Consolidated Financial Statements

Northwestern Memorial HealthCare and Subsidiaries
Years Ended August 31, 2017 and 2016
With Reports of Independent Auditors

Ernst & Young LLP

Building a better
working world

Northwestern Memorial HealthCare and Subsidiaries

Consolidated Financial Statements

Years Ended August 31, 2017 and 2016

Contents

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Report of Independent Auditors

The Board of Directors
Northwestern Memorial HealthCare

We have audited the accompanying consolidated financial statements of Northwestern Memorial HealthCare and Subsidiaries which comprise the consolidated balance sheets as of August 31, 2017 and 2016, and the related consolidated statements of operations and changes in net assets and 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 Northwestern Memorial HealthCare and Subsidiaries at August 31, 2017 and 2016, 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.

Ernst & Young LLP

November 30, 2017

Northwestern Memorial HealthCare and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	August 31	
	2017	**2016**
Assets		
Current assets:		
Cash and cash equivalents	**$ 258,463**	$ 218,163
Short-term investments	**30,685**	10,474
Current portion of investments, including assets limited as to use	**136,352**	296,029
Patient accounts receivable, net of estimated allowances for uncollectible accounts of $223,411 and $174,234 in 2017 and 2016, respectively	**716,277**	599,772
Current portion of pledges and grants receivable, net	**24,561**	20,121
Current portion of insurance recoverable	**14,186**	11,716
Inventories	**64,443**	60,338
Other current assets	**154,752**	139,159
Total current assets	**1,399,719**	1,355,772
Investments, including assets limited as to use, less current portion	**5,490,526**	4,843,924
Property and equipment, at cost:		
Land	**347,036**	348,841
Buildings	**3,465,273**	3,339,542
Equipment and furniture	**1,166,884**	1,017,617
Construction in progress	**539,340**	349,738
	5,518,533	5,055,738
Less accumulated depreciation	**2,059,946**	1,821,853
	3,458,587	3,233,885
Prepaid pension cost	**118,562**	43,488
Insurance recoverable, less current portion	**69,706**	64,339
Other assets, net	**189,222**	170,778
Total assets	**$ 10,726,322**	$ 9,712,186

	August 31	
	2017	**2016**
Liabilities and net assets		
Current liabilities:		
Accounts payable	**$ 230,588**	$ 237,282
Accrued salaries and benefits	**314,163**	304,521
Grants and academic support payable, current portion	**38,753**	50,753
Accrued expenses and other current liabilities	**115,254**	164,279
Due to third-party payors	**434,965**	406,123
Current accrued liabilities under self-insurance programs	**94,256**	89,789
Current maturities of long-term debt	**30,239**	29,565
Short-term debt	**87,299**	–
Long-term debt subject to short-term remarketing agreements	**–**	318,795
Total current liabilities	**1,345,517**	1,601,107
Long-term debt, net, less current maturities	**1,324,776**	1,077,180
Accrued liabilities under self-insurance programs, less current portion	**495,709**	495,352
Grants and academic support payable, less current portion	**79,469**	98,937
Interest rate swaps	**112,586**	150,107
Other liabilities	**143,428**	139,910
Total liabilities	**3,501,485**	3,562,593
Net assets:		
Unrestricted:		
Undesignated	**6,602,984**	5,556,407
Board-designated	**229,455**	221,750
Noncontrolling interest in consolidated venture	**(3,599)**	(2,244)
Total unrestricted	**6,828,840**	5,775,913
Temporarily restricted	**220,917**	211,769
Permanently restricted	**175,080**	161,911
Total net assets	**7,224,837**	6,149,593
Total liabilities and net assets	**$ 10,726,322**	$ 9,712,186

See accompanying notes to consolidated financial statements.

Northwestern Memorial HealthCare and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets

(In Thousands)

	Year Ended August 31	
	2017	**2016**
Revenue		
Net patient service revenue	**$ 4,749,433**	$ 4,236,441
Provision for uncollectible accounts	**202,047**	154,860
Net patient service revenue after provision for uncollectible accounts	**4,547,386**	4,081,581
Rental and other revenue	**256,362**	251,852
Net assets released from donor restrictions and federal and state grants	**27,248**	26,440
Total revenue	**4,830,996**	4,359,873
Expenses		
Salaries	**1,969,531**	1,769,381
Employee benefits	**297,842**	296,776
Supplies	**877,030**	759,795
Purchased services	**538,642**	476,344
Depreciation and amortization	**287,149**	273,778
Insurance	**104,578**	108,793
Rent and utilities	**91,307**	83,612
Repairs and maintenance	**88,331**	87,377
Interest	**44,106**	53,243
Illinois Hospital Assessment	**103,362**	84,484
Other	**127,949**	126,919
Total expenses	**4,529,827**	4,120,502
Operating income	**301,169**	239,371
Nonoperating gains (losses)		
Investment return	**655,269**	155,708
Change in fair value of interest rate swaps	**37,521**	(37,212)
Contribution of KishHealth unrestricted net assets	**–**	347,003
Contribution of Marianjoy unrestricted net assets	**–**	42,964
Loss on extinguishment of long-term debt	**(216)**	(4,030)
Grants and academic support provided	**(20,172)**	(26,748)
Other	**9,291**	1,792
Total nonoperating gains, net	**681,693**	479,477
Excess of revenue over expenses	**982,862**	718,848
Net (loss) gain attributable to noncontrolling interest in subsidiaries	**(703)**	698
Excess of revenue over expenses attributable to NMHC and subsidiaries	**983,565**	718,150

Northwestern Memorial HealthCare and Subsidiaries

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

(In Thousands)

	Year Ended August 31					
	2017			2016		
	Total	Controlling	Noncontrolling	Total	Controlling	Noncontrolling
Unrestricted net assets						
Excess (deficiency) of revenue over expenses	**$ 982,862**	**$ 983,565**	**$ (703)**	$ 718,848	$ 718,150	$ 698
Net assets released from restrictions used for property and equipment additions	**6,279**	**6,279**	**–**	15,858	15,858	–
Postretirement benefit-related changes other than net periodic pension cost	**64,884**	**64,884**	**–**	(81,400)	(81,400)	–
Initial value of noncontrolling interests in acquired companies	**–**	**–**	**–**	1,141	–	1,141
Distribution to noncontrolling interest	**(785)**	**–**	**(785)**	(1,787)	–	(1,787)
Other	**(313)**	**(446)**	**133**	407	1,132	(725)
Increase (decrease) in unrestricted net assets	**1,052,927**	**1,054,282**	**(1,355)**	653,067	653,740	(673)
Temporarily restricted net assets						
Contributions	**44,892**	**44,892**	**–**	39,411	39,411	–
Investment return	**14,051**	**14,051**	**–**	12,585	12,585	–
Net assets released from restrictions used for:						
Operating expenses, charity care, and research and education	**(34,859)**	**(34,859)**	**–**	(28,873)	(28,873)	–
Property and equipment additions	**(6,279)**	**(6,279)**	**–**	(15,858)	(15,858)	–
Change in fair value of split-interest agreements	**147**	**147**	**–**	261	261	–
Contribution of KishHealth restricted net assets	**–**	**–**	**–**	788	788	–
Contribution of Marianjoy restricted net assets	**–**	**–**	**–**	3,365	3,365	–
Other	**(8,804)**	**(8,804)**	**–**	(1,339)	(1,339)	–
Increase in temporarily restricted net assets	**9,148**	**9,148**	**–**	10,340	10,340	–
Permanently restricted net assets						
Contributions	**5,609**	**5,609**	**–**	1,330	1,330	–
Change in fair value of split-interest agreements	**775**	**775**	**–**	(778)	(778)	–
Contribution of KishHealth restricted net assets	**–**	**–**	**–**	601	601	–
Other	**6,785**	**6,785**	**–**	(17)	(17)	–
Increase in permanently restricted net assets	**13,169**	**13,169**	**–**	1,136	1,136	–
Change in total net assets	**1,075,244**	**1,076,599**	**(1,355)**	664,543	665,216	(673)
Net assets, beginning of year	**6,149,593**	**6,151,837**	**(2,244)**	5,485,050	5,486,621	(1,571)
Net assets, end of year	**$ 7,224,837**	**$ 7,228,436**	**$ (3,599)**	$ 6,149,593	$ 6,151,837	$ (2,244)

See accompanying notes to consolidated financial statements.

Northwestern Memorial HealthCare and Subsidiaries

Consolidated Statements of Cash Flows
(In Thousands)

	Year Ended August 31	
	2017	2016
Operating activities		
Change in net assets	**$ 1,075,244**	$ 664,543
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Postretirement benefit-related changes other than net periodic pension cost	**(64,884)**	81,400
Change in fair value of interest rate swaps	**(37,521)**	37,212
Loss on extinguishment of long-term debt	**216**	4,030
Net investment return and net change in unrealized investment gains	**(657,573)**	(156,791)
Restricted contributions, change in fair value of split-interest agreements, and realized investment return	**(63,170)**	(51,848)
Contribution of KishHealth net assets less noncontrolling interest	**–**	(349,533)
Contribution of Marianjoy net assets	**–**	(46,329)
Depreciation and amortization	**287,149**	273,778
Provision for uncollectible accounts	**202,047**	154,860
Changes in operating assets and liabilities:		
Patient accounts receivable	**(318,552)**	(217,814)
Due to third-party payors	**29,161**	8,169
Grants and academic support payable	**(31,468)**	(50,753)
Other operating assets and liabilities	**(38,764)**	38,494
Net cash provided by operating activities	**381,885**	389,418
Investing activities		
Purchases of trading securities	**(2,501,222)**	(1,653,436)
Sales of trading securities	**2,456,759**	1,595,003
Cash received from contribution of KishHealth	**–**	40,535
Cash paid for Marianjoy	**–**	(35,412)
Net unrestricted realized investment return	**194,902**	63,123
Capital expenditures, net	**(512,804)**	(461,614)
Net cash used in investing activities	**(362,365)**	(451,801)
Financing activities		
Proceeds from line of credit	**45,000**	59,750
Proceeds from commercial paper	**87,299**	–
Proceeds from issuance of long-term debt	**–**	80
Payments of line of credit	**(104,750)**	–
Payments of long-term debt	**(69,939)**	(89,445)
Restricted contributions, change in fair value of split-interest agreements, and realized investment return	**63,170**	51,848
Net cash provided by financing activities	**20,780**	22,233
Net increase (dcrease) in cash and cash equivalents	**40,300**	(40,150)
Cash and cash equivalents, beginning of year	**218,163**	258,313
Cash and cash equivalents, end of year	**$ 258,463**	$ 218,163

See accompanying notes to consolidated financial statements.

Report of Independent Auditors

The Board of Directors
Northwestern Memorial HealthCare

We have audited the accompanying consolidated financial statements of Northwestern Memorial HealthCare and Subsidiaries which comprise the consolidated balance sheets as of August 31, 2017 and 2016, and the related consolidated statements of operations and changes in net assets and 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 Northwestern Memorial HealthCare and Subsidiaries at August 31, 2017 and 2016, 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.

Ernst & Young LLP

November 30, 2017

1. Organization and Summary of Significant Accounting Policies

Northwestern Memorial HealthCare (NMHC) is the parent of an integrated nonprofit health care organization, anchored by Northwestern Memorial Hospital (NMH) and Northwestern Medical Group (NMG), that provides health care services to communities in northern Illinois. NMHC partners with Northwestern University's Feinberg School of Medicine (FSM) to form an academic medical center, branded as Northwestern Medicine, that is shaping the future of medicine through outstanding patient care, research and training of resident physicians.

Basis of Presentation

The accompanying consolidated financial statements include the accounts of NMHC and its subsidiaries (collectively referred to herein as Northwestern Memorial). All significant intercompany transactions and balances have been eliminated in consolidation.

Charity Care and Community Benefit

Northwestern Memorial provides care to patients regardless of their ability to pay. Northwestern Memorial developed a Free and Discounted Care Policy (the Policy) for both the uninsured and the underinsured. Under the Policy, patients are offered discounts of up to 100% of charges on a sliding scale, which is based on income as a percentage of the federal poverty level guidelines (up to 600%). The Policy also contains provisions that are responsive to those patients subject to catastrophic health care expenses and uninsured patients not covered by the provisions above. Since Northwestern Memorial does not pursue collection of these amounts, they are not reported as Net patient service revenue, and the cost of providing such care is recognized within operating expenses.

Northwestern Memorial estimates the direct and indirect costs of providing charity care by applying a cost to gross charges ratio to the gross uncompensated charges associated with providing charity care to patients. The cost of providing charity care was $61,258 and $59,643 for the years ended August 31, 2017 and 2016, respectively. Northwestern Memorial also received certain funds of $342 and $437 for the years ended August 31, 2017 and 2016, respectively, to offset or subsidize charity care services provided. These funds are primarily received from investment return on free care endowment funds. In the Annual Non Profit Hospital Community Benefits Plan Report filed with the Illinois Attorney General for the year ended August 31, 2016, Northwestern Memorial reported total community benefit of $747,373 (unaudited), including

1. Organization and Summary of Significant Accounting Policies (continued)

unreimbursed cost of charity care of $80,459 (unaudited), which is calculated using a different methodology than that used for the consolidated financial statements. Management is currently collecting the information needed to file the 2017 report; however, it does not expect a material change from prior year.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include highly liquid short-term investments with maturities of 90 days or less from the date of purchase.

Patient Accounts Receivable

Patient accounts receivable are stated at net realizable value. Northwestern Memorial maintains allowances for uncollectible accounts and for estimated losses resulting from a payor's inability to make payments on accounts. Northwestern Memorial estimates the allowance for uncollectible accounts based on management's assessment of historical and expected net collections, considering historical and current business and economic conditions, trends in health care coverage, and other collection indicators. Patient accounts receivable are charged to the provision for uncollectible accounts when they are deemed uncollectible.

Assets Limited as to Use

Assets limited as to use consist primarily of investments designated for certain medical education and health care programs. The particular Northwestern Memorial corporation that controls these investments makes such designations and may, at its discretion, subsequently use them for other purposes. In addition, assets limited as to use include investments held by trustees under debt agreements and for self-insurance and collateral related to interest rate swaps.

1. Organization and Summary of Significant Accounting Policies (continued)

Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are reported at fair value based on quoted market prices. Unless in pension plan assets, alternative investments are reported using the equity method. Alternative investments can include common collective trusts, commingled funds, 103-12 entities and other limited partnership interests in hedge funds, private equity, venture capital and real estate funds. Alternative investments in the pension plan are reported at fair value based on net asset value (NAV) per share or equivalent.

Derivative Instruments

Derivative instruments, specifically interest rate swaps, are recorded in the accompanying consolidated balance sheets at fair value. The change in the fair value of derivative instruments is recorded in Nonoperating gains (losses).

Inventories

Inventories, consisting primarily of pharmaceuticals and other medical supplies, are stated at the lower of cost on the first-in, first-out method or fair value.

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets. Generally, buildings and building service equipment have a composite life of approximately 40 years and equipment and furniture have useful lives of 3-20 years. Interest incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Other Intangible Assets

Intangible assets are stated at fair value at time of purchase and are amortized using the straight-line method over the estimated life based on terms of the underlying agreement giving rise to the intangible.

1. Organization and Summary of Significant Accounting Policies (continued)

Asset Impairment

Northwestern Memorial considers whether indicators of impairment are present and performs the necessary tests to determine if the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating income at the time the impairment is identified. There were no impairments of long-lived assets in 2017 or 2016.

Deferred Charges

Deferred finance charges and bond discounts or premiums are amortized or accreted using the effective interest method or the bonds outstanding method, which approximates the effective interest method, over the life of the related debt.

Net Assets

Resources are classified for reporting purposes as unrestricted, temporarily restricted and permanently restricted, according to the absence or existence of donor-imposed restrictions. In addition, unrestricted net assets are further classified as general unrestricted or board-designated unrestricted. Board-designated net assets are unrestricted net assets that have been set aside by the Board for specific purposes. Temporarily restricted net assets are those assets, including contributions and accumulated investment returns, whose use has been limited by donors for a specific purpose or time period. Permanently restricted net assets are those for which donors require the principal of the gifts to be maintained in perpetuity to provide a permanent source of income.

Any changes in donor restrictions that change the net asset category of previously recorded contributions are recorded as other in the accompanying consolidated statements of operations and changes in net assets in the period communicated by the donor.

1. Organization and Summary of Significant Accounting Policies (continued)

Net Patient Service Revenue

Northwestern Memorial has agreements with third-party payors that provide for payments to Northwestern Memorial at amounts different from its established rates. Payment arrangements include prospectively determined rates per admission or visit, reimbursed costs, discounted charges and per diem rates. Net patient service revenue is reported at the estimated net amount due from patients and third-party payors for services rendered, including estimated adjustments under reimbursement agreements with third-party payors, certain of which are subject to audit by administering agencies. These adjustments are accrued on an estimated basis and are adjusted, as needed, in future periods.

Contributions

Unrestricted gifts, other than long-lived assets, are included within Other in Nonoperating gains (losses) in the accompanying consolidated statements of operations and changes in net assets. Unrestricted gifts of long-lived assets, such as land, buildings or equipment, are recorded at fair value as an increase in unrestricted net assets. Contributions are reported as either temporarily or permanently restricted net assets if they are received with donor restrictions. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, Temporarily restricted net assets are reclassified as unrestricted net assets and reported in the accompanying consolidated statements of operations and changes in net assets as net assets released from restrictions.

Unconditional promises to give cash or other assets are reported as pledges receivable and contributions within the appropriate net asset category. An allowance for uncollectible pledges receivable is estimated based on historical experience and other collection indicators. Pledges receivable with payment terms extending beyond one year are discounted using market rates of return reflecting the terms and credit of the pledges at the time a pledge is made.

Northwestern Memorial is a beneficiary of several split-interest agreements, primarily perpetual trusts held by others, and recognizes its interest in these perpetual trusts as temporarily or permanently restricted net assets based on its percentage of the fair value of the trusts' assets.

1. Organization and Summary of Significant Accounting Policies (continued)

Nonoperating Gains (Losses)

Nonoperating gains (losses) consist primarily of investment returns (including realized and unrealized gains and losses, changes in Northwestern Memorial's equity interest in alternative investments, interest and dividends), contributions of unrestricted net assets in excess of consideration paid (where applicable), unrestricted contributions received, grants and academic support provided to external organizations, net assets released from restrictions and used for grants and academic support, changes in fair value of interest rate swaps and loss on extinguishment of debt.

Excess of Revenue Over Expenses

The accompanying consolidated statements of operations and changes in net assets include the Excess of revenue over expenses. Changes in unrestricted net assets, which are excluded from the Excess of revenue over expenses, consist primarily of contributions of long-lived assets (including assets acquired using contributions, which, by donor restriction, are to be used for the purposes of acquiring such assets), transfers between net asset categories based on changes in donor restrictions and Postretirement benefit-related changes other than net periodic pension cost.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 converged and replaced existing revenue recognition guidance, including industry specific guidance, and requires an entity to recognize 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. An entity should disclose sufficient information to enable the financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU 2015-14, which defers the effective date to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. This ASU allows two alternative methods for application, either retrospectively to each reporting period presented or a modified retrospective approach with a cumulative effect adjustment to net assets at the date of initial application. Northwestern Memorial expects to use the modified retrospective

1. Organization and Summary of Significant Accounting Policies (continued)

approach. Northwestern Memorial expects substantially all of its current provision for uncollectible accounts to qualify as a price concession under the new guidance and therefore be netted along with charity care and contractual discounts in Net patient service revenue. Northwestern Memorial expects expanded disclosures to also be made. Northwestern Memorial is currently evaluating the additional impacts this guidance will have on its consolidated financial statements.

In May 2015, the FASB issued new guidance on short-duration insurance contracts ASU 2015-09, *Financial Services – Insurance (Topic 944): Disclosures about Short-Duration Contracts*). The amendments in this new guidance are effective for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017. The new guidance should be applied retrospectively by providing comparative disclosures for each period presented, except for those requirements that apply only to the current period. The new guidance requires insurance entities to provide users of financial statements with more transparent information about initial claim estimates and subsequent adjustments to these estimates, including reconciling from the claim development table to the balance sheet liability; methodologies and judgments in estimating claims; and the timing, and frequency of claims. Northwestern Memorial is currently evaluating the impact of this guidance on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which will require lessees to put most leases on their balance sheets but recognize expenses on their income statements in a manner similar to existing accounting standards. This guidance also eliminates current real estate-specific provisions for all entities. This new guidance is effective for Northwestern Memorial for the fiscal years and interim periods within those fiscal years beginning after December 15, 2018, with early adoption permitted. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is prohibited. Northwestern Memorial is currently evaluating the effect this guidance will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. ASU 2016-14 will change certain financial statement requirements for not-for-profit (NFP) entities in the scope of Topic 958 in an effort to make the information more meaningful to users and make reporting less complex. NFP entities will no longer be required to distinguish between resources with temporary and permanent restrictions on the face of the financial statements. Additionally, NFP entities will be required to

1. Organization and Summary of Significant Accounting Policies (continued)

present expenses by their natural and functional classification and present investment returns net of external and direct internal investment expenses. This new guidance is effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. This guidance is to be applied retrospectively and early adoption is permitted. Northwestern Memorial is currently evaluating the effect this guidance will have on its consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost* (ASU 2017-07), which changes the presentation of periodic benefit cost components. Under ASU 2017-07, present service costs will continue to be presented within operating expenses but present amortization of prior service credits and other components of our net periodic benefit cost in Nonoperating gains (losses) in the consolidated statements of operation. ASU 2017-07 is effective for annual reporting periods beginning after December 15, 2017. Northwestern Memorial is currently evaluating the impact of this guidance on its consolidated financial statements.

2. Reclassifications

Certain reclassifications have been made to the 2016 consolidated financial statement disclosures to conform with classifications used in 2017. The reclassifications had no effect on total assets, total liabilities, total revenue or total revenue in excess of expenses previously reported.

3. Acquisitions

Affiliation With KishHealth

On December 1, 2015, KishHealth System (KishHealth) became a wholly owned subsidiary of NMHC pursuant to an affiliation agreement between NMHC and KishHealth. This affiliation positions Northwestern Memorial, under the Northwestern Medicine brand, to expand its integrated academic health delivery system to DeKalb County, offering patients access to leading-edge care closer to where they live and work.

(In Thousands)

3. Acquisitions (continued)

The affiliation was effected through a membership substitution with no consideration paid. For accounting purposes, this transaction is considered an acquisition under Accounting Standards Codification Topic (ASC) 958-805, *Not-for-Profit Entities: Business Combinations*, and a contribution was recorded for the fair value of assets, net of liabilities of KishHealth. No goodwill has been recorded as a result of this transaction.

The acquisition-date fair value of identifiable assets and liabilities of KishHealth at December 1, 2015, consisted of the following:

Fair value of identifiable net assets:	
Cash and cash equivalents	$ 40,535
Other current assets	210,407
Property and equipment	166,399
Other long-term assets	83,812
Current liabilities	(66,218)
Long-term debt	(74,025)
Other long-term liabilities	(11,377)
Non-controlling interest in unrestricted net assets	(1,141)
Temporarily restricted net assets	(788)
Permanently restricted net assets	(601)
Contribution of unrestricted net assets	$ 347,003

The valuation of property and equipment; other current and long-term assets, including identifiable intangible assets and current and long-term liabilities has been completed. In valuing these assets and liabilities, fair values were based on, but not limited to, independent appraisals, discounted cash flows, replacement costs and actuarially determined values.

Operating expenses for the year ended August 31, 2016, include costs related to the integration of KishHealth into Northwestern Memorial, including transition costs of benefit plans, incentive plans and operating programs with other health practitioners, as well as costs of valuation and integration consulting.

(In Thousands)

3. Acquisitions (continued)

Affiliation Agreement With Marianjoy

On March 1, 2016, Marianjoy, Inc. (Marianjoy) became a wholly owned subsidiary of NMHC pursuant to a Member Substitution Agreement and Real Estate Purchase Agreement (collectively, the acquisition) between NMHC and Marianjoy's corporate parent, Wheaton Franciscan Services, Inc. (WFSI). This acquisition expands the offerings of Northwestern Memorial, under the Northwestern Medicine brand, to include physical medicine and rehabilitation care in DuPage County and surrounding areas.

Under these agreements, NMHC transferred $35,412 to WFSI in exchange for Marianjoy's unrestricted net assets at the time of closing less Marianjoy's debt and cash, which were not acquired, and land purchased from WFSI. For accounting purposes, this transaction is considered an acquisition under ASC 958-805.

The acquisition-date fair value of identifiable assets and liabilities of Marianjoy at March 1, 2016, consisted of the following:

Fair value of identifiable net assets:	
Other current assets	$ 13,385
Property and equipment	68,996
Other long-term assets	3,921
Current liabilities	(4,561)
Temporarily restricted net assets	(3,365)
	78,376
Less consideration paid	(35,412)
Contribution of unrestricted net assets	$ 42,964

The valuation of property and equipment, other current and long-term assets, including identifiable intangible assets, current and long-term liabilities and noncontrolling interest has been completed. In valuing these assets and liabilities acquired, fair values were based on, but not limited to, independent appraisals, discounted cash flows, replacement costs and actuarially determined values.

(In Thousands)

3. Acquisitions (continued)

Operating expenses for the year ended August 31, 2016, include costs related to the integration of Marianjoy into Northwestern Memorial, including transition costs of benefit plans, incentive plans and operating programs with other health practitioners, as well as costs of valuation and integration consulting.

The following are the operating results and changes in net assets attributable to KishHealth and Marianjoy since the dates of acquisition included in the accompanying consolidated statement of operations and changes in net assets for the year ended August 31, 2017:

Total operating revenue	$ 375,624
Excess of revenue over expenses	37,410
Change in unrestricted net assets	43,521
Change in temporarily restricted net assets	(126)

The following are the unaudited supplemental pro forma operating results of Northwestern Memorial as if the KishHealth and Marianjoy affiliations had occurred on September 1, 2015:

	Year Ended August 31, 2016
Total operating revenue	$ 4,470,588
Operating income	244,997
Excess of revenue over expenses attributable to NMHC and subsidiaries	329,608

The pro forma information provided should not be construed to be indicative of Northwestern Memorial's results of operations had the acquisitions been consummated on September 1, 2015, and is not intended to project Northwestern Memorial's results of operations for any future period.

(In Thousands)

4. Investments and Other Financial Instruments

The composition of investments, including assets limited as to use, and cash and cash equivalents and short-term investments, at August 31 is as follows:

	2017	2016
Measured at fair value:		
Cash and short-term investments	**$ 321,507**	$ 351,099
Mutual funds	**228,599**	415,364
Corporate bonds	**312,980**	143,740
U.S. government and agency issues	**268,858**	264,074
Equity securities	**220,543**	234,344
Other fixed income	**13,393**	202
	1,365,880	1,408,823
Investments using net asset value as practical expedient:		
Common collective trusts and commingled funds	**685,948**	703,072
Interest in 103-12 investment entities	**291,304**	232,998
	977,252	936,070
Accounted for under the equity method:		
Alternative investments	**3,572,894**	3,023,697
	$ 5,916,026	$ 5,368,590

Investments, including assets limited as to use, and cash and cash equivalents and short-term investments, consist of the following at August 31:

	2017	2016
Assets limited as to use:		
Trustee-held funds	**$ 67,082**	$ 90,473
Self-insurance programs	**579,780**	572,661
Board-designated funds	**181,417**	176,268
Total assets limited as to use	**828,279**	839,402
Donor-restricted funds	**337,025**	319,544
Unrestricted, undesignated funds	**4,461,574**	3,981,007
Total investments, excluding short-term investments	**5,626,878**	5,139,953
Other financial instruments:		
Cash and cash equivalents and short-term investments	**289,148**	228,637
	$ 5,916,026	$ 5,368,590

(In Thousands)

4. Investments and Other Financial Instruments (continued)

The composition and presentation of investment returns are as follows for the years ended August 31:

	2017	2016
Interest and dividend income	**$ 25,135**	$ 39,222
Investment expenses	**(5,613)**	(4,516)
Realized gains on alternative investments, net	**123,759**	34,924
Realized gains on other investments, net	**62,870**	4,565
Net change in unrealized gains on alternative investments	**348,167**	18,886
Net increase in unrealized gains on other investments	**115,062**	76,705
Change in value of joint ventures	**497**	428
	$ 669,877	$ 170,214
Reported as:		
Rental and other revenue	**$ 557**	$ 1,921
Nonoperating investment return	**655,269**	155,708
Temporarily restricted – investment return	**14,051**	12,585
	$ 669,877	$ 170,214

Northwestern Memorial's investments measured at fair value include mutual funds; common equities; corporate and U.S. government debt issues; state, municipal and foreign government debt issues; commingled funds; common collective trusts and 103-12 entities.

Commingled investments, common collective trusts and 103-12 entities are commingled funds formed from the pooling of investments under common management. Unlike a mutual fund, these investments are not registered investment companies; therefore, are exempt from registering with the Securities and Exchange Commission.

The investment strategy for the mutual funds, commingled funds, common collective trusts and 103-12 entities involves maximizing the overall long-term return by investing in a wide variety of assets, including domestic large cap equities, domestic small cap equities, international developed equities, blended equities (i.e., a mix of domestic and international equities), natural resources and private investment limited partnerships (LPs).

4. Investments and Other Financial Instruments (continued)

Northwestern Memorial's non-pension plan investments measured under the equity method of accounting include absolute return hedge funds, equity long/short hedge funds, real estate, natural resources and LPs, collectively referred to as alternative investments. Alternative investments in the pension plan assets are measured at fair value.

Absolute return hedge funds include funds with the ability to opportunistically allocate capital among several strategies. Generally, these funds diversify across strategies in an effort to deliver consistently positive returns regardless of the movement within global markets, exhibit relatively low volatility and are redeemable quarterly with a 60-day notice period. Equity long/short hedge funds include hedge funds that invest both long and short in U.S. and international equities. These funds typically focus on diversifying or hedging across particular sectors, regions, or market capitalizations and are generally redeemable quarterly with a 60-day notice period. Absolute return and equity long/short managers are redeemable quarterly or annually with a 45- to 90-day notice period.

Real estate includes LPs that invest in land and buildings and seek to improve property level operations by increasing lease rates, recapitalizing properties, rehabilitating aging/distressed properties and repositioning properties to maximize revenues. Real estate LPs typically use moderate leverage. Natural resources include a diverse set of LPs that invest in oil and natural gas-related companies, commodity-oriented companies and timberland. Private equity includes LPs formed to make equity and debt investments in operating companies that are not publicly traded. These LPs typically seek to influence decision-making within the operating companies. Investment strategies in this category may include venture capital, buyouts and distressed debt. These three categories of investments cannot be redeemed with the funds. Distributions from each fund will be received as the underlying assets of the fund are expected to be liquidated periodically over the lives of the LPs, which generally run 10 to 12 years.

Because of the timing of the preparation and delivery of financial statements for limited partnership investments, the use of the most recently available financial statements provided by the general partners results in a two month delay in the inclusion of the limited partnership results in Northwestern Memorial's consolidated statements of operations and changes in net assets due to results recorded based on June 30 investment statements. Due to this delay, these consolidated financial statements do not yet reflect the market conditions experienced in the last two months of the fourth quarter of fiscal 2017 or 2016 for the limited partnership investments.

4. Investments and Other Financial Instruments (continued)

As of August 31, 2017, $2,732,171 of alternative investments are subject to various redemption limits and lockup provisions, of which $2,172,743 expires within one year and $559,428 expires after one year from the balance sheet date.

At August 31, 2017, Northwestern Memorial had commitments to fund approximately an additional $945,000 to alternative investment entities, which is expected to occur over the next 12 years.

5. Fair Value Measurements

Northwestern Memorial follows the requirements of ASC 820, *Fair Value Measurements*, in regard to measuring the fair value of certain assets and liabilities, as well as disclosures about fair value measurements. ASC 820 defines fair value as the price that would be received for an asset or paid for a transfer of a liability in an orderly transaction on the measurement date.

The methodologies used to determine fair value of assets and liabilities reflect market participant objectives and are based on the applications of a three-level valuation hierarchy that prioritizes observable market inputs over unobservable inputs. 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. Examples of Level 2 inputs are quoted prices for similar assets or liabilities in inactive markets or pricing models with inputs that are observable for substantially the full term of the asset or liability.
- Level 3 – Inputs to the valuation methodology are significant to the fair value of the asset or the liability and less observable. These inputs reflect the assumptions market participants would use in the estimation of the fair value of the asset or the liability.

(In Thousands)

5. Fair Value Measurements (continued)

Fair Values

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

The following table presents the financial instruments measured at fair value on a recurring basis as of August 31, 2017:

	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	$ 258,463	$ –	$ –	$ 258,463
Investments:				
Short-term investments:				
Currency	27	–	–	27
Fixed income	30,658	–	–	30,658
Total short-term investments	30,685	–	–	30,685
Mutual funds:				
Fixed income	98,130	–	–	98,130
U.S. equities	130,469	–	–	130,469
Total mutual funds	228,599	–	–	228,599
Other fixed income	–	13,393	–	13,393
Bonds:				
Corporate bonds	–	312,980	–	312,980
U.S. government and agencies' issues	–	268,858	–	268,858
Total bonds	–	581,838	–	581,838
Equity securities	220,037	506	–	220,543
Cash equivalents in investment accounts	32,359	–	–	32,359
Total investments	511,680	595,737	–	1,107,417
Beneficial interests in trusts	–	14,203	–	14,203
Total assets measured on a recurring basis at fair value	$ 770,143	609,940	$ –	1,380,083
Investments recorded at fair value based on NAV				977,252
Total assets measured at fair value				$ 2,357,335
Liabilities				
Interest rate swaps	$ –	$ 112,586	$ –	$ 112,586

(In Thousands)

5. Fair Value Measurements (continued)

The following table presents the financial instruments measured at fair value on a recurring basis as of August 31, 2016:

	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	$ 218,163	$ –	$ –	$ 218,163
Investments:				
Short-term investments:				
Currency	27	–	–	27
Fixed income	10,447	–	–	10,447
Total short-term investments	10,474	–	–	10,474
Mutual funds:				
Fixed income	212,714	–	–	212,714
International equities	9,431	–	–	9,431
U.S. equities	193,219	–	–	193,219
Total mutual funds	415,364	–	–	415,364
Other fixed income	–	202	–	202
Bonds:				
Corporate bonds	–	143,740	–	143,740
U.S. government and agencies' issues	–	264,074	–	264,074
Total bonds	–	407,814	–	407,814
Equity securities	233,927	417	–	234,344
Cash equivalents in investment accounts	122,462	–	–	122,462
Total investments	782,227	408,433	–	1,190,660
Beneficial interests in trusts	–	13,181	–	13,181
Total assets measured on a recurring basis at fair value	$ 1,000,390	$ 421,614	$ –	1,422,004
Investments recorded at fair value based on NAV				936,070
Total assets measured at fair value				$ 2,358,074
Liabilities				
Interest rate swaps	$ –	$ 150,107	$ –	$ 150,107

(In Thousands)

5. Fair Value Measurements (continued)

There were no transfers into or out of Level 1 or Level 2 during the years ended August 31, 2017 or 2016.

Reconciliation to the Consolidated Balance Sheets

A reconciliation of the fair value of the assets to the consolidated balance sheets at August 31 is as follows:

	2017	2016
Short-term investments measured at fair value	**$ 30,685**	$ 10,474
Investments, including assets limited as to use measured at fair value	**2,053,984**	2,116,256
Total investments at fair value	**2,084,669**	2,126,730
Alternative investments accounted for under equity method included in investments, including assets limited as to use	**3,572,894**	3,023,697
Total investments	**$ 5,657,563**	$ 5,150,427
Other long-term assets:		
Beneficial interests in trusts at fair value	**$ 14,203**	$ 13,181
Other long-term assets, net	**175,018**	157,597
Total other long-term assets, net	**$ 189,221**	$ 170,778

Valuation Techniques and Inputs

Beneficial Interests in Trusts

The fair value of beneficial interests in trusts is based on Northwestern Memorial Foundation's (the Foundation) percentage of the fair value of the trusts' assets adjusted for any outstanding liabilities (discounted using a rate per Internal Revenue Service (IRS) regulations), based on each trust arrangement.

5. Fair Value Measurements (continued)

Interest Rate Swaps

The fair value of interest rate swaps is based on generally accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative and quoted prices from dealer counterparties and other independent market sources. The valuation incorporates observable interest rates and yield curves for the full term of the swaps. The valuation is also adjusted to incorporate nonperformance risk for Northwestern Memorial or the respective counterparty. The adjustment is based on the credit spread for entities with similar credit characteristics as Northwestern Memorial or market-related data for the respective counterparty. Northwestern Memorial pays various fixed rates and receives cash flows based on rates equal to a percentage of the London Interbank Offered Rate (LIBOR) plus a spread for certain interest rate swaps.

Investments

The fair value of Level 1 investments, which consist of equity securities and mutual funds, is based on quoted market prices that are valued on a daily basis. Level 2 investments consist of U.S. government securities, corporate bonds, commingled funds, common collective trusts, interest in 103-12 entities and fixed income instruments issued by municipalities and foreign government agencies. The fair value of the U.S. government and agency securities and corporate bonds is established based on values obtained from nationally recognized pricing services that value the investments based on similar securities and matrix pricing of similar quality and maturity securities. The fair values of commingled funds, common collective trusts and 103-12 entities are based on either the fair value of the underlying investments of the fund, as determined by the fund, or on the ownership interest in the NAV per share or its equivalent, of the respective fund.

Northwestern Memorial's investments are exposed to various kinds and levels of risk. Equity securities and equity mutual funds expose Northwestern Memorial to market risk, performance risk and liquidity risk. Market risk is the risk associated with major movements of the equity markets. Performance risk is the risk associated with a company's operating performance. Fixed income securities and fixed income mutual funds expose Northwestern Memorial to interest rate risk, credit risk and liquidity risk. As interest rates change, the value of many fixed income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness of market participants to buy and sell particular securities. Liquidity risk tends to be higher for equities

5. Fair Value Measurements (continued)

related to small capitalization companies and certain alternative investments. Due to the volatility in the capital markets, there is a reasonable possibility of subsequent changes in fair value, resulting in additional gains and losses in the near term.

The carrying values of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and other current liabilities and short-term borrowings are reasonable estimates of their fair values due to their short-term nature.

The fair value of the long-term debt portfolio, including the current portion, was $1,414,681 and $1,527,365 at August 31, 2017 and 2016, respectively. The fair value of this Level 2 liability is based on quoted market prices for the same or similar issues and the relationship of those bond yields with various market indices. The market data used to determine yield and calculate fair value represents Aa/AA-rated tax-exempt municipal health care bonds. The effect of third-party credit valuation adjustments, if any, is immaterial.

The fair value of pledges receivable, a Level 2 asset, is based on discounted cash flow analysis and approximates the carrying value of $42,241 and $40,343 at August 31, 2017 and 2016, respectively.

6. Investment in Joint Ventures

Northwestern Memorial has joint venture and operating partnership investment interests ranging from 30.0% to 50.0% in health-related businesses, as well as a 33.3% restricted interest in two non-health-related businesses that were donated to Northwestern Memorial. These investment interests are accounted for under the equity method of accounting, as Northwestern Memorial holds a 20% or more voting interest. The carrying value of the non-health-related investments of $7,811 and $8,455 at August 31, 2017 and 2016, respectively, is included in Investments, including assets limited to use, less current portion in the accompanying consolidated balance sheets.

The carrying value of the health-related investments of $23,144 and $23,841 at August 31, 2017 and 2016, respectively, is included in Other assets, net in the accompanying consolidated balance sheets. Net equity earnings from the health-related investments totaled $446 and $403 for the years ended August 31, 2017 and 2016, respectively, and are included in Investment return in the accompanying consolidated statements of operations and changes in net assets. The carrying value of these investments exceeds the underlying equity in net assets by $5,926, reflecting the fair value change recorded at the time of acquisition of Cadence and KishHealth.

(In Thousands)

6. Investment in Joint Ventures (continued)

The following is a summary of financial information as of and for the years ended August 31 relating to these investments:

	2017	2016
Current assets	**$ 77,343**	$ 93,904
Current liabilities	**31,834**	28,212
Net working capital	**45,509**	65,692
Property, plant, and equipment	**36,192**	37,825
Other long-term assets	**3,192**	3,348
Long-term liabilities	**32,950**	40,905
Net assets	**$ 51,943**	$ 65,960
Revenue	**$ 37,869**	$ 46,413
Expenses	**29,821**	37,162
Excess of revenue over expenses	**$ 8,048**	$ 9,251

Net equity earnings from the non-health-related investments totaled $2,304 and $1,083 for the years ended August 31, 2017 and 2016, respectively, and are included in Temporarily restricted net assets investment return in the accompanying consolidated statements of operations and changes in net assets. Northwestern Memorial made no capital contributions to such joint ventures for the years ended August 31, 2017 or 2016. Northwestern Memorial received cash distributions from such joint ventures of $4,067 and $3,759 for the years ended August 31, 2017 and 2016, respectively.

7. Self-Insurance Liabilities and Related Insurance Recoverables

Northwestern Memorial retains certain levels of professional and general liability risks. Northwestern Memorial also retain certain levels of workers' compensation risks through State of Illinois sanctioned self-insurance arrangements and through commercial insurance programs subject to large deductibles. For those self-insured risks, Northwestern Memorial has established revocable trust funds and a captive insurance company to pay claims and related costs. In addition, various insurance policies have been purchased to provide coverage in excess of self-insured limits.

7. Self-Insurance Liabilities and Related Insurance Recoverables (continued)

Northwestern Memorial's self-insurance liability and related amounts recoverable from reinsurers are reported in the accompanying consolidated balance sheets at present value based on an annual discount rate of 1.5% as of August 31, 2017 and 2016. This discount rate is based on several factors, including rolling averages of risk-free rates based on estimated payment patterns of the underlying liability. The undiscounted gross liabilities for the self-insured programs were $614,884 and $613,265 at August 31, 2017 and 2016, respectively. The undiscounted amounts recoverable from reinsurers were $88,543 and $80,149 at August 31, 2017 and 2016, respectively. Provisions for the professional and general liability risks are based on an actuarial estimate of losses using actual loss data adjusted for industry trends and current conditions and on an evaluation of claims by Northwestern Memorial's legal counsel. The provision for estimated self-insured claims includes estimates of ultimate costs for both reported claims and claims incurred but not reported.

In the opinion of management, based in part on the advice of outside actuaries, adequate provision has been made at August 31, 2017, for all claims incurred to date. Although there is considerable variability inherent in such estimates, management further believes that the ultimate disposition of these claims will not have a material adverse effect on the consolidated financial position of Northwestern Memorial.

8. Employee Benefits Obligations

There are two noncontributory defined benefit pension plans: Northwestern Memorial Hospital and Lake Forest Hospital (the Plans), maintained within Northwestern Memorial that cover specified employee groups. The sponsors for the Plans approved resolutions to amend the Plans effective at the end of the day on December 31, 2012. The amendments implemented a hard freeze, such that no participant will earn any additional or new benefits under the Plans on and after January 1, 2013.

(In Thousands)

8. Employee Benefits Obligations (continued)

The following table summarizes the change in the projected benefit obligation for the years ended August 31:

	2017	2016
Projected benefit obligation, beginning of year	**$ 646,693**	$ 585,369
Interest cost	**19,130**	26,120
Net actuarial (gain) loss	**(9,648)**	60,776
Benefits paid	**(26,400)**	(25,572)
Projected benefit obligation, end of year	**$ 629,775**	$ 646,693

The net actuarial gain in 2017 was caused primarily by the change in the discount rate used compared to prior years as well as an updated mortality table.

The following table summarizes the changes in the Plans' assets for the years ended August 31:

	2017	2016
Plan assets at fair value, beginning of year	**$ 679,342**	$ 679,761
Actual return on the Plans' assets, net of expenses	**95,395**	25,153
Benefits paid	**(26,400)**	(25,572)
Plan assets at fair value, end of year	**$ 748,337**	$ 679,342

The following table sets forth the Plans' funded status, as well as recognized amounts in the accompanying consolidated balance sheets as of August 31:

	2017	2016
Plan assets at fair value	**$ 748,337**	$ 679,342
Projected benefit obligation	**629,775**	646,693
Funded status recognized as prepaid pension cost	**$ 118,562**	$ 32,649

(In Thousands)

8. Employee Benefits Obligations (continued)

The funded status of the Northwestern Memorial Hospital plan was $111,015 and $43,488 for the years ended August 31, 2017 and 2016, respectively. The funded status for the Northwestern Lake Forest Hospital plan was $7,547 and $(10,839) for the years ended August 31, 2017 and 2016, respectively. When the projected benefit obligation is greater than the plan assets, the net liability is recorded in Other liabilities.

Included in unrestricted net assets are the Plans' amounts that have not yet been recognized in net periodic pension cost at August 31, as follows:

	2017	2016
Unrecognized actuarial loss	**$ 132,539**	$ 196,424

Changes in the Plans' assets and benefit obligations recognized in unrestricted net assets for the years ended August 31 include the following:

	2017	2016
Current year actuarial gain (loss)	**$ 60,122**	$ (78,126)
Recognized actuarial loss	**3,763**	1,459
	$ 63,885	$ (76,667)

The Plans' prior service cost and net actuarial gain included in unrestricted net assets expected to be recognized in net periodic pension cost during the year ending August 31, 2018 are $0 and $1,860, respectively.

Net periodic pension benefit included in operating results for the years ended August 31 consists of the following:

	2017	2016
Plan expenses	**$ 1,407**	$ 1,686
Interest cost of projected benefit obligation	**19,130**	26,120
Expected return on the Plans' assets	**(46,330)**	(46,517)
Recognized actuarial loss	**3,763**	1,459
Net periodic pension benefit	**$ (22,030)**	$ (17,252)

(In Thousands)

8. Employee Benefits Obligations (continued)

The following table sets forth the discount rate assumptions used to determine the projected benefit obligation and benefit cost as of August 31:

	2017	2016
Used to determine projected benefit obligation		
Discount rate – Northwestern Memorial Hospital	**3.86%**	3.67%
Discount rate – Northwestern Lake Forest Hospital	**3.90**	3.73
Used to determine benefit cost		
Discount rate – Northwestern Memorial Hospital	**3.67%**	4.55%
Discount rate – Northwestern Lake Forest Hospital	**3.73**	4.55
Expected long-term rate of return on the Plans' assets	**7.00**	7.00

The expected long-term rate of return on assets is determined based on a capital market asset model, which assumes that future returns are based on long-term, historical performance as adjusted for contemporary dividend yields. The adjusted historical returns were weighted by the current long-term asset allocation targets and reduced by 100 basis points to produce a more normal risk premium. Northwestern Memorial's investment advisor assisted with the analysis.

At August 31, 2016, Northwestern Memorial changed the discount rate method used to measure the service and interest cost starting in fiscal 2017 to the spot rate approach from the yield curve methodology used historically. This change had no impact on the fiscal 2016 projected benefit obligation. This method does not apply to the service cost as both plans have been frozen, but results in different discount rates utilized for purposes of measuring the interest cost of the two plans as shown above. Northwestern Memorial has made this change to provide a more precise measurement of interest costs by improving the correlation between projected benefit cash flows to the corresponding spot yield curve rates. The future impact of this change is expected to be nominal.

The Plans' asset allocation and investment strategies are designed to earn returns on plan assets consistent with a reasonable and prudent level of risk. Investments are diversified across classes, sectors and manager style to minimize the risk of loss. Northwestern Memorial uses professional investment managers specializing in each asset category and, where appropriate, provides the investment managers with specific guidelines that include allowable and/or prohibited investment types. Northwestern Memorial regularly monitors manager performance and compliance with investment guidelines.

(In Thousands)

8. Employee Benefits Obligations (continued)

The target allocation of the Plans' assets as of August 31 is as follows:

	2017	2016
Equity securities	**51%**	49%
Alternative investments	**37**	41
Fixed income	**12**	10
	100%	100%

The following table presents the Plans' financial instruments as of August 31, 2017, measured at fair value on a recurring basis by the valuation hierarchy described in Note 5:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	**$ 508**	**$ –**	**$ –**	**$ 508**
U.S. government securities	**–**	**8,358**	**–**	**8,358**
Corporate debt:				
Preferred	**–**	**839**	**–**	**839**
Other	**–**	**12,881**	**–**	**12,881**
Total corporate debt	**–**	**13,720**	**–**	**13,720**
Equity securities:				
U.S. equities	**18,971**	**155**	**–**	**19,126**
Mutual funds:				
Fixed income	**64,103**	**–**	**–**	**64,103**
U.S. equities	**18,484**	**–**	**–**	**18,484**
Total mutual funds	**82,587**	**–**	**–**	**82,587**
Total assets measured on recurring basis at fair value	**$ 102,066**	**$ 22,233**	**$ –**	**124,299**
Investments recorded at fair value based on NAV				**624,038**
Total assets measured at fair value				**$ 748,337**

(In Thousands)

8. Employee Benefits Obligations (continued)

The following table presents the Plans' financial instruments as of August 31, 2016, measured at fair value on a recurring basis by the valuation hierarchy described in Note 5:

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	$ 232	$ –	$ –	$ 232
U.S. government securities	–	8,597	–	8,597
Corporate debt:				
Preferred	–	354	–	354
Other	–	10,633	–	10,633
Total corporate debt	–	10,987	–	10,987
Equity securities:				
U.S. equities	24,420	125	–	24,545
Mutual funds:				
Fixed income	54,717	–	–	54,717
International equities	1,084	–	–	1,084
U.S. equities	35,583	–	–	35,583
Total mutual funds	91,384	–	–	91,384
Total assets measured on recurring basis at fair value	$ 116,036	$ 19,709	$ –	135,745
Investments recorded at fair value based on NAV				543,597
Total assets measured at fair value				$ 679,342

8. Employee Benefits Obligations (continued)

The fair value of Level 1 investments, which consist of equity securities and certain mutual funds, is based on quoted market prices that are valued on a daily basis. Level 2 investments consist of U.S. government securities, corporate bonds and U.S. equities. The fair value of the U.S. government securities and corporate bonds is established based on values obtained from nationally recognized pricing services that value the investments based on similar securities and matrix pricing of similar quality and maturity securities.

Included in the other pension investments are commingled funds, common collective trusts, 103-12 entities and alternative investments (principally limited partnership interests in hedge, private equity, real estate and natural resources funds) for which the fair values are based on NAV. The fair values of the commingled funds, common collective trusts, and 103-12 entities are based on the Master Trust's ownership interest in the NAV per share of its equivalent of the respective fund.

The fair values of the securities held by limited partnerships that do not have readily determinable fair values are determined by the general partner taking into consideration, among other things, the financial performance of underlying investments, recent sales prices of underlying investments and other pertinent information. In addition, actual market exchanges at period-end provide additional observable market inputs of the exit price. NAV is calculated by the investment's management monthly for all of the Master Trust's alternative investments other than limited partnerships, whose NAV is calculated on a quarterly basis. 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 Plans' 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.

Investments in LPs, which cannot be redeemed on request, totaled $69,911 as of August 31, 2017. Certain marketable alternative investments are subject to various redemption restrictions. As of August 31, 2017, $414,620 of alternative investments is subject to various redemption limits and lockup provisions, of which $369,338 expires within one year and $45,282 expires after one year from the balance sheet date.

(In Thousands)

8. Employee Benefits Obligations (continued)

The Plans' assets are managed solely in the interest of the Plans' participants and their beneficiaries. The assets are invested with the investment objective of funding the accumulated and projected retirement benefit obligations of the Plans consistent with the Plans' long-term rate-of-return assumption. A time horizon of greater than five years is assumed; therefore, interim volatility in returns is regarded with appropriate perspective.

Northwestern Memorial has no current plans to contribute to the Plans during the year ending August 31, 2018.

Benefit payments, which reflect future service, as appropriate, are expected to be paid as follows:

Year ending August 31:	
2018	$ 33,814
2019	30,162
2020	31,464
2021	32,580
2022	33,112
2023–2027	177,910

Northwestern Memorial also maintains defined contribution plans covering substantially all of its full-time and part-time employees. Participants can make voluntary tax-deferred contributions to the plans, subject to certain IRS limitations. Northwestern Memorial contributes a specified percentage of eligible compensation to the plans on behalf of each participant. Participants are always fully vested in their own tax-deferred contributions and related earnings and become fully vested in Northwestern Memorial contributions and related earnings upon completion of vesting service. Employer contributions related to these defined contribution plans, included in Employee benefits expense in the accompanying consolidated statements of operations and changes in net assets totaled $100,388 and $88,042 in 2017 and 2016, respectively.

NMHC also maintains other noncontributory postretirement benefit plans (the Noncontributory Plans) for certain executive employees.

Included in unrestricted net assets is an unrecognized actuarial loss of $998 and $1,369 at August 31, 2017 and 2016, respectively, for the Noncontributory Plans that has not yet been recognized in net periodic pension cost.

(In Thousands)

8. Employee Benefits Obligations (continued)

Changes in the Noncontributory Plans' assets and benefit obligations recognized in unrestricted net assets include the following:

	2017	2016
Current year actuarial loss	**$ (643)**	$ (1,485)
Recognized actuarial net loss (gain)	**1,642**	(919)
	$ 999	$ (2,404)

As of August 31, 2017 and 2016, the Noncontributory Plans' unfunded projected benefit obligation amounted to $21,328 and $20,390, respectively, and is included in Other liabilities in the accompanying consolidated balance sheets. The Noncontributory Plans' actuarial loss included in unrestricted net assets expected to be recognized in net periodic pension cost during 2017 is $399.

The following table sets forth the discount rate assumptions used to determine the projected benefit obligation as of August 31:

	2017	2016
Used to determine projected benefit obligation		
Discount rate – Supplemental Retirement Plan	**1.60%**	1.74%
Discount rate – Executive Postretirement Health and Dental Plan	**3.20**	2.88

(In Thousands)

9. Long-Term Debt

Long-term debt consists of the following at August 31:

	2017	2016
Revenue Bonds, Series 2015A and 2015B (KishHealth System), payable in monthly installments through March 1, 2035 (fixed coupon rate of 2.80%)	**$ 11,158**	$ 11,642
Revenue Bonds, Series 2013 (NMHC), payable in annual installments beginning August 15, 2031 through August 15, 2043 (fixed coupon rates from 4.00% to 5.00%)	**111,235**	111,235
Revenue Bonds, Series 2011A and 2011B (CDH), with interest at a variable rate payable in annual installments through November 1, 2038 (weighted average interest rate of 0.98% and 0.67% for the twelve months ended August 31, 2017 and 2016, respectively)	**116,300**	117,950
Revenue Bonds, Series 2011C (Delnor), with interest at a variable rate payable in annual installments through November 1, 2038 (weighted average interest rate of 0.92% and 0.78% for the twelve months ended August 31, 2017 and 2016, respectively)	**56,595**	57,070
Revenue Bonds, Series 2009A (NMH), payable in annual installments through August 15, 2039 (fixed coupon rates range from 5.00% to 6.00%)	**291,760**	299,220
Revenue Bonds, Series 2009B (NMH), payable in annual installments through August 15, 2030 (fixed coupon rates range from 5.00% to 5.75%)	**37,700**	39,930
Revenue Bonds, Series 2009 (CDH) payable in annual installments through November 1, 2039 (fixed coupon rates range from 5.00% to 5.25%)	**84,165**	86,255
Revenue Bonds, Series 2009B (CDH) payable in annual installments through November 1, 2039 (fixed coupon rates range from 4.00% to 5.75%)	**215,330**	221,565
Variable Rate Demand Revenue Bonds, Series 2008A (NMH), payable in annual installments through August 15, 2038 (weighted average interest rate was 0.68% and 0.15% for the twelve months ended August 31, 2017 and 2016, respectively)	**74,250**	78,775
Variable Rate Demand Revenue Bonds, Series 2007A (NMH), payable in annual installments through August 15, 2042 (weighted average interest rate was 0.73% and 0.19% for the twelve months ended August 31, 2017 and 2016, respectively)	**204,700**	206,000

(In Thousands)

9. Long-Term Debt (continued)

	2017	2016
Revenue Bonds, Series 2003A–Series 2003C (Delnor) payable in annual installments through May 15, 2033 (fixed coupon rates range from 5.00%–5.25%)	**$ 19,950**	$ 22,350
Variable Rate Demand Revenue Bonds, Series 2002C (NMH) (weighted average interest rate was 0.15% for the twelve months ended August 31, 2016), paid off on October 4, 2016	**–**	27,450
Revenue Bonds, Series 2002A–Series 2002D (Delnor) payable in annual installments beginning May 15, 2020 through May 1, 2032 (fixed coupon rate of 5.25%)	**35,000**	35,000
Delnor medical office building loan, interest fixed at 6.34%, paid off on July 3, 2017	**–**	13,548
NMHC variable rate note dated October 4, 2016, matures October 4, 2019 (weighted average interest rate of 1.31% and 0.95% for the twelve months ended August 31, 2017 and 2016, respectively)	**105,000**	105,000
The Midland Surgical Center, LLC line of credit due July 10, 2019, interest payments required monthly at a variable rate not less than 3.75%, and loan with maturity date of December 10, 2018	**357**	449
NMHC line of credit (weighted average interest rate of 1.08% for the twelve months ended August 31, 2016)	**–**	59,750
NMHC commercial paper dated October 4, 2016 (weighted average interest rate of 0.97% for the ten months ended August 31, 2017)	**87,299**	–
	1,450,799	1,493,189
Less:		
Unamortized discount, net and debt issuance costs	**8,485**	7,899
Current maturities	**30,239**	29,565
Long-term debt subject to short-term remarketing agreements	**–**	318,795
Line of credit, included in Accrued expenses and other current liabilities	**–**	59,750
Commercial paper, included in Short-term debt	**87,299**	–
	$ 1,324,776	$ 1,077,180

9. Long-Term Debt (continued)

Per the Amended and Restated Master Trust Indenture dated as of May 1, 2004, as supplemented and amended (the NMHC Master Indenture), the Obligated Group includes NMHC, NMH, Northwestern Lake Forest Hospital (NLFH), Central DuPage Hospital (CDH), Cadence, Delnor-Community Hospital (Delnor), Cadence Physician Group (CPG), the Foundation, Northwestern Medical Faculty Foundation d/b/a Northwestern Medical Group (NMG), Northwestern Foundation for Research and Education d/b/a Northwestern Medical Group Management Services (NMGMS), and Lake Forest Health and Fitness Institute (HFI), with Wells Fargo Bank, N.A., as master trustee. Supplemental Master Trust Indentures were issued so that all the debt as of November 30, 2014, is either secured or guaranteed by the NMHC Obligated Group.

Effective December 18, 2015, KishHealth, Kishwaukee Community Hospital, Valley West Community Hospital and Kishwaukee Physician Group, Inc. became members of the Obligated Group created under the NMHC Master Indenture. The Series 2015A and Series 2015B Bonds were restructured and secured by direct note obligations within the NMHC Obligated Group. The KishHealth system’s Illinois Finance Authority Hospital Revenue Refunding Bonds, Series 2008, were legally defeased by placing sufficient assets in escrow funded by a debt reserve fund and a draw of $59,750 on a Northwestern Memorial line of credit, resulting in a loss on extinguishment of $4,030 for the year ended August 31, 2016.

Effective May 31, 2016, Marianjoy Inc., Marianjoy Rehabilitation Hospital & Clinic, Inc., Rehabilitation Medicine Clinic, Inc. and Marianjoy Foundation, Inc. became members of the Obligated Group created under the NMHC Master Indenture.

On September 1, 2017, NMHC implemented a number of actions to streamline its organization structure; some of which impacted members of the Obligated Group. LivingWell Cancer Resource Center was merged into CPG; Marianjoy, Inc. was merged into NMHC; NMGMS was merged into NMG; Delnor-Community Residential Living, Inc. d/b/a Delnor Glen merged into Delnor; Marianjoy Foundation was dissolved, transferring assets to the Foundation; and Tri-Cities Surgery Center, LLC was dissolved, transferring assets to Delnor. None of these actions had a material impact on the Obligated Group or any impact on the accompanying consolidated financial statements.

Northwestern Memorial had lines of credit of $50,000 and $80,000 that were to expire in May 2019 and September 2018, respectively. At August 31, 2016, Northwestern Memorial had drawn $59,750 on the $80,000 line of credit and restricted $467 of the $50,000 line to secure a letter of

(In Thousands)

9. Long-Term Debt (continued)

credit. The remaining amounts were available for operations. In October 2016, the lines of credit in the amounts of $50,000 and $80,000 were replaced with two $65,000 lines of credit. At August 31, 2017, Northwestern Memorial had restricted $1,556 of one of the $65,000 lines of credit to secure a letter of credit. Northwestern Memorial has the option to borrow at various rates expressed as an adjustment to LIBOR, prime rate or other bank-offered rates. At August 31, 2017, no amounts were borrowed under the lines of credit.

Northwestern Memorial has standby bond purchase agreements (SBPAs) with multiple banks that cover all of its variable rate demand revenue bonds (VRDBs). The short-term credit rating for each series of VRDBs is based on the respective bank's short-term credit rating. The long-term credit rating for each series of VRDBs is based on Northwestern Memorial's long-term credit rating. Changes in credit ratings may impact the interest paid on or remarketing of the VRDBs. The banks provide liquidity support in the event of a failed remarketing as follows:

	Par Value	Expiration Date
Series 2007A-2, 2007A-4	$ 102,350	October 2019
Series 2008A	74,250	October 2020
Series 2007A-1, 2007A-3	102,350	October 2020

The SBPAs include reporting and financial requirements and other covenants. If an SBPA is not renewed or replaced prior to its expiration, or if some portion, or all, of the related VRDBs are not successfully remarketed (failed remarketing) during the term of the SBPAs, the related VRDBs convert to a term loan at the earlier of the expiration date of the related SBPA or after 90 consecutive days of failed remarketing. The principal payment on the term loan would then be payable over a three-year term. The earliest principal payment on any term loan associated with the bonds is 367 days from the initial failed remarketing date. Therefore, the VRDBs, all SBPAs with maturities greater than one year less any current portion, are classified as long-term debt in the accompanying consolidated balance sheets.

CDH and Delnor Series 2011A, 2011B, and 2011C Revenue Bonds, which are classified as long-term due to their long-term amortization periods, have one-year remarketing periods that occur at staggered dates throughout the year. The bondholders are required to hold the bonds for additional one year periods, unless notice of their intent to put the bonds to the NMHC Obligated Group is

(In Thousands)

9. Long-Term Debt (continued)

given not less than 150 days prior to the end of the remarketing date. To the extent that bondholders may, under the terms of the debt, put their bonds within a maximum of 12 months after August 31, 2017, the principal amount of such bonds has been classified as a current obligation in the accompanying consolidated balance sheets. Management believes the likelihood of a material amount of bonds being put to the NMHC Obligated Group is remote.

Scheduled principal repayments for the next five years, assuming remarketing of variable rate debt, on long-term debt are as follows:

Year ending August 31:	
2018	$ 30,239
2019	31,570
2020	33,125
2021	34,731
2022	36,536

The provisions under the respective debt agreements require the Obligated Group to maintain reporting, financial, and other covenants. At August 31, 2017, the Obligated Group was in compliance with these provisions.

Northwestern Memorial paid interest of $49,475 and $47,897 in 2017 and 2016, respectively (which includes $7,266 and $8,884, respectively, for net swap payments included in Interest expense in the accompanying consolidated statements of operations and changes in net assets). Northwestern Memorial capitalized interest of $18,703 and $10,772 in 2017 and 2016, respectively.

In October 2016, the SBPAs for the $103,000 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Subseries 2007A-1 and Subseries 2007A-3 (NMH) and for the $78,775 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2008A (NMH) were each extended for four years. The SBPA for the $103,000 Illinois Finance Authority Variable Rate Demand Revenue Bonds, Subseries 2007A-2 and Subseries 2007A-4 was replaced by a new standby bond purchase agreement provider. At August 31, 2016, the expiration date for these SBPAs was less than one year from the consolidated balance sheet date and as such the related debt was classified as short-term.

9. Long-Term Debt (continued)

In October 2016, the Illinois Finance Authority Variable Rate Demand Revenue Bonds, Series 2011A, 2011B, and 2011C (CDH-Delnor Health System) in the aggregate amount of $175,020 were purchased by different banks at variable rates for a period of seven years, five years, and three years, respectively.

In October 2016, the existing $105,000 CDH-Delnor Health System variable rate note was replaced with a $105,000 NMHC variable rate note with a different lender and extended to 2019.

In October 2016, NMHC issued commercial paper in the aggregate amount of $87,299. Proceeds were used to redeem all outstanding $27,450 NMH Series 2002C Bonds and pay down a $59,750 NMHC line of credit.

In July 2017, Northwestern Memorial paid Morton Bank $13,534 to extinguish the existing Delnor medical office building loan.

On August 30, 2017, Northwestern Memorial gave notice that it was evaluating the refunding of all or a portion of the outstanding bonds issued for the benefit of the Obligated Group through the issuance of tax-exempt or taxable bonds, other indebtedness or other funds (collectively, the Bonds). On November 30, 2017, a Preliminary Official Statement (POS) was circulated in which such a refunding of certain bonds and a plan of finance is outlined. There is no assurance that the proposed transaction will occur in the format outlined in the POS or at all.

10. Derivatives

Northwestern Memorial's only derivative financial instruments are interest rate swaps approximately equal to its Series 2007A and Series 2011A-C variable rate bonds for the sole purpose of risk management. These bonds expose Northwestern Memorial to variability in interest payments due to changes in interest rates. To manage fluctuations in cash flows resulting from interest rate risk, Northwestern Memorial entered into various interest rate swap agreements. These swaps limit the variable rate cash flow exposure on the variable rate bonds to synthetically fixed cash flows. By using interest rate swaps to manage the risk of changes in interest rates, Northwestern Memorial exposes itself to credit risk and market risk. Credit risk is the risk that a counterparty will fail to perform under the terms of a derivative contract. When the fair value of a swap is positive, the counterparty owes Northwestern Memorial, which creates credit risk for Northwestern Memorial. When the fair value of a swap is zero or negative, the counterparty does not owe Northwestern Memorial. Northwestern Memorial minimizes the credit risk in its swap contracts by entering into transactions that require the counterparty to post collateral for the benefit of Northwestern Memorial based on the credit rating of the counterparty and the fair value of the swap contract or whose cash flows are insured by a third party. The aggregate fair value liability of the swaps in the accompanying consolidated balance sheets

(In Thousands)

10. Derivatives (continued)

as of August 31, 2017 and 2016, reflects a reduction of $3,555 and $4,707, respectively, for nonperformance risk. Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. Management also mitigates risk through periodic reviews of its swap positions in the context of their total blended cost of capital.

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

2017	2016	Maturity	Rate Paid	Rate Received
$ 102,350	$ 103,000	Aug-42	3.89%	63% of 1-Month LIBOR + 28 bps
102,350	103,000	Aug-42	3.89	63% of 1-Month LIBOR + 28 bps
61,650	62,175	Nov-38	3.82	67% of 3-Month LIBOR
61,650	62,175	Nov-38	3.52	67% of 3-Month LIBOR
35,000	35,000	May-32	4.18	67% of 1-Month LIBOR
19,950	22,350	May-33	2.89	67% of 1-Month LIBOR
$ 382,950	$ 387,700			

The fair value of derivative instruments at August 31 is as follows:

	Balance Sheet Location	Liabilities 2017	Liabilities 2016
Derivatives not designated as hedging instruments:			
Interest rate contracts	Interest rate swaps	**$ 112,586**	$ 150,107

(In Thousands)

10. Derivatives (continued)

The effects of derivative instruments on the accompanying consolidated statements of operations and changes in net assets for August 31 are as follows:

	Amount of Loss Recognized in Excess of Revenue Over Expenses on Derivatives	
Interest Rate Contracts	**2017**	**2016**
Derivatives not designated as hedging instruments:		
Operating expense – interest	**$ (7,266)**	$ (8,884)
Nonoperating – change in fair value of interest rate swaps	**37,521**	(37,212)

Northwestern Memorial's derivative instruments contain provisions that require Northwestern Memorial's debt to maintain an A- or better credit rating from Standard & Poor's and an A3 or better rating from Moody's. If Northwestern Memorial's debt were to fall below those levels, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. Northwestern Memorial has posted collateral of $330 and $24,203 as of August 31, 2017 and 2016, respectively. If the credit risk-related contingent features underlying these agreements were triggered to the fullest extent on August 31, 2017, Northwestern Memorial would be required to post $115,811 of collateral to its counterparties.

In October 2016, three of the four interest rate swaps were novated under the same notional amounts and contract terms to a new counterparty. As a result of this transaction, none of the novated swaps require collateral, leaving only one remaining swap subject to a collateral requirement.

11. Goodwill and Other Intangible Assets

Goodwill has been recorded for the excess of purchase price over fair value of assets purchased in business acquisitions of several medical practices. Northwestern Memorial has goodwill of $25,115 and $24,701 included in Other assets, net at August 31, 2017 and 2016, respectively. There were no impairments of goodwill in the years ended August 31, 2017 or 2016.

(In Thousands)

11. Goodwill and Other Intangible Assets (continued)

The fair value of in-place leases is the present value associated with re-leasing the in-place lease as if the property was vacant. The value of at market in-place leases is amortized as amortization expense over the expected life of the lease. Above-market and below-market lease values for acquired properties are recorded based upon the present value of the difference between the contractual amounts to be paid pursuant to the in-place leases and management's estimates of the fair market lease rates for comparable leases. The values of above- and below-market leases are recorded as an adjustment to rental revenue over the remaining terms of the leases.

The following table summarizes Northwestern Memorial's identifiable intangible asset balances as of August 31, which are included in Other assets, net on the accompanying consolidated balance sheets:

	2017		
	Gross Carrying Value	**Accumulated Amortization**	**Net Carrying Amount**
Amortized intangible assets:			
In-place leases	**$ 14,580**	**$ (9,736)**	**$ 4,844**
Above-market leases	**308**	**(192)**	**116**
Total intangible assets	**$ 14,888**	**$ (9,928)**	**$ 4,960**
Below-market lease intangibles	**$ (7,861)**	**$ 4,690**	**$ (3,171)**

	2016		
	Gross Carrying Value	**Accumulated Amortization**	**Net Carrying Amount**
Amortized intangible assets:			
In-place leases	$ 14,604	$ (6,949)	$ 7,655
Above-market leases	309	(294)	15
Total intangible assets	$ 14,913	$ (7,243)	$ 7,670
Below-market lease intangibles	$ (7,861)	$ 3,268	$ (4,593)

11. Goodwill and Other Intangible Assets (continued)

Amortization expense, which is included in Depreciation and amortization, was $2,632 and $3,375 for the years ended August 31, 2017 and 2016, respectively. The estimated amortization expense for intangible assets subject to amortization for each of the years ending August 31, 2018 through 2022 is as follows: $2,246, $1,727, $540, $199 and $76.

12. Income Tax Status

Each of the NMHC not-for-profit entities is qualified under the Internal Revenue Code (the Code) as a tax-exempt organization and is exempt from tax on income related to its tax-exempt purposes under Section 501(a) of the Code. Accordingly, no income taxes are provided for the majority of the income in the accompanying consolidated financial statements for these corporations. Certain corporations had unrelated business income (UBI) generated primarily from the sale of certain services that are not directly related to patient care and through limited partnerships within the investment portfolio. Certain corporations have unused net operating loss carryforwards available to offset the UBI tax. The net operating loss carryforwards expire through 2036. The deferred tax assets associated with these net operating loss carryforwards of $6,802 and $6,186 at August 31, 2017 and 2016, respectively, are offset by valuation allowances on the accompanying consolidated balance sheets of $6,802 and $6,186, respectively. The total net operating loss carryforwards at August 31, 2017 and 2016 were $16,938 and $15,469, respectively.

NMHC calculates income taxes for its taxable subsidiaries. Taxable income differs from pretax book income principally due to certain income and deductions for tax purposes being recorded in the consolidated financial statements in different periods. Deferred income tax assets and liabilities are recorded for the tax effect of these differences using enacted tax rates for the years in which the differences are expected to reverse.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent on the generation of future taxable income during the periods in which those temporary differences become deductible.

The Cayman Islands government imposes no tax on income or capital gains. However, such corporations are subject to U.S. federal corporate taxation to the extent that they generate net income that is effectively connected with a U.S. trade or business. These corporations were not engaged in any such trade or business in the U.S. during fiscal years 2017 or 2016. Therefore, no income tax provision has been recorded related to these corporations and their operations.

(In Thousands)

12. Income Tax Status (continued)

Provisions for federal and state income taxes of $13,010 and $8,897 for the years ended August 31, 2017 and 2016, respectively, are included within Other in Nonoperating gains (losses) in the accompanying consolidated statements of operations and changes in net assets.

13. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at August 31:

	2017	**2016**
Health care services:		
Purchase of property and equipment	**$ 26,273**	$ 30,228
Operating expenses and charity care	**96,462**	89,874
Research, education, and other	**98,182**	91,667
	$ 220,917	$ 211,769

Net assets were released from donor restrictions by incurring expenditures for the following purposes in the years ended August 31:

	2017	**2016**
Health care services:		
Purchase of property and equipment	**$ 6,279**	$ 15,858
Clinical expenses and charity care	**16,167**	10,612
Research, education, and other	**18,692**	18,261
	$ 41,138	$ 44,731

(In Thousands)

13. Temporarily and Permanently Restricted Net Assets (continued)

Net assets released from donor restrictions reported in the statements of operations and changes in net assets were recorded as follows for the years ended August 31:

	2017	2016
Net assets released from donor restrictions and federal and state grants	**$ 17,916**	$ 17,452
Nonoperating other	**16,943**	11,421
	$ 34,859	$ 28,873

Permanently restricted net assets are summarized below, the income from which is expendable to support the following for the years ended August 31:

	2017	2016
Health care services:		
Purchase of property and equipment	**$ 14,304**	$ 14,387
Operating expenses and charity care	**64,412**	76,001
Research, education, and other	**96,364**	71,523
	$ 175,080	$ 161,911

Northwestern Memorial's endowment consists of individual donor-restricted funds established for a variety of purposes. Net assets associated with endowment funds are classified and reported based on the donor-imposed restrictions.

Northwestern Memorial has interpreted the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA), as adopted by the state of Illinois, 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, Northwestern Memorial classifies as permanently restricted net assets the original value of gifts donated to the permanent endowment, the original value of subsequent gifts to the permanent endowment, and accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time. The remaining portion of the donor-restricted endowment fund that is not classified as permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure, consistent with the donor intent or, where silent, the standard of prudence prescribed by UPMIFA.

13. Temporarily and Permanently Restricted Net Assets (continued)

In accordance with UPMIFA, Northwestern Memorial considers the following factors in making a determination to appropriate or accumulate donor-restricted funds:

- The duration and preservation of the fund
- The purposes of Northwestern Memorial and the endowment fund
- General economic conditions
- The possible effects of inflation and deflation
- The expected total return from investment income
- Other resources of Northwestern Memorial
- The investment policies of Northwestern Memorial

Northwestern Memorial has adopted investment and spending policies for endowment assets designed to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that must be held in perpetuity or for a donor-specified period. Under this policy, endowment assets are allocated a fixed annual return, which is currently set at 6%.

Northwestern Memorial has a policy that generally limits annual spending from endowment funds to 4% of the endowment fund balance at the midpoint of the preceding fiscal year. In establishing this policy, Northwestern Memorial considered the long-term expected return on its endowment. Accordingly, over the long term, Northwestern Memorial expects the spending policy to allow its endowment to grow at an average annual rate of 2%. This is consistent with its objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specific term, as well as to provide additional real growth through new gifts and investment return.

(In Thousands)

13. Temporarily and Permanently Restricted Net Assets (continued)

The changes in endowment net assets for the years ended August 31, 2017 and 2016 are summarized below:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, September 1, 2015	$ 55,431	$ 160,775	$ 216,206
Contributions	225	1,330	1,555
Contribution – KishHealth net assets	–	601	601
Change in value of trusts	(23)	(778)	(801)
Investment return	7,812	–	7,812
Appropriation for expenditure	(5,989)	–	(5,989)
Other	(140)	(17)	(157)
Endowment net assets, August 31, 2016	57,316	161,911	219,227
Contributions	**460**	**5,609**	**6,069**
Change in value of trusts	**–**	**775**	**775**
Investment return	**7,353**	**–**	**7,353**
Appropriation for expenditure	**(5,602)**	**–**	**(5,602)**
Other	**(705)**	**6,785**	**6,080**
Endowment net assets, August 31, 2017	**$ 58,822**	**$ 175,080**	**$ 233,902**

14. Pledges Receivable

As of August 31, 2017, donor-restricted pledges, which are included in Current portion of pledges and grants receivable, net and Other assets, are expected to be realized as follows:

Less than one year	$ 20,851
One to five years	21,607
Thereafter	8,175
Total pledges receivable	50,633
Less allowances	(2,011)
Less present value discount	(6,353)
Net pledges receivable	$ 42,269

15. Net Patient Service Revenue

Northwestern Memorial recognizes net patient service revenue associated with services provided to patients who have third-party payment coverage with Medicare, Medicaid, Blue Cross, other managed care programs and other third-party payors on the basis of the contractual rates for the services rendered at the time services are provided. Payment arrangements with those payors include prospectively determined rates per admission or visit, reimbursed costs, discounted charges and per diem rates. Reported costs and/or services provided under certain of the arrangements are subject to retroactive audit and adjustment. Net patient service revenue increased by $33,843 and $ 16,462 in 2017 and 2016, respectively, as a result of changes in estimates due to the prior fiscal year's cost report settlements and the disposition of other payor audits and settlements. Changes in Medicare and Medicaid programs and reduction in funding levels could have an adverse effect on Northwestern Memorial.

Northwestern Memorial also provides care to self-pay patients. Under its Free and Discounted Care Policy, Northwestern Memorial provides medically necessary care to patients in its community with inadequate financial resources at discounts of up to 100% of charges using a sliding scale that is based on patient household income as a percentage (up to 600%) of the federal poverty level guidelines. The Policy also contains a catastrophic financial assistance provision that limits a patient's total financial responsibility to Northwestern Memorial. Since Northwestern Memorial does not pursue collection of these amounts, they are not reported as net patient service revenue. The Policy has not changed in fiscal year 2017 or 2016. Northwestern Memorial implemented presumptive eligibility screening procedures for free care in fiscal year 2014. Northwestern Memorial recognizes net patient service revenue on services provided to these patients at the discounted rate at the time services are rendered.

Net patient service revenue, net of contractual allowances and discounts, is reduced by the provision for uncollectible accounts, and net patient accounts receivable are reduced by an allowance for uncollectible accounts. These amounts are based primarily on management's assessment of historical and expected write-offs and net collections, along with the aging status for each major payor source. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the estimated allowances for uncollectible accounts. Based on historical experience, a portion of Northwestern Memorial's self-pay patients who do not qualify for charity care will be unable or unwilling to pay for the services provided. Thus, a provision is recorded for uncollectible accounts in the period services are provided related to these patients. After all reasonable collection efforts have been exhausted in accordance with Northwestern Memorial's policies, accounts receivable are written off and charged against the estimated allowances for uncollectible accounts.

(In Thousands)

15. Net Patient Service Revenue (continued)

For receivables associated with self-pay patients, Northwestern Memorial records estimated allowances for uncollectible accounts in the period of service on the basis of past experience. These adjustments are accrued on an estimated basis and are adjusted as needed in future periods.

Net patient service revenue (including patient co-pays and deductibles), net of contractual allowances and discounts (but before the provision for uncollectible accounts) by primary payor source was as follows for the years ended August 31:

	2017	2016
Third-party payors	**$ 4,643,685**	$ 4,180,832
Patients	**105,748**	55,609
	$ 4,749,433	$ 4,236,441

Northwestern Memorial grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. Patient accounts receivable, by major primary payor source, including related patient co-pays and deductibles, before deducting estimated uncollectibles, were as follows at August 31:

	2017	2016
Medicare	**14%**	15%
Medicaid	**11**	9
Blue Cross	**16**	16
Other managed care	**32**	33
Other third-party payors	**8**	11
Patients	**19**	16
	100%	100%

The estimated allowances for uncollectible accounts was $223,411 and $174,234, or 24.3% and 22.4%, of the related patient accounts receivable, net of contractual adjustments as of August 31, 2017 and 2016, respectively. The significant variance was caused primarily due to the aging of outstanding accounts receivable.

(In Thousands)

16. Illinois Hospital Assessment Program

In December 2008, the Illinois Hospital Assessment Program was approved by the Federal Centers for Medicare and Medicaid Services (CMS) for the period from July 1, 2008 through June 30, 2013. In July 2012, this program was extended to December 31, 2014, as part of the Save Medicaid Access and Resources Together (SMART) Act. In June 2014, this program was extended to June 30, 2018 as part of the Omnibus Medicaid Bill Senate Bill 741. In October 2013, the Enhanced Illinois Hospital Assessment Program as authorized under Illinois Public Act 97-688 was approved by CMS retroactive to June 10, 2012. (Collectively referred to herein as HAP). Under HAP, the state receives additional federal Medicaid funds for the State's healthcare system, administered by the Illinois Department of Healthcare and Family Services. HAP includes payments to Northwestern Memorial hospitals from the state and assessments against Northwestern Memorial hospitals, which are paid to the state in the same year.

In June 2014, Omnibus Medicaid Bill Senate Bill 741 authorized a new supplemental program (Access Program) to cover new Medicaid beneficiaries under the Affordable Care Act (ACA), which was approved by CMS in January 2015. In May 2016, the State of Illinois passed HB 4678 (Expanded Access Program) which implemented a framework to increase ACA access funds to Illinois hospitals. The new ACA access funds are attributable to the ACA adults enrolled in managed care products. In September 2016, the Illinois Department of Family and Healthcare Services submitted its certification of the new Medicaid managed care organization rates to CMS. After agreements between managed care organizations and providers were executed, payments for this new program and an adjustment to the assessments began in November 2016 and were retroactive to January 1, 2016.

A summary of the amounts recognized for the HAP and Access programs is as follows:

	2017	2016
Net patient service revenue:		
HAP	**$ 112,813**	$ 109,208
Access Program	**20,418**	20,292
Expanded Access Program	**42,557**	–
	175,788	129,500
Illinois Assessment Program	**103,362**	84,484
Net excess of HAP and ACA revenue over Illinois assessment	**$ 72,426**	$ 45,016

(In Thousands)

16. Illinois Hospital Assessment Program (continued)

The Expanded Access Program Revenue and Illinois Hospital Assessment expense for the twelve months ended August 31, 2017 includes retroactive portions from January 1, 2016 through August 31, 2016 of $16,728 and $2,004, respectively.

17. Functional Expenses

Northwestern Memorial provides general health care services primarily to residents within its geographic location and supports research and education programs. Expenses related to providing these services were as follows for the years ended August 31:

	2017	2016
Health care services	**$ 3,310,405**	$ 3,024,091
Research and education	**138,425**	142,795
Fundraising	**13,559**	12,982
General, administrative, and other	**1,067,438**	940,634
	$ 4,529,827	$ 4,120,502

The research and education costs include $3,317 and $2,873 of expenses supported by federal, state, and corporate grants and $15,279 and $15,174 of expenses supported by other donor-restricted funds in 2017 and 2016, respectively.

18. Commitments and Contingencies

Academic, Program, and Other Support

Consistent with its mission, Northwestern Memorial provides academic, program, and other support to other not-for-profit entities. The present value of the total remaining commitments related to this support is $118,222 and $149,690 at August 31, 2017 and 2016, respectively, which is reported as Grants and academic support payable, current portion and Grants and academic support payable, less current portion in the accompanying consolidated balance sheets.

Northwestern Memorial will provide continuing funding to Northwestern University in support of the research and education mission of the FSM. The continuing funding is based on the average net patient service revenue and operating results of Northwestern Memorial, with the minimum

(In Thousands)

18. Commitments and Contingencies (continued)

annual amount of such funding being $39,500, plus inflation based on the Consumer Price Index, for fiscal years 2014 through 2016 and no minimum thereafter. The expense incurred of $63,898 and $57,864 for the years ended August 31, 2017 and 2016, respectively, is recorded in Other expense in the accompanying consolidated statements of operations and changes in net assets, and a related liability of $452 and $52 is reported in Accrued expenses and other current liabilities in the accompanying consolidated balance sheets as of August 31, 2017 and 2016, respectively.

Other

As of August 31, 2017, approximately 6% of Northwestern Memorial employees, on a full time equivalent basis, were represented by a collective bargaining agreement. This collective bargaining agreement expires on January 27, 2020.

Capital and Leases

Various capital projects are currently being constructed that are expected to be placed in service over the next three years. The total estimated cost of these projects is $1,699,000 (unaudited). As of August 31, 2017, project commitments totaled $1,160,600 of which $916,118 has been incurred. These commitments include the construction of a replacement hospital on the Lake Forest Campus as agreed to in the 2010 affiliation agreement with Lake Forest Hospital. All governmental reviews, approvals and building permits have been received. Construction began in February 2015. Building occupancy and hospital opening is to be staggered in fiscal 2018.

Certain Northwestern Memorial buildings are located on land leased from Northwestern University under various lease agreements. The principal lease requires annual payments of $314 through 2075. At August 31, 2017, minimum future rental payments under other noncancelable operating leases, which consist primarily of leases for office space and equipment, some of which include renewal options, are as follows:

Year ending August 31:	
2018	$ 29,360
2019	25,391
2020	21,373
2021	19,200
2022	16,545
Thereafter	79,733

18. Commitments and Contingencies (continued)

Regulatory

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is a reasonable possibility that recorded amounts will change by a material amount in the near term. During the last few years, as a result of nationwide investigations by governmental agencies, various health care organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties and potential exclusion from the Medicare and Medicaid programs.

In addition, an increasing number of the operations or practices of not-for-profit health care providers has been challenged or questioned to determine whether they are consistent with the regulatory requirements for nonprofit, tax-exempt organizations. These challenges are broader than concerns about compliance with federal and state statutes and regulations of core business practices of the health care organizations. The laws and regulations regarding these practices are also subject to interpretation and challenge. Areas that have come under examination have included pricing practices, billing and collection practices, charity care, community benefit, executive compensation, exemption of property from real property taxation and others. Northwestern Memorial expects that the level of review and audit to which it and other health care providers are subject will increase. There can be no assurance that regulatory authorities will not challenge Northwestern Memorial's compliance with these laws and regulations or that the laws and regulations themselves will not be subject to challenge, and it is not possible to determine the effect, if any, such claims, penalties or challenges would have on Northwestern Memorial.

Northwestern Memorial is aware of, has investigated, and made disclosure to the United States Department of Health and Human Services Office of Civil Rights (OCR) of certain privacy breaches. OCR has requested information for these breaches. NMHC has responded to OCR's requests for information from OCR with respect to one breach related to the theft of a password-protected, unencrypted laptop that contained patient identifiable health information. OCR has also requested information on a separate matter relating to whether an NMHC affiliate had a Business Associate Agreement with a vendor that has been implicated in privacy breaches not involving Northwestern Memorial records. OCR has been taking a more aggressive enforcement position relating to similar privacy matters by comparable health care organizations, including multiple seven-figure settlements against the disclosing party. NMHC is unable to determine which, if any,

18. Commitments and Contingencies (continued)

fines might be imposed by OCR or other actions that might be taken as a result of any privacy breaches or OCR investigations. Northwestern Memorial is a defendant in various other lawsuits arising in the ordinary course of business. Although the outcome of these lawsuits cannot be predicted with certainty, management believes the ultimate disposition of such matters will not have a material effect on Northwestern Memorial's consolidated financial condition or results of operations.

In March 2016, a settlement was reached with various vendors and insurance companies over costs incurred and to be incurred to remediate certain facility issues. Costs incurred related to these issues have been expensed as incurred in operating expenses. The settlement amount of $50,000 is recorded in Rental and other revenue in the consolidated statement of operations and changes in net assets for the year ended August 31, 2016.

19. Centegra Letter of Intent

In April 2016, NMHC and Centegra Health System (Centegra) executed a nonbinding letter of intent that provides for a period of exclusive discussions regarding a potential affiliation between NMHC and Centegra. NMHC cannot predict whether these discussions will result in an agreement between the two organizations. Any definitive agreement would be subject to both parties' governing bodies and applicable regulatory approvals.

20. Subsequent Events

Northwestern Memorial evaluated events and transactions occurring subsequent to August 31, 2017 through November 30, 2017, the date of issuance of the accompanying consolidated financial statements. There were no recognized subsequent events and no unrecognized subsequent events requiring disclosure other than those disclosed in Note 9.

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