

Mayo Clinic

Consolidated Financial Report
December 31, 2017

Ernst & Young LLP



Building a better
working world

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Independent Auditor's Report

Board of Trustees
Mayo Clinic

We have audited the accompanying consolidated financial statements of Mayo Clinic (the "Clinic"), which comprise the consolidated statements of financial position as of December 31, 2017, and the related consolidated statements of activities and cash flows for the year 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 audit. We conducted our audit 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 Mayo Clinic at December 31, 2017, and the consolidated results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Report of Other Auditors on December 31, 2016 Financial Statements

The consolidated financial statements of Mayo Clinic for the year ended December 31, 2016, were audited by other auditors who expressed an unmodified opinion on those statements on February 24, 2017.

Ernst & Young LLP

February 19, 2018

Mayo Clinic

Consolidated Statements of Financial Position December 31, 2017 and 2016 (In Millions)

	2017	2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 66	\$ 57
Accounts receivable for medical services, less allowances for uncollectible accounts of \$667 in 2017 and \$674 in 2016 (Note 2)	1,791	1,635
Securities lending collateral (Note 4)	5	30
Other receivables (Notes 9 and 14)	348	309
Other current assets (Note 14)	228	253
Total current assets	2,438	2,284
Investments (Note 3)	8,760	7,700
Investments under securities lending agreement (Note 4)	42	55
Other long-term assets (Notes 3, 9, 12 and 14)	578	574
Property, plant and equipment, net (Note 5 and 8)	4,489	4,308
Total assets	\$ 16,307	\$ 14,921
Liabilities and Net Assets		
Current liabilities:		
Accounts payable	\$ 443	\$ 403
Accrued payroll	722	678
Accrued employee benefits	153	153
Deferred revenue	63	50
Mandatory tender debt (Note 7)	150	—
Long-term variable-rate debt (Note 7)	470	670
Securities lending payable (Note 4)	5	30
Other current liabilities (Notes 8, 12, 13 and 14)	340	359
Total current liabilities	2,346	2,343
Long-term debt, net of current portion (Note 7)	2,413	2,371
Accrued pension and postretirement benefits, net of current portion (Note 12)	2,324	2,012
Other long-term liabilities (Notes 8, 13 and 14)	1,201	1,028
Total liabilities	8,284	7,754
Net assets (Notes 9 and 10):		
Unrestricted	5,018	4,542
Temporarily restricted	1,629	1,357
Permanently restricted	1,376	1,268
Total net assets	8,023	7,167
Total liabilities and net assets	\$ 16,307	\$ 14,921

See notes to consolidated financial statements.

Mayo Clinic

Consolidated Statements of Activities Years Ended December 31, 2017 and 2016 (In Millions)

	2017				2016			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenue, gains and other support:								
Net medical service revenue (Note 2)	\$ 9,937	\$ —	\$ —	\$ 9,937	\$ 9,220	\$ —	\$ —	\$ 9,220
Grants and contracts	449	—	—	449	426	—	—	426
Investment return allocated to current activities (Note 3)	296	54	—	350	198	96	—	294
Contributions available for current activities	59	179	—	238	44	118	—	162
Premium revenue	153	—	—	153	145	—	—	145
Other (Note 15)	866	—	—	866	751	—	—	751
Net assets released from restrictions (Note 9)	254	(254)	—	—	210	(210)	—	—
Total revenue, gains and other support	12,014	(21)	—	11,993	10,994	4	—	10,998
Expenses (Note 11):								
Salaries and benefits	7,326	—	—	7,326	6,844	—	—	6,844
Supplies and services	3,069	—	—	3,069	2,840	—	—	2,840
Facilities	778	—	—	778	735	—	—	735
Finance and investment	113	—	—	113	104	—	—	104
Total expenses	11,286	—	—	11,286	10,523	—	—	10,523
Income (loss) from current activities	728	(21)	—	707	471	4	—	475
Noncurrent and other items:								
Contributions not available for current activities, net	(29)	90	108	169	(18)	34	102	118
Unallocated investment return, net (Note 3)	392	203	—	595	26	—	—	26
Income tax expense (Note 6)	(71)	—	—	(71)	(13)	—	—	(13)
Gain (loss) from disposal of affiliates, net (Note 17)	21	—	—	21	(90)	—	—	(90)
Other	—	—	—	—	3	—	—	3
Total noncurrent and other items	313	293	108	714	(92)	34	102	44
Increase in net assets before other changes in net assets	1,041	272	108	1,421	379	38	102	519
Pension and other postretirement benefit adjustments (Note 12)	(565)	—	—	(565)	(999)	—	—	(999)
Increase (decrease) in net assets	476	272	108	856	(620)	38	102	(480)
Net assets at beginning of year	4,542	1,357	1,268	7,167	5,162	1,319	1,166	7,647
Net assets at end of year	\$ 5,018	\$ 1,629	\$ 1,376	\$ 8,023	\$ 4,542	\$ 1,357	\$ 1,268	\$ 7,167

See notes to consolidated financial statements.

Mayo Clinic

Consolidated Statements of Cash Flows Years Ended December 31, 2017 and 2016 (In Millions)

	2017	2016
Cash flows from operating activities:		
Change in net assets	\$ 856	\$ (480)
Adjustments to reconcile changes in net assets to net cash provided by operating activities:		
Depreciation and amortization	524	491
Provision for uncollectible accounts	200	218
Net realized and unrealized gain on investments	(817)	(217)
Restricted gifts, bequests and other	(186)	(102)
Net change in accounts receivable and other current assets and liabilities	(299)	(80)
Pension and other postretirement benefits adjustments	312	689
Net change in other long-term assets and liabilities	209	126
Net cash provided by operating activities	799	645
Cash flows from investing activities:		
Purchase of property, plant and equipment	(705)	(631)
Purchases of investments	(2,458)	(2,351)
Sales and maturities of investments	2,168	1,948
Proceeds from disposal of affiliates	67	—
Net cash used in investing activities	(928)	(1,034)
Cash flows from financing activities:		
Restricted gifts, bequests and other	146	100
Borrowings on long-term debt	—	839
Payment of long-term debt	(8)	(546)
Net cash provided by financing activities	138	393
Net increase in cash and cash equivalents	9	4
Cash and equivalents at beginning of year	57	53
Cash and equivalents at end of year	\$ 66	\$ 57

See notes to consolidated financial statements.

Note 1. Organization and Summary of Significant Accounting Policies

Organization: Mayo Clinic and its Arizona, Florida, Iowa, Minnesota and Wisconsin affiliates (the Clinic) provide comprehensive medical care and education in clinical medicine and medical sciences and conduct extensive programs in medical research. The Clinic also provides hospital and outpatient services, and at each major location, the clinical practice is closely integrated with advanced education and research programs. The Clinic and most of its subsidiaries have been determined to qualify as tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code (the Code) and as a public charity under Section 509(a)(2) of the Code.

Basis of presentation: Included in the Clinic's consolidated financial statements are all of its wholly owned or wholly controlled subsidiaries. All significant intercompany transactions have been eliminated in consolidation. In addition, these statements follow generally accepted accounting principles applicable to the not-for-profit industry as described in the Financial Accounting Standards Board's *FASB Accounting Standards Codification* (ASC) Topic 958.

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 at the date of the financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

New Accounting Standards Not Yet Adopted:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. In August 2015, the FASB amended the guidance to defer the effective date of this standard by one year. The ASU converged and replaced existing revenue recognition guidance, including industry-specific guidance and requires revenue to be recognized in an amount that reflects the consideration the entity expects to be entitled in an exchange of goods or services.

We have closely assessed the new standard and monitored FASB activity, including the interpretations by the FASB Transition Resource Group for Revenue Recognition, throughout 2017. The Clinic adopted the standard on January 1, 2018 using the full retrospective method of transition. As part of adopting the standard, the Clinic identified revenue streams of like contracts to allow for ease of implementation. The Clinic used primarily a portfolio approach to apply the new model to classes of customers with similar characteristics.

The impact of adopting the new standard on our 2017 and 2016 total revenue, gains and other support and income from current activities is not material. The immaterial impact of adopting Topic 606 primarily relates to recognizing certain credit and collection issues not known at the date of service, including bankruptcy, in the provision for uncollectible accounts included in expenses on the consolidated statement of activities, which previously were netted against medical service revenue. The impact to income from current activities is not material because the analysis of our contracts under the new revenue recognition standard supports the recognition of revenue consistent with our current revenue recognition model. In addition, the number of our performance obligations under the new standard is not

Notes to Consolidated Financial Statements (in Millions)

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

materially different from our contract segments under the existing standard. Lastly, the accounting for the estimate of variable consideration is not materially different compared to our current practice.

We also do not expect the standard to have a material impact on our consolidated statements of financial position. The immaterial impact primarily relates to reclassifications among financial statement accounts to align with the new standard. Most notably, contracts in process will be reclassified as receivables or contract assets based on amounts billed or unbilled, respectively.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This ASU requires the rights and obligations arising from the lease contracts, including existing and new arrangements, to be recognized as assets and liabilities on the statements of financial position. The ASU will require disclosures to help financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. The ASU is effective for the Clinic beginning January 1, 2019 and will be applied using a modified retrospective approach. The primary effect of adopting the new standard will be to record right-of-use assets and obligations for current operating leases.

In August 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)*. This ASU changes certain financial statement requirements for not-for-profit entities in an effort to make the information more meaningful to users and reduce reporting complexity. This update is effective for year-end December 31, 2018.

In March 2017, the FASB issued ASU No. 2017-07, *Compensation – Retirement Benefits (Topic 715)*. This ASU provides guidance on the presentation of service cost and other components of net periodic benefit cost in the consolidated statement of activities. The ASU is effective January 1, 2019.

The Clinic is currently assessing the impact of the preceding ASUs on its consolidated financial statements.

Cash and equivalents: Cash and equivalents include currency on hand, demand deposits with banks or other financial institutions, and short-term investments with maturities of three months or less from the date of purchase, which are not managed by the Clinic's investment managers.

Accounts receivable for medical services: Accounts receivable for medical services are stated at estimated net realizable value. The Clinic estimates the allowances for uncollectible accounts based on historic write-offs and the aging of the accounts. Accounts are written off when collection efforts have been exhausted.

Inventories: Inventories, consisting primarily of medical supplies and pharmaceuticals, are stated at the lower of cost or net realizable value, determined using the first-in, first-out method.

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

Investments: Investments in equity and debt securities, including alternative investments, are recorded at fair value (Notes 3 and 4). Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Realized gains and losses are calculated based on the average cost method. Investment income or loss (including realized and unrealized gains and losses on investments, interest and dividends) are included in the consolidated statements of activities.

Alternative investments (principally limited partnership interests in absolute return, hedge, private equity, real estate and natural resources funds), represents the Clinic's ownership interest in the respective partnership, which is valued at net asset value (NAV) obtained from fund manager statements and historical audited financial statements. The investments in alternative investments may individually expose the Clinic to securities lending, short sales, and trading in futures and forward contract options and other derivative products. The Clinic's risk is limited to the investment's carrying value.

It is the Clinic's intent to maintain a long-term investment portfolio to support research, education and other activities. Accordingly, the total investment return is reported in the consolidated statements of activities in two categories. The investment return allocated to current activities is determined by a formula, which involves allocating five percent of a three-year moving average of investments related to endowments, the matching of financing costs for the assets required for operations and additional expenses covered by investment returns. Management believes this return is approximately equal to the real return that the Clinic expects to earn on its investments over the long term. The unallocated investment return, included in noncurrent and other items in the consolidated statements of activities, represents the difference between the total investment return and the amount allocated to current activities.

Property, plant and equipment: Property, plant and equipment are carried at cost if purchased or at fair value on the date received through affiliation or donation, less accumulated depreciation. Plant and equipment are depreciated over estimated useful lives ranging from three to fifty years using the straight-line method. Depreciation expense is reflected in facilities expense and was \$524 and \$491 in 2017 and 2016, respectively, and includes amortization of assets recorded under capital leases.

Costs associated with the development and installation of internal-use software are accounted for in accordance with the *Intangibles—Goodwill and Other, Internal-Use Software* subtopic of the FASB ASC 350-40. Accordingly, internal-use software costs are expensed or capitalized and amortized according to the provisions of the accounting standard.

Deferred revenue: Deferred revenue consists of payments received in advance for grant, subscription and tuition revenue. Deferred revenues are subsequently recognized as revenue in accordance with the Clinic's revenue recognition policies.

Deferred compensation: The Clinic offers eligible employees a nonqualified, tax-deferred compensation retirement plan. Employees defer compensation into the plan on a pretax basis. For the most part, the plan operates similar to a defined contribution plan.

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

Asset retirement obligations: The Clinic accounts for the estimated cost of legal obligations associated with long-lived asset retirements in accordance with the Asset Retirement and Environmental Obligations topic of the FASB ASC. The asset retirement liability, recorded in other long-term liabilities, is accreted to the present value of the estimated future costs of these obligations at the end of each period.

Net assets: Resources are classified for reporting purposes into three net asset categories (unrestricted, temporarily restricted and permanently restricted) according to the absence or existence of donor-imposed restrictions. Temporarily restricted net assets are those assets, including contributions and accumulated investment returns, whose use has been limited by donors to specific purposes or time periods. Permanently restricted net assets are those for which donors require the principal of the gifts to be maintained in perpetuity and provide a permanent source of income. Reclassifications of net assets are primarily the result of donor redesignations.

Net medical service revenue: Net medical service revenue is recognized when services are provided. The Clinic has agreements with third-party payors that provide for payments to the Clinic at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem rates. Net medical service revenue is reported at the estimated net amounts due from patients and third-party payors for services rendered. For patients that do not qualify for charity care, the Clinic recognizes revenue on the basis of its standard rates for services provided less an allowance for uncollectible accounts (or on the basis of discounted rates, if negotiated or provided by policy). Based on historical experience, a portion of the Clinic's patients will be unable or unwilling to pay for the services provided. Thus, the Clinic records a provision for uncollectible accounts related to patients in the period the services are provided.

Grants and contracts: Reciprocal grants and contracts revenue is recognized when the expenses have been incurred for the purpose specified by the grantor or in accordance with the terms of the agreement. Grant and contract amounts due to the Clinic are included in other receivables.

Premium revenue: Premium revenue represents capitated health premiums received by a managed care subsidiary from third parties and is recognized as revenue in the period in which enrollees are entitled to health care services.

Charity and uncompensated care: The Clinic provides health care services to patients who meet certain criteria under its Charity Care Policy without charge or at amounts less than established rates. Since the Clinic does not pursue collection of these amounts, they are not reported as revenue. The estimated cost of providing these services was \$72 and \$83 in 2017 and 2016, respectively, calculated by multiplying the ratio of cost to gross charges for the Clinic by the gross uncompensated charges associated with providing care to charity patients. In addition to the charges related to the direct patient care provided under the Clinic's Charity Care Policy, the Clinic has programs offered to benefit the broader community and other governmental reimbursement programs. The Clinic also participates in various state Medicaid programs for indigent patients. The estimated unreimbursed cost of providing services related to Medicaid programs totaled \$503 and \$546 in 2017 and 2016, respectively.

Note 1. Organization and Summary of Significant Accounting Policies (Continued)

Contributions: The Clinic classifies unrestricted contributions and temporarily restricted contributions that are available for current activities as revenue, based on the lack of specific donor restriction or the presence of donor restrictions and the ability of the Clinic to meet those restrictions within the year. Permanently restricted contributions and temporarily restricted contributions that are not available for current activities are classified in noncurrent and other items in the consolidated statements of activities. Development expenses of \$43 (\$24 allocated to current and \$19 allocated to noncurrent) and \$39 (\$21 allocated to current and \$18 allocated to noncurrent) were incurred in 2017 and 2016, respectively. The current portion is recorded in expenses, and the noncurrent portion is netted against unrestricted contributions not available for current activities in the consolidated statements of activities. Unconditional promises to give and contributions are reported at fair value at the time of the gift. An allowance for uncollectible pledges receivable is estimated based on a combination of historical experience and specific identification. Conditional promises to give are recognized at fair value when the conditions on which they depend are substantially met or the probability that the condition will not be met is remote.

The Clinic does not imply a time restriction that expires over the useful life for gifts of long-lived assets.

The Clinic periodically receives works of art from various benefactors. These items are unique in nature and are held on display for the benefit and enjoyment of the Clinic's patients. It is the Clinic's policy to neither capitalize contributed works of art nor record the related contribution revenue.

Income from current activities: The Clinic's policy is to include in income from current activities all net medical service and other revenue, grants and contracts, investment return allocated to current activities, contributions available for current activities, premium revenue, net assets released from restrictions, and substantially all expenses. Contributions not available for current activities, unallocated investment return, and those items not expected to recur on a regular basis, such as disposal of an affiliate, are included in noncurrent and other items in the consolidated statements of activities.

Subsequent events: The Clinic evaluated events and transactions occurring subsequent to December 31, 2017, through February 19, 2018, the date of issuance of the consolidated financial statements. During this period, there were no subsequent events requiring recognition in the consolidated financial statements. Additionally, there were no unrecognized events requiring disclosure.

Note 2. Net Medical Service Revenue, Contractual Arrangements With Third-Party Payors, and Allowance for Uncollectible Accounts

The Clinic provides care to patients under the Medicare program and contractual arrangements with other third-party payors. The Medicare program pays for inpatient and most outpatient services at predetermined rates. Certain hospital services are reimbursed based on allowable costs as reported in cost reports, which are subject to retroactive audit and adjustment.

Contractual adjustments arising from reimbursement arrangements with third-party payors are recognized on an estimated basis in the period in which the services are rendered. Estimates for recognized cost report settlements can differ from actual reimbursement based on the results of subsequent reviews and cost report audits. The impact to net medical service revenue of such items was not significant in 2017 and 2016.

Notes to Consolidated Financial Statements (in Millions)

Note 2. Net Medical Service Revenue, Contractual Arrangements With Third-Party Payors, and Allowance for Uncollectible Accounts (Continued)

Future changes in the Medicare program and reduction of funding levels could have an adverse effect on the Clinic. Net medical service revenue under the Medicare program represented approximately 24 percent and 25 percent of total net medical service revenue for 2017 and 2016, respectively. At December 31, 2017 and 2016, approximately 12 percent of accounts receivable for medical services was due from the Medicare program.

As a service to the patient, the Clinic bills third-party payors directly and bills the patient when the patient's liability is determined. Accounts receivable are reduced by an allowance for uncollectible accounts. In evaluating the collectability of accounts receivable, the Clinic analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for uncollectible accounts and provision for uncollectible accounts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For charges associated with services provided to patients who have third-party coverage, the Clinic analyzes contractually due amounts and provides contractual allowances based on these amounts. Additionally, an allowance for uncollectible accounts and a provision for uncollectible accounts is provided for expected uncollectible deductibles and copayments on accounts for which the patient is responsible. For receivables associated with self-pay patients, the Clinic records a significant provision for uncollectible accounts in the period of service on the basis of its past experience and current expectations, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

The Clinic's allowance for uncollectible accounts was 27 percent and 29 percent of accounts receivable at December 31, 2017 and 2016, respectively. In addition, the Clinic's write-offs were \$201 and \$260 for the years ended December 31, 2017 and 2016, respectively.

Net medical service revenue for the years ended December 31 consisted of the following:

	2017	2016
Medical service revenue (net of contractual allowances and discounts)	\$ 10,131	\$ 9,429
Provision for uncollectible accounts	(194)	(209)
Net medical service revenue	<u>\$ 9,937</u>	<u>\$ 9,220</u>

The Clinic recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. Medical service revenue, net of contractual allowances and discounts (but before the provision for uncollectible accounts), recognized in the years ended December 31 from these major payor sources, is as follows:

	2017	2016
Third-party payors	\$ 9,729	\$ 8,961
Self-pay	402	468
Total all payors	<u>\$ 10,131</u>	<u>\$ 9,429</u>

Note 3. Fair Value Measurements

The Clinic holds certain financial instruments that are required to be measured at fair value on a recurring basis. The valuation techniques used to measure fair value under the *Fair Value Measurements and Disclosures* topic of the FASB ASC 820 are based upon observable and unobservable inputs. The standard establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1: Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the same term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The Clinic's policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that caused the transfer. During the year ended December 31, 2017, there were no significant transfers. During the year ended December 31, 2016, the Clinic transferred \$136 of funds from NAV to Level 2 due to a change in measurement inputs.

Notes to Consolidated Financial Statements (in Millions)

Note 3. Fair Value Measurements (Continued)

The following tables present the financial instruments carried at fair value as of December 31, 2017 and 2016, by caption on the consolidated statements of financial position categorized by the valuation hierarchy and NAV:

	December 31, 2017				
	Level 1	Level 2	Level 3	NAV	Total Fair Value
Assets:					
Securities lending collateral	\$ 5	\$ —	\$ —	\$ —	5
Investments:					
Cash and equivalents	1,093	—	—	—	1,093
Fixed-income securities:					
U.S. government	—	204	—	—	204
U.S. government agencies	—	318	—	—	318
U.S. corporate	—	297	3	—	300
Foreign	—	17	—	—	17
Common and preferred stocks:					
U.S.	529	—	—	—	529
Foreign	350	—	—	—	350
Funds:					
Fixed-income	420	—	—	—	420
Equities	607	476	—	—	1,083
Other investments	(22)	—	—	—	(22)
Less securities under lending agreement	(42)	—	—	—	(42)
Investments at NAV	—	—	—	4,510	4,510
Total investments	2,935	1,312	3	4,510	8,760
Investments under securities lending agreement	42	—	—	—	42
Other long-term assets:					
Trust receivables	75	29	58	—	162
Technology-based ventures	—	—	19	—	19
Total other long-term assets	75	29	77	—	181
Total assets at fair value	\$ 3,057	\$ 1,341	\$ 80	\$ 4,510	\$ 8,988
Liabilities:					
Securities lending payable	\$ 5	\$ —	\$ —	\$ —	5
Total liabilities at fair value	\$ 5	\$ —	\$ —	\$ —	5

Mayo Clinic

Notes to Consolidated Financial Statements (in Millions)

Note 3. Fair Value Measurements (Continued)

	December 31, 2016				
	Level 1	Level 2	Level 3	NAV	Total Fair Value
Assets:					
Securities lending collateral	\$ 30	\$ —	\$ —	\$ —	\$ 30
Investments:					
Cash and equivalents	857	—	—	—	935
Fixed-income securities:					
U.S. government	—	216	—	—	200
U.S. government agencies	—	301	—	—	294
U.S. corporate	—	307	10	—	314
Foreign	—	13	—	—	13
Common and preferred stocks:					
U.S.	444	—	2	—	446
Foreign	345	—	—	—	345
Funds:					
Fixed-income	415	—	—	—	415
Equities	629	289	—	—	866
Other investments	65	—	—	—	65
Less securities under lending agreement	(55)	—	—	—	(55)
Investments at NAV	—	—	—	3,862	3,862
Total investments	2,700	1,126	12	3,862	7,700
Investments under securities lending agreement	55	—	—	—	55
Other long-term assets:					
Trust receivables	90	30	55	—	175
Technology-based ventures	—	—	18	—	18
Total other long-term assets	90	30	73	—	193
Total assets at fair value	\$ 2,875	\$ 1,156	\$ 85	\$ 3,862	\$ 7,978
Liabilities:					
Securities lending payable	\$ 30	\$ —	\$ —	\$ —	\$ 30
Total liabilities at fair value	\$ 30	\$ —	\$ —	\$ —	\$ 30

The following is a description of the Clinic's valuation methodologies for assets and liabilities measured at fair value. Fair value for Level 1 is based upon quoted market prices. Fair value for Level 2 is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources, including market participants, dealers and brokers. Level 3 primarily consists of trusts recorded at fair value based on the underlying value of the assets in the trust or discounted cash flow of the expected payment streams. The trusts reported as

Notes to Consolidated Financial Statements (in Millions)

Note 3. Fair Value Measurements (Continued)

Level 3 are primarily perpetual trusts managed by third parties invested in stocks, mutual funds, and fixed-income securities that are traded in active markets with observable inputs, and since the Clinic will never receive the trust assets, these perpetual trusts are reported as Level 3.

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

The following information pertains to those alternative investments recorded at NAV in accordance with the *Fair Value Measurements and Disclosures* topic of the FASB ASC 820.

At December 31, 2017, alternative investments recorded at NAV consisted of the following:

	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return/hedge funds (a)	\$ 2,354	\$ —	Monthly to annually	30–90 days
Private partnerships (b)	2,156	1,053		
Total alternative investments	<u>\$ 4,510</u>	<u>\$ 1,053</u>		

At December 31, 2016, alternative investments recorded at NAV consisted of the following:

	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return/hedge funds (a)	\$ 1,983	\$ —	Monthly to annually	30–90 days
Private partnerships (b)	1,879	1,015		
Total alternative investments	<u>\$ 3,862</u>	<u>\$ 1,015</u>		

- (a) This category includes investments in absolute return/hedge funds, which are actively managed commingled investment vehicles that derive the majority of their returns from factors other than the directional flow of the markets in which they invest. Representative strategies include high-yield credit, distressed debt, merger arbitrage, relative value, and long-short equity strategies. The fair values of the investments in this category have been estimated using the NAV per share of the investments. Investments in this category generally carry “lockup” restrictions that do not allow investors to seek redemption in the first year after acquisition. Following the initial lockup period, liquidity is generally available monthly, quarterly or annually following a redemption request. Over 90 percent of the investments in this category have at least annual liquidity.
- (b) This category includes limited partnership interests in closed-end funds that focus on venture capital, private equity, real estate and resource-related strategies. The fair values of the investments in this category have been estimated using the NAV of the Clinic’s ownership interest in partners’ capital. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of most funds will generally be liquidated over a seven- to ten-year period.

Notes to Consolidated Financial Statements (in Millions)

Note 3. Fair Value Measurements (Continued)

From time to time, the Clinic invests directly in certain derivative contracts that do not qualify for hedge accounting and are recorded at fair value in investments. Changes in fair value are reported as a component of net unrealized gains or losses in the investment returns. These contracts are used in the Clinic's investment management program to minimize certain investment risks. During the years ended December 31, 2017 and 2016, the realized and unrealized loss from derivative contracts totaled \$33 and \$50, respectively.

The carrying values of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses are reasonable estimates of their fair values due to the short-term nature of these financial instruments. The estimated fair value of long-term debt (Note 7), based on quoted market prices for the same or similar issues (Level 2), was approximately \$170 and \$75 more than its carrying value at December 31, 2017 and 2016, respectively.

The Clinic uses various external investment managers to diversify the investments. The largest allocation to any investment strategy manager as of December 31, 2017 and 2016, is \$426 (6.2 percent) and \$231 (3.5 percent), respectively.

The Clinic is required to maintain funds held by trustees under bond indentures and other arrangements. The trustee-held investments, which primarily consist of mutual funds, were \$589 and \$484, respectively, at December 31, 2017 and 2016, which includes segregated investments for deferred compensation plans of \$586 and \$479 at December 31, 2017 and 2016, respectively.

The Clinic has internally designated investment balances of \$2,243 and \$1,931 at December 31, 2017 and 2016, respectively, for research, education, and capital replacement and expansion.

Investment return consisted of the following for the years ended December 31:

	2017	2016
Dividends and interest	\$ 128	\$ 103
Net realized gains or losses	345	171
Net change in unrealized gains or losses	472	46
Total investment return	<u>\$ 945</u>	<u>\$ 320</u>

Investment return is reported in the consolidated statements of activities as follows for the years ended December 31:

	2017	2016
Investment return allocated to current activities	\$ 350	\$ 294
Unallocated investment return, net	595	26
Total investment return	<u>\$ 945</u>	<u>\$ 320</u>

Notes to Consolidated Financial Statements (in Millions)

Note 4. Securities Lending

The Clinic has an arrangement with its investment custodian to lend Clinic securities to approved brokers in exchange for a fee. Among other provisions that limit the Clinic's risk, the securities lending agreement specifies that the custodian is responsible for lending securities and obtaining adequate collateral from the borrower. Collateral is limited to cash, government securities, and irrevocable letters of credit. Investments are loaned to various brokers and are returnable on demand. In exchange, the Clinic receives collateral. The cash collateral is shown as both an asset and a liability on the consolidated statements of financial position.

At December 31, 2017 and 2016, the aggregate market value of securities on loan under securities lending agreements totaled \$42 and \$55, respectively, and the total value of the collateral supporting the securities is \$44 and \$56, respectively, which represents 104 percent and 103 percent of the value of the securities on loan at December 31, 2017 and 2016, respectively. The cash portion of the collateral supporting the securities as of December 31, 2017 and 2016, is \$5 and \$30, respectively. Noncash collateral provided to the Clinic is not recorded in the consolidated statements of financial position, as the collateral may not be sold or repledged. The Clinic's claim on such collateral is limited to the market value of loaned securities. In the event of nonperformance by the other parties to the securities lending agreements, the Clinic could be exposed to a loss.

Note 5. Property, Plant and Equipment, Net

Property, plant and equipment, net, at December 31 consisted of the following:

	2017	2016
Land	\$ 291	\$ 288
Buildings and improvements	5,546	5,365
Furniture and equipment	3,939	3,501
	9,776	9,154
Accumulated depreciation and amortization	(5,542)	(5,227)
	4,235	3,927
Construction in progress	255	381
Total property, plant and equipment	\$ 4,489	\$ 4,308

The above costs and accumulated depreciation include costs for capitalized software, including costs capitalized in accordance with the Intangibles—Goodwill and Other, Internal-Use Software subtopic of the FASB ASC Topic 350. The total cost for capitalized software was \$891 and \$570, and the total accumulated amortization was \$543 and \$507 at December 31, 2017 and 2016, respectively. Amortization expense for capitalized software was \$54 and \$47 for 2017 and 2016, respectively.

Note 6. Income Taxes

Most of the income received by the Clinic and its subsidiaries is exempt from taxation under Section 501(a) of the Code. Some of its subsidiaries are taxable entities, and some of the income received by otherwise exempt entities is subject to taxation as unrelated business income (UBI). The Clinic and its subsidiaries file income tax returns in the U.S. federal, various state, and foreign jurisdictions. The

Notes to Consolidated Financial Statements (in Millions)

Note 6. Income Taxes (Continued)

statutes of limitations for tax years 2014 through 2016 remain open in the major U.S. taxing jurisdictions in which the Clinic and subsidiaries are subject to taxation.

The Internal Revenue Service (IRS) performed an examination of the tax and information returns of the Clinic and two subsidiaries for 2005 and 2006. The IRS has concluded a limited-scope audit of the Clinic for tax year 2011. As of December 31, 2015, the IRS proposed an \$11 tax and interest assessment for 2005 through 2012 that the Clinic paid. The Clinic has filed a claim for refund for these amounts, which was rejected by the IRS. The Clinic is litigating the denial of the claims in U.S. District Court. Management has taken this into consideration during its determination of unrecognized tax benefits.

The Clinic has recorded \$3, including interest and penalties, for uncertain tax positions during the year ended December 31, 2017. It is not anticipated that a significant change in the reserve will occur over the next 12 months.

The Clinic's practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The components of tax expense are as follows:

	December 31	
	2017	2016
Current—federal	\$ 36	\$ 15
Current—state	6	2
	<u>42</u>	<u>17</u>
Deferred—U.S. domestic	29	(4)
Total	<u>\$ 71</u>	<u>\$ 13</u>

Cash payments for income taxes were \$38 and \$14 for the years ended December 31, 2017 and 2016, respectively.

Notes to Consolidated Financial Statements (in Millions)

Note 6. Income Taxes (Continued)

The Clinic records deferred income taxes due to temporary differences between financial reporting and tax reporting for certain assets and liabilities of its taxable activities. The following is a summary of the components of deferred taxes as of December 31:

	2017	2016
Deferred compensation	13	20
Pension	15	20
Postretirement benefits	5	7
Other	8	10
Total deferred tax asset	41	57
Deferred tax liability	(3)	(5)
Valuation allowance	(12)	(1)
Net deferred tax asset	26	51

As of December 31, 2017, the Clinic had no federal net operating losses.

The Tax Cuts and Jobs Act (Tax Act) was enacted on December 22, 2017. The Tax Act reduces the US federal corporate tax rate from 35 percent to 21 percent, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, and creates new taxes on certain foreign sourced earnings.

At December 31, 2017, we have accounted for the reduction in US federal corporate tax rate and other domestic tax provisions of the Tax Act. However, in certain cases, as described below, we have made a reasonable estimate of the effects on our existing deferred tax balances. Furthermore, in relation to the international provisions in the Act, we have not been able to make a reasonable estimate and continue to account for those items based on our existing accounting under ASC 740, Income Taxes, and the provisions of the tax laws that were in effect immediately prior to enactment. We do not anticipate a material impact from the international provisions, but guidance from the Internal Revenue Service regarding application of these provisions to tax-exempt entities will be necessary in order to confirm that no material impact will occur.

Deferred tax assets and liabilities were remeasured based on the rates at which they are expected to reverse in the future, which is generally 21 percent. However, there is still analysis required for certain aspects of the Act and refining the calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the remeasurement of the deferred tax balance was \$19.

Mayo Clinic

Notes to Consolidated Financial Statements (in Millions)

Note 7. Financing

Long-term debt at December 31 consisted of the following:

	2017	2016
City of Rochester, Minnesota Revenue Bonds issued in various series, subject to variable interest rates to a maximum rate of 15.00% (the average rate was 0.86% in 2017 and 0.41% in 2016), principal due in varying amounts from 2033 through 2052	\$ 395	\$ 595
City of Rochester, Minnesota Revenue Bonds originally issued at variable interest rate, converted in 2017 to fixed interest rate of 2.196% based on a provision to increase the rate if the federal tax rate is decreased, the rate has been adjusted to 2.67% effective January 1, 2018 through 2027, principal due in varying amounts from 2022 through 2032	200	—
City of Rochester, Minnesota Revenue Bonds issued in various series with fixed rates of interest ranging from 4.00% to 5.00%, principal due in varying amounts from 2028 through 2041	615	615
City of Rochester, Minnesota Health Care Facilities Revenue Refunding Bonds, series 2016B, issued with fixed interest rate of 5.00%, an effective rate of 2.97% in 2017 and 2.63% in 2016 after amortization of premium, principal due November 15, 2029 through 2036 (unamortized premium of \$68 in 2017 and \$73 in 2016)	220	220
Industrial Development Authority of the City of Phoenix, Arizona issued in various series, subject to variable interest rates to a maximum rate of 10.00% (the average rate was 0.74% in 2017 and 0.33% in 2016), principal due in varying amounts from 2048 through 2052	180	180
City of Jacksonville, Florida Health Care Facilities Revenue Refunding Bonds, series 2016, issued in various series, subject to variable interest rates to a maximum rate of 10.00% (the average rate 0.86% in 2017 and 0.61% in 2016), principal due in varying amounts from 2033 through 2047	125	125
Wisconsin Health and Educational Facilities Authority Revenue Bonds, Series 2008, issued in various series, with fixed interest rates ranging from 4.50% to 5.75%, principal due in varying amounts through 2030	67	71
Mayo Clinic Taxable Bonds issued with fixed interest rates ranging from 3.774% to 4.128%, principal due in varying amounts from 2039 through 2052	950	950
Fixed-rate notes, payable to an insurance company, interest rate at 4.71%, principal due in equal amounts from 2042 through 2046	215	215
Other notes payable	15	15
Unamortized discounts and premiums, net	69	74
Debt issuance cost	(14)	(15)
	3,037	3,045
Long-term variable-rate debt classified as current	(470)	(670)
Long-term debt subject to mandatory tender for purchase	(150)	—
Current maturities included in other current liabilities	(4)	(4)
Long-term debt, net of current portion	\$ 2,413	\$ 2,371

Notes to Consolidated Financial Statements (in Millions)

Note 7. Financing (Continued)

The Clinic's outstanding revenue bond issues are limited obligations of various issuing authorities payable solely by the Clinic pursuant to loan agreements between the borrowing entities and the issuing authorities. Under various financing agreements, the Clinic must meet certain operating and financial performance covenants.

At December 31, 2017, the \$700 of variable-rate bonds consist of variable-rate demand revenue bonds. In conjunction with the issuance of the variable-rate demand revenue bonds, the Clinic has entered into various bank standby purchase and credit agreements in the amount of \$230 that expire at various dates commencing with \$50 in January 2019 and \$180 that expire in May 2020. Under the terms of these agreements, the bank will make liquidity loans to the Clinic in the amount necessary to purchase a portion of the variable-rate demand revenue bonds if not remarketed. The liquidity loans would be payable over a three- to five-year period, with the first payment due after December 31, 2018. The Clinic has provided self-liquidity for the remaining \$470 of variable-rate demand revenue bonds, which have been classified as current in the accompanying consolidated statements of financial position.

The Clinic's \$150 City of Rochester, Minnesota Revenue Bonds Series 2011 AB fixed rate bonds are subject to mandatory tender for purchase on November 15, 2018, and, therefore, classified as current.

The fixed-rate revenue bonds Series 2016B are not callable. The remaining fixed-rate interest revenue bonds are callable from 2018 to 2052 at the option of the Clinic, at a redemption price of 100 percent of the principal amount or at a price based on U.S. Treasury rates at the time of redemption.

On March 24, 2017, the Clinic's \$200 City of Rochester, Minnesota Health Care Facilities Revenue Bonds Series 2002 AB&C variable rate bonds were acquired by a bank through a direct purchase for ten years at an initial fixed interest rate of 2.196 percent. The bond modification was accounted for as an extinguishment of debt. The loss on extinguishment was not significant.

The following are scheduled maturities of long-term debt for each of the next five years, assuming the variable-rate demand revenue bonds are remarketed and the standby purchase agreements are renewed. As described above, if such bonds are not remarketed, \$470 may be due in 2018 and \$230 may be due in years from 2019 to 2023.

Years ending December 31:

2018	\$	4
2019		4
2020		5
2021		5
2022		43

Interest payments on long-term debt, net of amounts capitalized for 2017 and 2016, totaled \$92 and \$85, respectively. The amount of interest capitalized, net of related interest income, was \$6 and \$5 during 2017 and 2016, respectively. Interest expense totaled \$94 and \$83 for 2017 and 2016, respectively.

At December 31, 2017 and 2016, the Clinic had unsecured lines of credit available with banks totaling \$625 and \$525, respectively, with varying renewable terms and interest up to 2.5 percent over various published rates. There were no amounts drawn during December 31, 2017 and 2016.

Notes to Consolidated Financial Statements (in Millions)

Note 8. Lease Commitments

Certain leases are classified as capital leases. The leased assets are included as part of property, plant and equipment (Note 5), and the capital lease obligations of \$48 and \$43 as of December 31, 2017 and 2016, respectively, are recorded in other current and long-term liabilities. Other leases are classified as operating and are not capitalized. The payments on such leases are recorded as expense.

Details of the capitalized lease assets are as follows at December 31:

	2017	2016
Buildings and equipment	\$ 33	\$ 34
Furniture and equipment	35	21
	68	55
Accumulated depreciation	(18)	(12)
Total	\$ 50	\$ 43

Rental expense incurred for operating leases was \$31 and \$30 for the years ended December 31, 2017 and 2016, respectively.

At December 31, 2017, the estimated future minimum lease payments under noncancellable operating leases and capital leases were as follows:

	Operating	Capital
Years ending December 31:		
2018	\$ 22	\$ 11
2019	18	11
2020	15	8
2021	13	5
2022	12	2
Thereafter	43	27
Minimum lease payments	\$ 123	64
Less amount representing interest		(16)
Net minimum lease payments under capital leases		\$ 48

Mayo Clinic

Notes to Consolidated Financial Statements (in Millions)

Note 9. Contributions and Restricted Expenditures

The Clinic receives unrestricted, temporarily restricted and permanently restricted contributions in support of research, education and clinical activities.

Temporarily restricted net assets were available for the following at December 31:

	2017	2016
Research	\$ 734	\$ 612
Education	316	268
Buildings and equipment	51	27
Charity care	56	50
Clinical	101	88
Other	46	37
Pledges and trusts	325	275
Total temporarily restricted net assets	<u>\$ 1,629</u>	<u>\$ 1,357</u>

Permanently restricted net assets at December 31 are summarized below, the income from which is expendable to support the following:

	2017	2016
Research	\$ 805	\$ 721
Education	233	221
Charity care	15	17
Clinical	81	64
Other	31	28
Pledges and trusts	211	217
Total permanently restricted net assets	<u>\$ 1,376</u>	<u>\$ 1,268</u>

Net assets were released from donor restrictions as expenditures were made, which satisfied the following restricted purposes for the years ended December 31:

	2017	2016
Research	\$ 169	\$ 151
Education	22	22
Buildings and equipment	9	3
Other	54	34
Total net assets released from donor restrictions	<u>\$ 254</u>	<u>\$ 210</u>

Notes to Consolidated Financial Statements (in Millions)

Note 9. Contributions and Restricted Expenditures (Continued)

At December 31, outstanding pledges from various corporations, foundations and individuals, included in other receivables and other long-term assets, were as follows:

	2017	2016
Pledges due:		
In less than one year	\$ 159	\$ 132
In one to five years	195	171
In more than five years	33	24
	387	327
Allowance for uncollectible pledges and discounts	(18)	(11)
Total	\$ 369	\$ 316

Estimated cash flows from pledge receivables due after one year are discounted using a risk-adjusted rate, ranging from 1 percent to 6 percent, that is commensurate with the pledges' due dates and established in the year the pledge is received.

The Clinic has received interests in various trusts, primarily split-interest, which are included in other long-term assets. The trusts, which are recorded at fair value based on the underlying value of the assets in the trust or discounted cash flow using a risk-adjusted discount rate of 4.31 percent and 4.70 percent at December 31, 2017 and December 31, 2016, respectively. During the years ended December 31, 2017 and 2016, there were no contributions recorded related to the split-interest trusts. The balance of the expected payment streams, were \$162 and \$175 at December 31, 2017 and 2016, respectively.

Note 10. Endowment

The Clinic's endowment consists of approximately 1,900 individual funds established for a variety of purposes. The endowment includes both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments (board-designated funds). Net assets associated with endowment funds, including funds designated by the Board of Trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions. The Board of Trustees retains the right to re-designate board-designated funds.

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

Notes to Consolidated Financial Statements (in Millions)

Note 10. Endowment (Continued)

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

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

The Clinic has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the Clinic must hold in perpetuity or for a donor-specified period(s), as well as board-designated funds. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that is intended to produce a real return, net of inflation and investment management costs, of at least five percent over the long term. Actual returns in any given year may vary from this amount.

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

The Clinic has a policy of appropriating for distribution each year five percent of its endowment fund's moving average fair value over the prior 36 months as of September 30 of the preceding year in which the distribution is planned. In establishing this policy, the Clinic considered the long-term expected return on its endowment. Accordingly, over the long term, the Clinic expects the current spending policy to allow its endowment to grow at an average of the long-term rate of inflation. This is consistent with the Clinic's 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.

At December 31, 2017, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	\$ —	\$ 814	\$ 1,376	\$ 2,190
Board-designated funds	2,121	—	—	2,121
Total funds	\$ 2,121	\$ 814	\$ 1,376	\$ 4,311

Mayo Clinic

Notes to Consolidated Financial Statements (in Millions)

Note 10. Endowment (Continued)

Changes in endowment net assets for the year ended December 31, 2017, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 1,804	\$ 645	\$ 1,268	\$ 3,717
Investment return:				
Investment income	31	26	—	57
Net appreciation (realized and unrealized)	261	224	—	485
Total investment return	292	250	—	542
Contributions	—	—	108	108
Appropriation of endowment assets for expenditure	(101)	(81)	—	(182)
Other changes:				
Transfers to create board-designated endowment funds	126	—	—	126
Endowment net assets, end of year	\$ 2,121	\$ 814	\$ 1,376	\$ 4,311

At December 31, 2016, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	\$ —	\$ 645	\$ 1,268	\$ 1,913
Board-designated funds	1,804	—	—	1,804
Total funds	\$ 1,804	\$ 645	\$ 1,268	\$ 3,717

Mayo Clinic**Notes to Consolidated Financial Statements (in Millions)****Note 10. Endowment (Continued)**

Changes in endowment net assets for the year ended December 31, 2016, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	\$ 1,582	\$ 628	\$ 1,166	\$ 3,376
Investment return:				
Investment income	21	18	—	39
Net appreciation (depreciation) (realized and unrealized)	82	71	—	153
Total investment return	103	89	—	192
Contributions	—	—	102	102
Appropriation of endowment assets for expenditure	(78)	(72)	—	(150)
Other changes:				
Transfers to create board-designated endowment funds	197	—	—	197
Endowment net assets, end of year	\$ 1,804	\$ 645	\$ 1,268	\$ 3,717

Note 11. Functional Expenses

The expenses reported in the consolidated statements of activities for the years ended December 31, 2017 and 2016, supported the following:

	2017	2016
Patient care	\$ 8,469	\$ 7,976
Lab and technology ventures	1,117	1,103
Research	751	710
Graduate and other education	323	298
General and administrative	245	168
Development expenses	24	21
Other activities	357	247
Total expenses	\$ 11,286	\$ 10,523

Note 12. Employee Benefit Programs

The Clinic serves as plan sponsor for several defined benefit pension funds and other postretirement benefits.

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

Included in other changes in unrestricted net assets at December 31, 2017 and 2016, are the following amounts, respectively, that have not yet been recognized in net periodic cost: unrecognized actuarial losses of \$4,137 and \$3,664 and unrecognized prior service benefit of \$382 and \$480. Actuarial losses are amortized as a component of net periodic pension cost, only if the losses exceed ten percent of the greater of the projected benefit obligation or the fair value of plan assets. Unrecognized prior service benefits are amortized on a straight-line basis over the estimated life of plan participants. The unrecognized actuarial losses and prior service benefit included in net assets are expected to be recognized in net periodic pension cost during the year ending December 31, 2018, in the amount of \$228 and \$85, respectively.

Changes in plan assets and benefit obligations recognized in unrestricted net assets during 2017 and 2016 included the following:

	2017	2016
Current-year actuarial loss	\$ (638)	\$ (986)
Amortization of actuarial loss	170	126
Current-year prior service cost	—	(27)
Amortization of prior service credit	(97)	(112)
Pension and other postretirement benefit adjustments	<u>\$ (565)</u>	<u>\$ (999)</u>

Pension plans:

Obligations and funded status: Following is a summary of the changes in the benefit obligation and plan assets, the resulting funded status of the qualified and nonqualified pension plans, and accumulated benefit obligation as of and for the years ended December 31:

	2017	2016
Change in projected benefit obligation:		
Benefit obligation, beginning of year	\$ 8,316	\$ 7,313
Service cost	425	367
Interest cost	350	336
Actuarial loss	1,027	639
Benefits paid	(471)	(339)
Estimated benefit obligation at end of year	<u>\$ 9,647</u>	<u>\$ 8,316</u>
Change in plan assets:		
Fair value of plan assets, beginning of year	\$ 7,260	\$ 6,792
Actual return on plan assets	\$ 1,048	\$ 341
Employer contributions	535	466
Benefits paid	(471)	(339)
Fair value of plan assets at end of year	<u>\$ 8,372</u>	<u>\$ 7,260</u>

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

	2017	2016
Funded status of the plan	\$ (1,275)	\$ (1,056)
Accumulated benefit obligation	\$ 9,360	\$ 8,140

Amounts recognized in the consolidated statements of financial position consist of the following at December 31:

	2017	2016
Noncurrent liabilities	(1,275)	(1,056)
Net amount recognized	\$ (1,275)	\$ (1,056)

Components of net periodic benefit cost are as follows at December 31:

	2017	2016
Service cost	\$ 425	\$ 367
Interest cost	350	336
Expected return on plan assets	(573)	(559)
Amortization of unrecognized:		
Prior service benefit	(50)	(58)
Net actuarial loss	157	125
Net periodic benefit cost	\$ 309	\$ 211

Plan assets: The largest of the pension funds is the Mayo Clinic Master Retirement Trust Plan, which holds \$8,260 of the \$8,372 in combined plan assets at December 31, 2017, and \$7,155 of the \$7,260 in combined plan assets at December 31, 2016. The investment policies described below apply to the Mayo Clinic Master Retirement Trust Plan (the Plan).

The Plan employs a global, multi-asset approach in managing its retirement plan assets. This approach is designed to maximize risk-adjusted returns over a long-term investment horizon, consistent with the nature of the pension liabilities being funded. The plan asset portfolio's target allocation for total return investment strategies, which include public equities, private equities, absolute return, and real assets, is 82.5 percent. The portfolio's target fixed-income exposure is 17.5 percent. The fixed-income exposure may include the use of long-term interest rate swap contracts structured to increase the portfolio's interest rate sensitivity and thereby provide a hedge of the plan liabilities resulting from falling long-term interest rates. Investments in private equities, real assets, and absolute return strategies are held to improve diversification and thereby enhance long-term, risk-adjusted returns. However, recognizing that these investments are not as liquid as publicly traded stocks and bonds, portfolio investment policies limit overall exposure to these assets. The portfolio's allocation to private equities and real assets is limited to a maximum of 30 percent (with a target allocation of 22.5 percent), and exposure to absolute return strategies is limited to a maximum of 35 percent (with a target of 27.5 percent). The Clinic reviews performance, asset allocation, and risk management reports for plan asset portfolios on a monthly basis.

Mayo Clinic

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

The fair values of the Plan's assets at December 31, 2017, by asset category are as follows:

Assets	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	NAV	Total
Cash and equivalents	\$ 752	\$ 23	\$ —	\$ —	775
Fixed-income securities:					
U.S. government	—	67	—	—	67
U.S. government agencies	—	138	—	—	138
U.S. corporate	—	358	—	—	358
Foreign	—	25	—	—	25
Common and preferred stocks:					
U.S.	650	30	—	—	680
Foreign	477	—	—	—	477
Funds:					
Fixed-income	343	—	—	—	343
Equities	156	518	—	—	674
Investments at NAV	—	—	—	4,723	4,723
Total investments	\$ 2,378	\$ 1,159	\$ —	\$ 4,723	\$ 8,260

The fair values of the Plan's assets at December 31, 2016, by asset category are as follows:

Assets	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	NAV	Total
Cash and equivalents	\$ 541	\$ 18	\$ —	\$ —	559
Fixed-income securities:					
U.S. government	—	124	—	—	124
U.S. government agencies	—	147	—	—	147
U.S. corporate	—	287	—	—	287
Foreign	—	21	—	—	21
Common and preferred stocks:					
U.S.	546	31	10	—	587
Foreign	356	—	—	—	356
Funds:					
Fixed-income	240	—	—	—	240
Equities	266	404	—	—	670
Investments at NAV	—	—	—	4,164	4,164
Total investments	\$ 1,949	\$ 1,032	\$ 10	\$ 4,164	\$ 7,155

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

The following is a description of the Plan's valuation methodologies for assets and liabilities measured at fair value. Fair value for Level 1 is based upon quoted market prices. Fair value for Level 2 is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources, including market participants, dealers and brokers.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The Clinic's policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that caused the transfer. There were no significant transfers in 2017. During the year ended December 31, 2016, the Clinic transferred \$217 of funds from NAV to Level 2 due to a change in measurement inputs.

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

The following information pertains to those alternative investments recorded at NAV in accordance with the *Fair Value Measurements and Disclosures* topic of the FASB ASC 820.

At December 31, 2017, alternative investments recorded at NAV consisted of the following:

	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return/hedge funds (a)	\$ 2,791	\$ —	Monthly to annually	30–90 days
Private partnerships (b)	1,932	1,047		
	<u>\$ 4,723</u>	<u>\$ 1,047</u>		

At December 31, 2016, alternative investments recorded at NAV consisted of the following:

	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return/hedge funds (a)	\$ 2,564	\$ —	Monthly to annually	30–90 days
Private partnerships (b)	1,600	962		
	<u>\$ 4,164</u>	<u>\$ 962</u>		

- (a) This category includes investments in absolute return/hedge funds, which are actively managed commingled investment vehicles that derive the majority of their returns from factors other than the directional flow of the markets in which they invest. Representative strategies include high-yield

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

credit, distressed debt, merger arbitrage, relative value, and long-short equity strategies. The fair values of the investments in this category have been estimated using the NAV per share of the investments. Investments in this category generally carry “lockup” restrictions that do not allow investors to seek redemption in the first year after acquisition. Following the initial lockup period, liquidity is generally available monthly, quarterly or annually following a redemption request. Over 90 percent of the investments in this category have at least annual liquidity.

- (b) This category includes limited partnership interests in closed-end funds that focus on venture capital, private equity, real estate and resource-related strategies. The fair values of the investments in this category have been estimated using the NAV of the Plan’s ownership interest in partners’ capital. These investments cannot be redeemed with the funds. Distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of most funds will generally be liquidated over a seven- to ten-year period.

No plan assets are expected to be returned to the employer during 2018.

Other postretirement benefits:

Obligations and funded status: A summary of the changes in the benefit obligation and plan assets and the resulting funded status of the other postretirement plans is as follows as of and for the years ended December 31:

	2017	2016
Change in projected benefit obligation:		
Benefit obligation at beginning of year	\$ 1,005	\$ 841
Service cost	11	10
Interest cost	42	38
Plan participants’ contributions	26	25
Amendments	—	26
Medicare subsidy	3	3
Actuarial loss	90	139
Benefits paid	(82)	(77)
Estimated benefit obligation at end of year	\$ 1,095	\$ 1,005
Change in plan assets:		
Fair value of plan assets at beginning of year	\$ —	\$ —
Employer contributions	53	49
Plan participants’ contributions	26	25
Medicare subsidy	3	3
Benefits paid	(82)	(77)
Fair value of plan assets at end of year	\$ —	\$ —
Funded status of the plan	\$ (1,095)	\$ (1,005)

Amounts recognized in the consolidated statements of financial position for postretirement benefits consist of the following at December 31:

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

	2017	2016
Current liabilities	\$ (46)	\$ (48)
Noncurrent liabilities	(1,049)	(957)
Net amount recognized	<u>\$ (1,095)</u>	<u>\$ (1,005)</u>

Components of net periodic benefit cost for other postretirement benefits are as follows for the years ended December 31:

	2017	2016
Service cost	\$ 11	\$ 10
Interest cost	42	38
Amortization of:		
Unrecognized prior service benefit	(47)	(54)
Unrecognized net actuarial loss	13	2
Net periodic benefit cost for other postretirement benefits	<u>\$ 19</u>	<u>\$ (4)</u>

The Clinic has concluded that the prescription drug benefits under its defined benefit postretirement plan are actuarially equivalent to Medicare Part D under the Medicare Modernization Act (the Act) and that the Clinic will receive the subsidy available under the Act.

The following reflects the expected future Medicare Part D subsidy receipts:

Years ending December 31:

2018	\$ 5
2019	5
2020	6
2021	6
2022	6
2023–2027	31

Plan trend rates are the annual rates of increase expected for the benefits payable from the plan; these rates include Health Care Cost Trend plus the leveraging effect of plan design. The assumed plan trend rate is 5%. A one-percentage-point change in the assumed health care cost trend rate would have the following effects:

	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on total service and interest cost components in 2017	\$ 2	\$ (2)
Effect on postretirement benefit obligation at December 31, 2017	54	(46)

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

Pension and postretirement benefits:

Assumptions: Weighted-average assumptions used to determine pension and postretirement benefit obligations at the measurement date are as follows:

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Discount rate	3.74%	4.31%	3.72%	4.24%
Rate of compensation increase	3.39%	3.36%	N/A	N/A

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

	Pension Benefits		Postretirement Benefits	
	2017	2016	2017	2016
Discount rate	4.31%	4.70%	4.24%	4.63%
Expected long-term return on plan assets	7.50%	8.00%	N/A	N/A
Rate of compensation increase	3.36%	3.33%	N/A	N/A

The Clinic utilizes a building block approach in determining the expected long-term rate of return for its plan assets. First, historical data on individual asset class returns are studied. Next, the historical correlation among and between asset class returns is studied under both normal conditions and in times of market turbulence. Then, various mixes of asset classes are considered under multiple long-term investment scenarios. Finally, after considering liquidity concerns related to the use of certain alternative asset classes, the plan sponsor selects the portfolio blend that it believes will produce the highest expected long-term return on a risk-adjusted basis.

Cash flows:

Contributions: The Clinic expects to contribute \$764 to its pension plans in 2018.

Estimated future benefit payments: The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	Pension Benefits	Postretirement Benefits
Years ending December 31:		
2018	\$ 441	\$ 46
2019	461	48
2020	481	52
2021	509	54
2022	534	56
2023–2027	2,910	305

Notes to Consolidated Financial Statements (in Millions)

Note 12. Employee Benefit Programs (Continued)

In addition to the defined benefit plans, the Clinic sponsors various defined contribution benefit plans. Expense recognized by the Clinic for those plans was \$99 and \$93 for 2017 and 2016, respectively.

Note 13. General and Professional Liability Insurance

The Clinic insures substantially all general and professional liability risks through a combination of a wholly owned captive insurance company and self-insurance. The insurance program combines various levels of self-insured retention with excess commercial insurance coverage. Actuarial consultants have been retained to assist in the estimation of outstanding general and professional liability losses.

The Clinic's general and professional liability as reported in the accompanying consolidated statements of financial position was \$88 and \$81 at December 31, 2017 and 2016, respectively. Provisions for the general and professional liability risks are based on an actuarial estimate of losses using the Clinic's actual loss data adjusted for industry trends and current conditions and considering an evaluation of claims by the Clinic's legal counsel. The provision includes estimates of ultimate costs for both reported claims and claims incurred but not reported.

Activity in the liability is summarized as follows for the years ended December 31:

	2017	2016
Balance, beginning of year	\$ 81	\$ 100
Incurred related to captive insurance company liability:		
Current year	19	22
Prior years	2	(9)
Total incurred	21	13
Paid related to captive insurance company liability:		
Current year	(1)	—
Prior years	(15)	(23)
Total paid	(16)	(23)
Net change in self-insurance liability	2	(9)
Balance, end of year	\$ 88	\$ 81

Note 14. Other Receivables, Other Current and Long-Term Assets, and Other Current and Long-Term Liabilities

At December 31, other receivables consisted of the following:

Notes to Consolidated Financial Statements (in Millions)

Note 14. Other Receivables, Other Current and Long-Term Assets, and Other Current and Long-Term Liabilities (Continued)

	2017	2016
Pledges receivable	\$ 159	\$ 132
Grants receivable	82	66
Other	107	111
Total other receivables	<u>\$ 348</u>	<u>\$ 309</u>

At December 31, other current assets consisted of the following:

	2017	2016
Inventories	\$ 123	\$ 129
Prepaid expenses	64	59
Other	41	65
Total other current assets	<u>\$ 228</u>	<u>\$ 253</u>

At December 31, other long-term assets consisted of the following:

	2017	2016
Pledges receivable	\$ 210	\$ 184
Trust receivables	162	175
Oil and gas interests	64	49
Long-term portion of deferred tax asset	29	51
Technology-based ventures	19	18
Other	94	97
Total other long-term assets	<u>\$ 578</u>	<u>\$ 574</u>

At December 31, other current liabilities consisted of the following:

	2017	2016
Other taxes	73	\$ 64
Short-term disability	32	37
Current portion of long-term disability	30	29
Current portion of professional and general liability	28	29
Real estate tax accrual	26	26
Liabilities held for sale	25	39
Refunds/recoupments	21	20
Current portion of workers' compensation liability	16	15
Other	89	100
Total other current liabilities	<u>\$ 340</u>	<u>\$ 359</u>

Notes to Consolidated Financial Statements (in Millions)**Note 14. Other Receivables, Other Current and Long-Term Assets, and Other Current and Long-Term Liabilities (Continued)**

At December 31, other long-term liabilities consisted of the following:

	2017	2016
Deferred compensation	\$ 586	\$ 478
Long-term disability	160	150
Electronic medical record	87	62
Professional and general liability	60	52
Gift annuities	49	46
Trust obligations	46	43
Lease agreement liability	42	38
Retirement community obligations	35	36
Workers' compensation liability	27	21
Asset retirement obligation	23	24
Contract deposit	22	22
Other	64	56
Total other long-term liabilities	<u>\$ 1,201</u>	<u>\$ 1,028</u>

Note 15. Other Revenue

For the years ended December 31, other revenue consisted of the following:

	2017	2016
Retail pharmacy sales	\$ 301	\$ 267
Royalties	95	61
Technology commercialization, health information and medical products	54	53
Retail stores	46	49
Graduate medical and other education revenue	38	40
Cafeteria revenue	35	35
Oil- and gas-producing activities	18	15
Third-party administrative revenue	13	11
Other	266	220
Total other revenue	<u>\$ 866</u>	<u>\$ 751</u>

Note 16. Commitments and Contingencies

The Clinic has various construction projects in progress related to patient care, research, and educational facilities. The estimated costs committed to complete the various projects at December 31, 2017, approximated \$707, all of which is expected to be expended over the next three to five years. In addition, the Clinic has a project in progress to replace the electronic medical record with estimated costs committed to complete at December 31, 2017, approximating \$325, anticipated to be completed in 2018.

Note 16. Commitments and Contingencies (Continued)

One of the Clinic's affiliation agreements limits the involvement of a third party in operations of a consolidated affiliate. A process exists to resolve disputes; however, in the event of an irreconcilable dispute between the parties, the agreement further provides for a one-time payment of approximately \$87 by the consolidated affiliate to release the third party from the affiliation. Such payment would be subordinate to other debtors of the consolidated affiliated entity. No amount has been accrued in the consolidated financial statements for this contingency.

While the Clinic is self-insured for a substantial portion of its general and workers' compensation liabilities, the Clinic maintains commercial insurance coverage against catastrophic loss. Additionally, the Clinic maintains a self-insurance program for its long-term disability coverage. The provision for estimated self-insured claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Laws and regulations concerning government programs, including Medicare, Medicaid and various research grant programs, are complex and subject to varying interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. 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 related programs. The Clinic expects that the level of review and audit to which it is subject will increase. There can be no assurance that regulatory authorities will not challenge the Clinic's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon the Clinic.

The Clinic is a defendant in various lawsuits arising in the ordinary course of business and records an estimated liability for probable claims. 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 the Clinic's consolidated financial position or statement of activities.

Note 17. Disposal of Affiliates

On May 1, 2017, the Clinic withdrew as the sole member of Mayo Clinic Health System - Waycross in a transaction with the Hospital Authority of Ware County and HCA Management Services, L.P.A. A loss from disposal of affiliate of \$13 and \$90, is included in noncurrent and other items of the consolidated statements of activities for the years ended December 31, 2017 and December 31, 2016, respectively.

In August 2017, the Clinic entered into an agreement with Medica, a Minnesota-based health services company, to sell its ownership interest in Mayo Clinic Health Solutions (MMSI). For the year ended December 31, 2017, a \$34 gain from disposal of affiliate is included in noncurrent and other items of the consolidated statements of activities.

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