total remaining minimum operating lease payments were \$35.4 million.

At December 31, 2018, the System has commitments for construction and other related capital contracts of \$366 million and letters of credit of \$0.6 million. Guarantees of mortgage loans made by banks to certain staff members are \$20.5 million at December 31, 2018. In addition, the System has remaining commitments to invest approximately \$841 million in alternative investments at December 31, 2018. The largest commitment at December 31, 2018, to any one alternative strategy manager is \$81.0 million. These investments are expected to occur over the next three to five years. No amounts have been recorded in the consolidated balance sheets for these commitments and guarantees.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

17. Commitments and Contingent Liabilities (continued)

Pledge liabilities to various foundations and other entities at December 31, 2018 are as follows (in thousands): 2019 – \$1,255; 2020 – \$5,550; 2021 – \$1,000; 2022 – \$4,600; 2023 – \$500; and thereafter – \$13,200. The unamortized discount on pledge liabilities at December 31, 2018 was \$3.2 million. Pledge liabilities are recorded in other current liabilities and other noncurrent liabilities in the consolidated balance sheets.

18. Endowment

The System's endowment consists of approximately 331 individual donor-restricted funds established for a variety of purposes. Endowment funds are classified and reported based on donor-imposed restrictions as net assets with donor restrictions.

Interpretation of Relevant Law

In 2009, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) was enacted to update and replace Ohio's previous law, the Uniform Management of Institutional Funds Act. The System has interpreted UPMIFA as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds, absent explicit donor stipulations to the contrary. As a result of this interpretation, the System classifies as net assets with donor restrictions (1) the original value of gifts donated to the permanent endowment, (2) the original value of subsequent gifts to the permanent endowment, and (3) 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 remaining portion of the donor-restricted endowment fund that is not classified in the permanent endowment is available for appropriation for expenditure by the System in a manner consistent with the standard for expenditure prescribed by UPMIFA. In accordance with UPMIFA, the System considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

1. The duration and preservation of the fund.
2. The purposes of the System 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 System.
7. The investment policies of the System.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

18. Endowment (continued)

Funds With Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the value of the original and subsequent donor gift amounts. As of December 31, 2018, the System had deficiencies of this nature in 18 donor-restricted endowment funds, which together have an original gift value of \$23.2 million, a current fair value of \$22.6 million, and a deficiency of \$0.6 million. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new contributions for donor-restricted endowment funds and continued appropriations for certain programs that were deemed prudent by the System. The System maintains policies that permit spending from underwater endowment funds depending on the degree to which the fund is underwater, unless otherwise precluded by donor intent or relevant laws and regulations.

Return Objectives and Risk Parameters

The System has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the organization must hold in perpetuity. Under this policy, the endowment assets are invested in a highly diversified portfolio of U.S. and non-U.S. publicly traded equities, alternative investments, and fixed income securities structured to achieve an optimal balance between return and risk. The System expects its endowment funds, over time, to provide an average rate of return of approximately 7.5% annually. Actual returns in any given year may vary from this amount.

Strategies Employed for Achieving Objectives

To satisfy its long-term rate-of-return objectives, the System relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The System targets a diversified asset allocation to achieve its long-term return objective within prudent risk constraints.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

18. Endowment (continued)

Spending Policy and How the Investment Objectives Relate to Spending Policy

The System has a policy of appropriating for distribution each year up to 5% of its endowment fund's average fair value over the prior three years through the calendar year-end preceding the fiscal year in which the distribution is planned. In establishing this policy, the System considered the long-term expected return on its endowment. Accordingly, over the long term, the System expects the current spending policy to allow its endowment to grow at an average of 2.5% annually. This is consistent with the System's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

Changes in Endowment Net Assets

The following table summarizes the changes in endowment net assets for the years ended December 31, 2018 and 2017 (in thousands):

	<u>2018</u>	<u>2017</u>
Endowment net assets, beginning of year	\$ 381,810	\$ 324,552
Investment income	2,303	2,251
Net (depreciation) appreciation	(7,885)	38,172
Contributions	17,655	22,160
Appropriation of endowment assets for expenditure	(5,748)	(5,325)
Endowment net assets, end of year	<u>\$ 388,135</u>	<u>\$ 381,810</u>

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

19. Functional Expenses

The System provides healthcare services and education and performs research. The following table presents expenses by both their nature and their function for the years ended December 31, 2018 and 2017 (in thousands):

	2018					
	Healthcare Services	Research	Medical Education	General and Administrative	Non- Healthcare Services	Total
Salaries, wages, and benefits	\$3,809,548	\$ 163,740	\$ 301,073	\$ 561,890	\$ 21,175	\$4,857,426
Supplies	816,522	20,217	7,409	12,048	8,674	864,870
Pharmaceuticals	1,090,116	393	9	463	-	1,090,981
Purchased services and other fees	306,136	5,609	9,060	243,317	(352)	563,770
Administrative services	96,024	43,510	23,741	44,534	14,307	222,116
Facilities	318,726	3,801	2,024	19,778	9,149	353,478
Insurance	68,776	-	340	2,113	355	71,584
Interest	124,309	1,732	-	3,545	9,258	138,844
Depreciation and amortization	364,571	12,119	151	100,374	18,421	495,636
Special charges	2,419	-	-	-	-	2,419
	<u>\$6,997,147</u>	<u>\$251,121</u>	<u>\$ 343,807</u>	<u>\$ 988,062</u>	<u>\$ 80,987</u>	<u>\$8,661,124</u>

	2017					
	Healthcare Services	Research	Medical Education	General and Administrative	Non- Healthcare Services	Total
Salaries, wages, and benefits	\$3,563,863	\$ 151,172	\$ 290,549	\$ 534,382	\$ 25,176	\$4,565,142
Supplies	747,656	18,335	7,726	9,628	10,019	793,364
Pharmaceuticals	956,465	243	-	337	-	957,045
Purchased services and other fees	282,998	4,537	10,367	230,540	4,602	533,044
Administrative services	69,766	37,526	23,233	54,238	14,099	198,862
Facilities	294,204	3,827	2,267	23,801	10,272	334,371
Insurance	58,186	-	295	2,122	457	61,060
Interest	129,844	1,815	-	2,594	6,571	140,824
Depreciation and amortization	355,533	11,334	126	101,757	18,491	487,241
Special charges	5,491	-	-	-	-	5,491
	<u>\$6,464,006</u>	<u>\$ 228,789</u>	<u>\$ 334,563</u>	<u>\$ 959,399</u>	<u>\$ 89,687</u>	<u>\$8,076,444</u>

The consolidated financial statements report certain categories of expenses that are attributable to more than one function. Therefore, these expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include salaries, wages and benefits, which include allocations on the basis of estimates of time and effort.

Cleveland Clinic Health System

Notes to Consolidated Financial Statements (continued)

20. Special Charges

The System incurred and recorded special charges of \$2.4 million and \$5.5 million in 2018 and 2017, respectively. Special charges include accelerated depreciation expense and other costs related to LHA. The Clinic, LHA and the City of Lakewood entered into an agreement in December 2015 that outlines the transition of healthcare services in the City of Lakewood. Under the terms of the agreement, the Clinic constructed an approximately 62,000-square-foot family health center that opened in July 2018 that is located adjacent to the site of the former hospital. In addition, the Clinic and LHA will make contributions over the next 15 years for the creation of a new health and wellness community foundation to be used to address community health and wellness needs in the City of Lakewood.

21. Subsequent Events

The System evaluated events and transactions occurring subsequent to December 31, 2018 through March 14, 2019, the date the consolidated financial statements were issued. During this period, there were no subsequent events requiring recognition in the consolidated financial statements, and there were no nonrecognized subsequent events requiring disclosure, except that on January 1, 2019, the Clinic through a subsidiary became the sole member of Martin Memorial Health Systems, Inc. (Martin) and Indian River Memorial Hospital, Inc. (Indian River) through non-cash business combination transactions. Martin Health System is a regional not-for-profit, community-based healthcare provider located in Southeast Florida comprising three acute-care hospitals with approximately 513 staffed beds, a 150-member employed physician group and a network of outpatient services. Indian River is a not-for-profit medical center with approximately 250 staffed beds that provides healthcare services to Indian River and surrounding counties in Southeast Florida. Effective January 1, 2019, the financial results of Martin and Indian River will be included in the System's consolidated financial statements.

Supplementary Information



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Report of Independent Auditors on Supplementary Information

The Board of Directors
The Cleveland Clinic Foundation

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The following consolidating balance sheets, statements of operations and changes in net assets, and statements of cash flows are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Ernst & Young LLP

March 14, 2019

Cleveland Clinic Health System

Consolidating Balance Sheet

December 31, 2018

(In Thousands)

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Assets				
Current assets:				
Cash and cash equivalents	\$ 279,847	\$ 164,916	\$ -	\$ 444,763
Patient receivables, net	1,008,777	150,582	(36,441)	1,122,918
Due from affiliates	5,053	20	(5,073)	-
Investments for current use	-	53,841	-	53,841
Other current assets	359,623	67,392	(550)	426,465
Total current assets	<u>1,653,300</u>	<u>436,751</u>	<u>(42,064)</u>	<u>2,047,987</u>
Investments:				
Long-term investments	6,959,237	574,431	-	7,533,668
Funds held by trustees	49,353	24	-	49,377
Assets held for self-insurance	-	106,966	-	106,966
Donor-restricted assets	715,268	29,583	-	744,851
	<u>7,723,858</u>	<u>711,004</u>	<u>-</u>	<u>8,434,862</u>
Property, plant, and equipment, net	4,144,790	927,674	-	5,072,464
Other assets:				
Pledges receivable, net	150,876	1,572	-	152,448
Trusts and interests in foundations	67,279	20,327	-	87,606
Other noncurrent assets	546,032	63,367	(197,637)	411,762
	<u>764,187</u>	<u>85,266</u>	<u>(197,637)</u>	<u>651,816</u>
Total assets	<u>\$ 14,286,135</u>	<u>\$ 2,160,695</u>	<u>\$ (239,701)</u>	<u>\$ 16,207,129</u>

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Liabilities and net assets				
Current liabilities:				
Accounts payable	\$ 448,095	\$ 79,693	\$ (116)	\$ 527,672
Compensation and amounts withheld from payroll	329,434	29,908	–	359,342
Current portion of long-term debt	185,676	5,746	(72)	191,350
Variable rate debt classified as current	351,024	56,752	–	407,776
Due to affiliates	20	5,053	(5,073)	–
Other current liabilities	411,584	121,009	(39,140)	493,453
Total current liabilities	<u>1,725,833</u>	<u>298,161</u>	<u>(44,401)</u>	<u>1,979,593</u>
Long-term debt	3,028,825	723,115	(193,029)	3,558,911
Other liabilities:				
Professional and general liability insurance reserves	55,556	85,626	–	141,182
Accrued retirement benefits	420,436	45,091	–	465,527
Other noncurrent liabilities	505,891	36,289	(151)	542,029
	<u>981,883</u>	<u>167,006</u>	<u>(151)</u>	<u>1,148,738</u>
Total liabilities	<u>5,736,541</u>	<u>1,188,282</u>	<u>(237,581)</u>	<u>6,687,242</u>
Net assets:				
Without donor restrictions	7,547,813	919,775	(2,120)	8,465,468
With donor restrictions	1,001,781	52,638	–	1,054,419
Total net assets	<u>8,549,594</u>	<u>972,413</u>	<u>(2,120)</u>	<u>9,519,887</u>
Total liabilities and net assets	<u>\$ 14,286,135</u>	<u>\$ 2,160,695</u>	<u>\$ (239,701)</u>	<u>\$ 16,207,129</u>

See accompanying note.

Cleveland Clinic Health System

Consolidating Balance Sheet

December 31, 2017

(In Thousands)

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Assets				
Current assets:				
Cash and cash equivalents	\$ 27,644	\$ 213,583	\$ –	\$ 241,227
Patient receivables, net	904,105	142,450	(33,652)	1,012,903
Due from affiliates	55,942	50	(55,992)	–
Investments for current use	103,920	51,051	–	154,971
Other current assets	310,960	64,134	(368)	374,726
Total current assets	1,402,571	471,268	(90,012)	1,783,827
Investments:				
Long-term investments	7,289,000	440,697	–	7,729,697
Funds held by trustees	69,234	–	–	69,234
Assets held for self-insurance	–	159,802	–	159,802
Donor-restricted assets	685,292	32,118	–	717,410
	8,043,526	632,617	–	8,676,143
Property, plant, and equipment, net	3,819,800	879,897	–	4,699,697
Other assets:				
Pledges receivable, net	150,690	329	–	151,019
Trusts and interests in foundations	71,866	8,777	–	80,643
Other noncurrent assets	566,548	60,388	(151,926)	475,010
	789,104	69,494	(151,926)	706,672
Total assets	<u>\$ 14,055,001</u>	<u>\$ 2,053,276</u>	<u>\$ (241,938)</u>	<u>\$ 15,866,339</u>

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Liabilities and net assets				
Current liabilities:				
Accounts payable	\$ 432,859	\$ 71,024	\$ (192)	\$ 503,691
Compensation and amounts withheld from payroll	311,159	34,287	–	345,446
Current portion of long-term debt	77,208	380,677	(72)	457,813
Variable rate debt classified as current	514,396	58,874	–	573,270
Due to affiliates	50	55,942	(55,992)	–
Other current liabilities	358,475	116,352	(36,165)	438,662
Total current liabilities	1,694,147	717,156	(92,421)	2,318,882
 Long-term debt	 2,972,113	 171,562	 (147,397)	 2,996,278
Other liabilities:				
Professional and general liability insurance reserves	55,875	91,452	–	147,327
Accrued retirement benefits	453,710	39,123	–	492,833
Other noncurrent liabilities	526,814	40,752	–	567,566
	<u>1,036,399</u>	<u>171,327</u>	<u>–</u>	<u>1,207,726</u>
Total liabilities	5,702,659	1,060,045	(239,818)	6,522,886
Net assets:				
Without donor restrictions	7,397,798	950,971	(2,120)	8,346,649
With donor restrictions	954,544	42,260	–	996,804
Total net assets	8,352,342	993,231	(2,120)	9,343,453
Total liabilities and net assets	\$ 14,055,001	\$ 2,053,276	\$ (241,938)	\$ 15,866,339

See accompanying note.

Cleveland Clinic Health System

Consolidating Statements of Operations and Changes in Net Assets

Year Ended December 31, 2018
(In Thousands)

Operations

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Unrestricted revenues				
Net patient service revenue	\$ 7,334,426	\$ 966,755	\$ (269,382)	\$ 8,031,799
Other	753,137	301,295	(158,674)	895,758
Total unrestricted revenues	<u>8,087,563</u>	<u>1,268,050</u>	<u>(428,056)</u>	<u>8,927,557</u>
Expenses				
Salaries, wages, and benefits	4,486,481	682,986	(312,041)	4,857,426
Supplies	758,369	107,452	(951)	864,870
Pharmaceuticals	1,012,348	78,633	-	1,090,981
Purchased services and other fees	490,408	98,784	(25,422)	563,770
Administrative services	160,416	85,015	(23,315)	222,116
Facilities	281,921	74,809	(3,252)	353,478
Insurance	69,121	65,438	(62,975)	71,584
	<u>7,259,064</u>	<u>1,193,117</u>	<u>(427,956)</u>	<u>8,024,225</u>
Operating income before interest, depreciation, amortization, and special charges	828,499	74,933	(100)	903,332
Interest	119,904	18,940	-	138,844
Depreciation and amortization	432,794	62,942	(100)	495,636
Operating income (loss) before special charges	<u>275,801</u>	<u>(6,949)</u>	<u>-</u>	<u>268,852</u>
Special charges	-	2,419	-	2,419
Operating income (loss)	<u>275,801</u>	<u>(9,368)</u>	<u>-</u>	<u>266,433</u>
Nonoperating gains and losses				
Investment loss	(173,401)	(17,789)	-	(191,190)
Derivative gains (losses)	1,458	(1,644)	-	(186)
Other, net	(9,459)	38,321	-	28,862
Net nonoperating (losses) gains	<u>(181,402)</u>	<u>18,888</u>	<u>-</u>	<u>(162,514)</u>
Excess of revenues over expenses	<u>94,399</u>	<u>9,520</u>	<u>-</u>	<u>103,919</u>

(continued on next page)

Changes in Net Assets

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Changes in net assets without donor restrictions:				
Excess of revenues over expenses	\$ 94,399	\$ 9,520	\$ –	\$ 103,919
Donated capital	592	11	–	603
Net assets released from restriction for capital purposes	11,378	781	–	12,159
Retirement benefits adjustment	28,398	(3,809)	–	24,589
Foreign currency translation	–	(23,332)	–	(23,332)
Transfers from (to) affiliates	15,793	(15,793)	–	–
Other	(545)	1,426	–	881
Increase (decrease) in net assets without donor restrictions	150,015	(31,196)	–	118,819
Changes in net assets with donor restrictions:				
Gifts and bequests	117,396	4,418	–	121,814
Net investment (loss) income	(9,159)	154	–	(9,005)
Net assets released from restrictions used for operations included in other unrestricted revenues	(46,459)	(5,427)	–	(51,886)
Net assets released from restriction for capital purposes	(11,378)	(781)	–	(12,159)
Change in interests in foundations	(3,300)	–	–	(3,300)
Change in value of perpetual trusts	355	(1,339)	–	(984)
Union Hospital member substitution contribution	–	13,180	–	13,180
Other	(218)	173	–	(45)
Increase in net assets with donor restrictions	47,237	10,378	–	57,615
Increase (decrease) in net assets	197,252	(20,818)	–	176,434
Net assets at beginning of year	8,352,342	993,231	(2,120)	9,343,453
Net assets at end of year	\$ 8,549,594	\$ 972,413	\$ (2,120)	\$ 9,519,887

See accompanying note.

Cleveland Clinic Health System

Consolidating Statements of Operations and Changes in Net Assets

Year Ended December 31, 2017

(In Thousands)

Operations

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Unrestricted revenues				
Net patient service revenue	\$ 7,151,809	\$ 916,179	\$ (273,437)	\$ 7,794,551
Provision for uncollectible accounts	(240,971)	(55,498)	-	(296,469)
Net patient service revenue less provision for uncollectible accounts	6,910,838	860,681	(273,437)	7,498,082
Other	769,719	302,217	(163,016)	908,920
Total unrestricted revenues	7,680,557	1,162,898	(436,453)	8,407,002
Expenses				
Salaries, wages, and benefits	4,291,356	587,955	(314,171)	4,565,140
Supplies	693,166	101,572	(1,373)	793,365
Pharmaceuticals	872,841	84,204	-	957,045
Purchased services and other fees	435,791	126,802	(29,548)	533,045
Administrative services	151,282	70,462	(22,881)	198,863
Facilities	269,428	68,627	(3,684)	334,371
Insurance	66,917	58,839	(64,696)	61,060
	6,780,781	1,098,461	(436,353)	7,442,889
Operating income before interest, depreciation, amortization, and special charges	899,776	64,437	(100)	964,113
Interest	128,956	11,868	-	140,824
Depreciation and amortization	424,771	62,569	(100)	487,240
Operating income (loss) before special charges	346,049	(10,000)	-	336,049
Special charges	-	5,491	-	5,491
Operating income (loss)	346,049	(15,491)	-	330,558
Nonoperating gains and losses				
Investment return	830,497	65,642	-	896,139
Derivative gains (losses)	44	(2,349)	-	(2,305)
Other, net	(70,802)	(3,276)	-	(74,078)
Net nonoperating gains	759,739	60,017	-	819,756
Excess of revenues over expenses	1,105,788	44,526	-	1,150,314

(continued on next page)

Changes in Net Assets

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Changes in net assets without donor restrictions:				
Excess of revenues over expenses	\$ 1,105,788	\$ 44,526	\$ –	\$ 1,150,314
Net assets released from restriction for capital purposes	73,920	7,951	–	81,871
Retirement benefits adjustment	(7,257)	3,884	–	(3,373)
Foreign currency translation	–	29,301	–	29,301
Transfers (to) from affiliates	(27,471)	27,471	–	–
Other	(540)	(461)	1,328	327
Increase in net assets without donor restrictions	1,144,440	112,672	1,328	1,258,440
Changes in net assets with donor restrictions:				
Gifts and bequests	118,562	2,109	–	120,671
Net investment income	51,721	3,391	–	55,112
Net assets released from restrictions used for operations included in other unrestricted revenues	(38,081)	(3,594)	–	(41,675)
Net assets released from restriction for capital purposes	(73,920)	(7,951)	–	(81,871)
Change in interests in foundations	5,047	–	–	5,047
Change in value of perpetual trusts	1,717	618	–	2,335
Other	(533)	128	–	(405)
Increase (decrease) in net assets with donor restrictions	64,513	(5,299)	–	59,214
Increase in net assets	1,208,953	107,373	1,328	1,317,654
Net assets at beginning of year	7,143,389	885,858	(3,448)	8,025,799
Net assets at end of year	\$ 8,352,342	\$ 993,231	\$ (2,120)	\$ 9,343,453

See accompanying note.

Cleveland Clinic Health System
Consolidating Statement of Cash Flows

Year Ended December 31, 2018
(In Thousands)

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Operating activities and net nonoperating gains and losses				
Increase (decrease) in total net assets	\$ 197,252	\$ (20,818)	\$ -	\$ 176,434
Adjustments to reconcile increase (decrease) in total net assets to net cash provided by (used in) operating activities and net nonoperating gains and losses:				
Retirement benefits adjustment	(28,398)	3,809	-	(24,589)
Net realized and unrealized losses on investments	227,207	22,152	-	249,359
Depreciation and amortization	432,794	64,663	(100)	497,357
Foreign currency translation loss	-	23,332	-	23,332
Donated capital	(592)	(11)	-	(603)
Restricted gifts, bequests, investment income, and other	(105,292)	(3,233)	-	(108,525)
Transfers (from) to affiliates	(15,793)	15,793	-	-
Amortization of bond premiums and debt issuance costs	(6,109)	63	-	(6,046)
Net gain in value of derivatives	(13,126)	(2,575)	-	(15,701)
Union Hospital member substitution contribution	-	(64,876)	-	(64,876)
Changes in operating assets and liabilities:				
Patient receivables	(104,672)	12,775	2,789	(89,108)
Other current assets	22,876	467	(50,737)	(27,394)
Other noncurrent assets	19,890	283	45,811	65,984
Accounts payable and other current liabilities	86,971	(54,916)	48,020	80,075
Other liabilities	(1,129)	(8,933)	(151)	(10,213)
Net cash provided by (used in) operating activities and net nonoperating gains and losses	711,879	(12,025)	45,632	745,486
Financing activities				
Proceeds from long-term borrowings	45,000	557,496	(45,632)	556,864
Payments for advance refunding and redemption of long-term debt	-	(420,030)	-	(420,030)
Principal payments on long-term debt	(82,613)	(5,824)	-	(88,437)
Debt issuance costs	-	(6,417)	-	(6,417)
Change in pledges receivables, trusts and interests in foundations	(16,249)	(51)	-	(16,300)
Restricted gifts, bequests, investment income, and other	105,292	3,233	-	108,525
Net cash provided by financing activities	51,430	128,407	(45,632)	134,205
Investing activities				
Expenditures for property, plant, and equipment	(723,445)	(81,070)	-	(804,515)
Proceeds from sale of property, plant, and equipment	165	-	-	165
Cash acquired through member substitution	-	1,515	-	1,515
Net change in cash equivalents reported in long-term investments	171,538	(103,273)	-	68,265
Purchases of investments	(3,401,430)	(282,340)	-	(3,683,770)
Sales of investments	3,426,273	320,828	-	3,747,101
Transfers from (to) affiliates	15,793	(15,793)	-	-
Net cash used in investing activities	(511,106)	(160,133)	-	(671,239)
Effect of exchange rate changes on cash	-	(4,916)	-	(4,916)
Increase (decrease) in cash and cash equivalents	252,203	(48,667)	-	203,536
Cash and cash equivalents at beginning of year	27,644	213,583	-	241,227
Cash and cash equivalents at end of year	\$ 279,847	\$ 164,916	\$ -	\$ 444,763

See accompanying note.

Cleveland Clinic Health System
Consolidating Statement of Cash Flows

Year Ended December 31, 2017
(In Thousands)

	Obligated Group	Non-Obligated Group	Consolidating Adjustments and Eliminations	Consolidated
Operating activities and net nonoperating gains and losses				
Increase in total net assets	\$ 1,208,953	\$ 107,373	\$ 1,328	\$ 1,317,654
Adjustments to reconcile increase in total net assets to net cash provided by operating activities and net nonoperating gains and losses:				
Loss on extinguishment of debt	46,159	-	-	46,159
Retirement benefits adjustment	7,257	(3,884)	-	3,373
Net realized and unrealized gains on investments	(832,374)	(65,467)	-	(897,841)
Depreciation and amortization	424,771	65,992	(100)	490,663
Foreign currency translation gain	-	(29,301)	-	(29,301)
Restricted gifts, bequests, investment income, and other	(177,047)	(6,118)	-	(183,165)
Transfers to (from) affiliates	27,471	(27,471)	-	-
Amortization of bond premiums and debt issuance costs	(3,118)	12	-	(3,106)
Net gain in value of derivatives	(26,509)	-	-	(26,509)
Changes in operating assets and liabilities:				
Patient receivables	76,139	(37,222)	7,351	46,268
Other current assets	(59,278)	19,521	49,930	10,173
Other noncurrent assets	(53,297)	(9,392)	(3,798)	(66,487)
Accounts payable and other current liabilities	5,764	70,258	(59,618)	16,404
Other liabilities	111,364	(18,969)	-	92,395
Net cash provided by operating activities and net nonoperating gains and losses	756,255	65,332	(4,907)	816,680
Financing activities				
Proceeds from long-term borrowings	1,118,137	2,710	(2,710)	1,118,137
Payments for advance refunding and redemption of long-term debt	(1,110,120)	-	-	(1,110,120)
Principal payments on long-term debt	(86,096)	(5,778)	7,617	(84,257)
Debt issuance costs	(8,173)	-	-	(8,173)
Change in pledges receivables, trusts and interests in foundations	(1,482)	276	-	(1,206)
Restricted gifts, bequests, investment income, and other	177,047	6,118	-	183,165
Net cash provided by financing activities	89,313	3,326	4,907	97,546
Investing activities				
Expenditures for property, plant, and equipment	(519,040)	(88,680)	-	(607,720)
Proceeds from sale of property, plant, and equipment	1,070	416	-	1,486
Net change in cash equivalents reported in long-term investments	(394,195)	31,682	-	(362,513)
Purchases of investments	(2,226,802)	(214,566)	-	(2,441,368)
Sales of investments	2,045,412	169,822	-	2,215,234
Transfers (to) from affiliates	(27,471)	27,471	-	-
Net cash used in investing activities	(1,121,026)	(73,855)	-	(1,194,881)
Effect of exchange rate changes on cash	-	1,254	-	1,254
Decrease in cash and cash equivalents	(275,458)	(3,943)	-	(279,401)
Cash and cash equivalents at beginning of year	303,102	217,526	-	520,628
Cash and cash equivalents at end of year	\$ 27,644	\$ 213,583	\$ -	\$ 241,227

See accompanying note.

Cleveland Clinic Health System

Note to Consolidating Financial Statements

December 31, 2018 and 2017

1. Presentation of Consolidating Financial Statements

The accompanying financial statement information presents consolidating financial statement information for the Obligated Group (as defined herein) and certain controlled affiliates of The Cleveland Clinic Foundation (collectively referred to as the Non-Obligated Group), which have no liability under the Master Trust Indenture (Indenture), amended and restated as of April 1, 2003 (as supplemented, the Indenture), between The Cleveland Clinic Foundation and The Huntington National Bank, as successor Master Trustee. The Cleveland Clinic Foundation, Cleveland Clinic Avon Hospital, Cleveland Clinic Health System – East Region, Fairview Hospital, Lutheran Hospital, Marymount Hospital, Inc., Medina Hospital, Cleveland Clinic Florida (a nonprofit corporation) and Cleveland Clinic Florida Health System Nonprofit Corporation are the sole members of the Obligated Group under the Indenture.

With respect to the Obligated Group, certain properties and interests are considered to be Excluded Property under the Indenture. In addition, the provisions of the Indenture provide that additional property may be categorized as Excluded Property upon satisfaction of various financial tests. As such, these properties and interests are not subject to the restrictions contained in the Indenture and, under the Indenture, are not subject to the restriction on liens and other encumbrances that may be placed on property of the Obligated Group. Furthermore, the revenues derived from the Excluded Property are not subject to the restrictions contained in the Indenture until they are received and commingled with other revenues of the Obligated Group. The accompanying financial statement information is presented by legal entity, and no adjustment has been made for the Excluded Property.

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