# KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES

Consolidated Financial Statements

Federal Uniform Guidance Reports

Year ended December 31, 2017

(With Independent Auditors' Reports Thereon)

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES**

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KPMG LLP
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## Independent Auditors' Report

The Board of Directors
Kaiser Foundation Health Plan of Washington:

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Kaiser Foundation Health Plan of Washington and Subsidiaries, which comprise the consolidated balance sheet as of December 31, 2017, and the related consolidated statements of operations and changes in net worth and cash flows for the period February 1, 2017 to December 31, 2017, the Group Health Cooperative and Subsidiaries (Predecessor) consolidated statements of operations and changes in net worth and cash flows for the period January 1, 2017 to January 31, 2017, 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 consolidated financial statements in accordance 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

*Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of 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 consolidated financial statements.

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

*Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Kaiser Foundation Health Plan of Washington and Subsidiaries as of December 31, 2017, and the results of their operations and their cash flows for the period February 1, 2017 to December 31, 2017 and Predecessor results of operations and cash flows for the period January 1, 2017 to January 31, 2017 in accordance with U.S. generally accepted accounting principles.

KPMG

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated August 14, 2018 on our consideration of Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control over financial reporting and on our tests of their compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control over financial reporting and compliance.

KPMG LLP

Seattle, Washington
August 14, 2018

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES**

Consolidated Balance Sheet

December 31, 2017

(In thousands)

| **Assets** | | **Successor** |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $ | 43,632 |
| Current investments | | 303,684 |
| Broker receivables | | 1,672 |
| Accounts receivable – net | | 162,506 |
| Due from affiliated organizations | | 12,834 |
| Inventories and other current assets | | 59,829 |
| Total current assets | | 584,157 |
| Noncurrent investments | | 775,444 |
| Land, buildings, equipment, and software – net | | 856,946 |
| Goodwill | | 297,299 |
| Other acquired intangible assets – net | | 215,067 |
| Other long-term assets | | 55,698 |
| Total assets | $ | 2,784,611 |

| **Liabilities and Net Worth** | | |
|---|---|---|
| Current liabilities: | | |
| Accounts payable and accrued expenses | $ | 183,775 |
| Medical claims payable | | 266,224 |
| Due to associated medical group | | 42,410 |
| Due to affiliated organizations | | 22,361 |
| Payroll and related charges | | 84,781 |
| Broker payables | | 1,583 |
| Professional and other insured liabilities | | 14,731 |
| Other current liabilities | | 115,815 |
| Total current liabilities | | 731,680 |
| Pension and other retirement liabilities | | 149,481 |
| Professional and other insured liabilities | | 37,621 |
| Other long-term liabilities | | 72,004 |
| Total liabilities | | 990,786 |
| Net worth | | 1,793,825 |
| Total liabilities and net worth | $ | 2,784,611 |

See accompanying notes to consolidated financial statements.

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES**

Consolidated Statements of Operations and Changes in Net Worth

(In thousands)

| | Predecessor | Successor |
|---|---|---|
| | **For the One Month Period ended January 31, 2017** | **For the Eleven Month Period Ended December 31, 2017** |
| Revenues: | | |
| Premiums | $ 301,947 | $ 3,267,391 |
| Clinicial services – net | 34,554 | 355,049 |
| Other | 10,291 | 106,346 |
| Total operating revenues | 346,792 | 3,728,786 |
| Expenses: | | |
| External delivery services | 167,372 | 1,961,610 |
| Employee compensation | 51,851 | 568,881 |
| Medical and operating supplies | 37,889 | 423,820 |
| Associated medical group expense | 31,040 | 359,117 |
| Other expenses | 19,517 | 229,655 |
| Services purchased | 10,694 | 126,600 |
| Depreciation and amortization | 5,578 | 98,818 |
| Business taxes and insurance | 2,011 | 26,207 |
| Total operating expenses | 325,952 | 3,794,708 |
| Operating income (loss) | 20,840 | (65,922) |
| Other income and expense: | | |
| Investment income – net | (772) | 27,082 |
| Interest expense | (19) | (3,161) |
| Total other income and expense | (791) | 23,921 |
| Net income (loss) | 20,049 | (42,001) |
| Change in pension and other retirement liability charges | 3,440 | (48,370) |
| Change in net unrealized (losses) gains on investments | (14,992) | 30,723 |
| Other | (32) | 473 |
| Change in net worth | 8,465 | (59,175) |
| Net worth at beginning of period | 1,060,261 | 1,853,000 |
| Net worth at end of period | $ 1,068,726 | $ 1,793,825 |

See accompanying notes to consolidated financial statements.

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES**

Consolidated Statements of Cash Flows

(In thousands)

| | | Predecessor | | Successor |
|---|---|---|---|---|
| | | For the One Month Period ended January 31, 2017 | | For the Eleven Month Period Ended December 31, 2017 |
| Cash flows from operating activities: | | | | |
| Net income (loss) | $ | 20,049 | $ | (42,001) |
| Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities: | | | | |
| Depreciation and software amortization | | 5,578 | | 63,085 |
| Other amortization | | — | | 35,733 |
| Provision for self-insurance | | 768 | | 8,145 |
| Gain recognized on investments – net | | (18,352) | | (874) |
| Recognized other-than-temporary impairment | | — | | 9,613 |
| Equity (income) loss on equity method investees | | (370) | | 4,946 |
| Divestiture of investment in Group Health Foundation | | 21,927 | | — |
| Gain on extinguishment of finance obligation | | — | | (11,172) |
| Other | | 8 | | 473 |
| Changes in assets and liabilities: | | | | |
| Accounts receivable – net | | 26,719 | | 36,647 |
| Due from affiliated organizations | | — | | (12,834) |
| Inventories and other current assets | | 1,813 | | (26,347) |
| Accounts payable and accrued expenses | | (27,324) | | 42,895 |
| Medical claims payable | | 20,806 | | (11,002) |
| Due to associated medical groups | | (2,910) | | 4,007 |
| Due to affiliated organizations | | — | | 22,361 |
| Payroll and related charges | | 5,888 | | 9,443 |
| Professional and other insured liabilities | | (1,224) | | (13,934) |
| Pension and other retirement liabilities | | (143,000) | | (9,400) |
| Other liabilities | | 13,425 | | 3,453 |
| Net cash (used in) provided by operating activities | | (76,199) | | 113,237 |
| Cash flows from investing activities: | | | | |
| Additions to land, buildings, equipment, and software | | (8,132) | | (163,499) |
| Proceeds from sales of land, buildings, equipment, and software | | 6 | | 6 |
| Proceeds from investments | | 359,852 | | 643,247 |
| Investment purchases | | (223,138) | | (655,847) |
| Broker receivables / payables | | — | | (5,924) |
| Purchase of equity investments | | (140) | | (976) |
| Net cash provided by (used in) investing activities | | 128,448 | | (182,993) |
| Cash flows from financing activities: | | | | |
| Prepayment and repayment of debt | | — | | (455) |
| Net cash used in financing activities | | — | | (455) |
| Net change in cash and cash equivalents | | 52,249 | | (70,211) |
| Cash and cash equivalents at beginning of period | | 61,594 | | 113,843 |
| Cash and cash equivalents at end of period | $ | 113,843 | $ | 43,632 |
| Supplemental cash flows disclosure: | | | | |
| Cash paid for: | | | | |
| Interest | $ | 19 | $ | 51 |
| Income taxes | $ | — | | 6,485 |
| Noncash changes in: | | | | |
| Divestiture of investment in Group Health Foundation due to loss of control | $ | 21,927 | $ | — |
| Gain on extinguishment of finance obligation | $ | — | $ | 11,172 |

See accompanying notes to consolidated financial statements.

## (1) Description of Business

The accompanying Successor consolidated financial statements include Kaiser Foundation Health Plan of Washington (KFHPWA), KFHPWA's wholly owned subsidiary, Kaiser Foundation Health Plan of Washington Options, Inc. (KFHPWAO), and KFHPWA's controlled affiliate Columbia Medical Associates, LLC (CMA).

The accompanying Predecessor consolidated financial statements include Group Health Cooperative (GHC), its wholly owned subsidiary, Group Health Options, Inc. (GHO), and its controlled affiliate, CMA. The entities in the Successor and Predecessor are substantially the same and collectively referred to as the Group.

KFHPWA is a Washington nonprofit corporation registered as a health maintenance organization headquartered in Seattle, Washington. KFHPWA offers comprehensive, coordinated health care to an enrolled membership for a fixed fee through its owned and leased facilities, employed providers, and contracted providers, in addition to providing certain health care services on a fee-for-service basis to both members and nonmembers.

KFHPWAO is a Washington for-profit corporation registered and operating as a health care service contractor headquartered in Seattle, Washington. KFHPWAO provides health care coverage products that feature increased customer choice, including point of service and preferred provider organization plan benefits. It is also registered in Idaho as a Disability, Including Managed Care Carrier, operating in two counties.

CMA is a Washington limited liability company headquartered in Spokane, Washington. CMA provides medical services to families and individuals within the greater Spokane area.

In December 2015, GHC signed an agreement to be acquired by KFHPW Holdings (Holdings), a subsidiary of Kaiser Foundation Health Plan of Washington, Inc. (KFHP, a Washington nonprofit corporation). Closing of the acquisition was subject to certain conditions, including approval by GHC's eligible voting members; filings with and approval by, state and federal regulators; and just prior to closing, separation of Group Health Foundation as a controlled affiliate of GHC. On March 12, 2016, GHC's eligible voting members approved the Plan of Member Substitution, the resolution supporting Holdings' acquisition of GHC. The federal antitrust regulatory review pursuant to the Hart-Scott-Rodino Act was complete on March 10, 2016.

On January 13, 2017, the Washington State Office of Insurance Commissioner approved the acquisition. On January 31, 2017, Group Health Foundation separated from GHC. Holdings acquired and became the sole corporate member of GHC on February 1, 2017.

Following the acquisition, GHC was renamed "Kaiser Foundation Health Plan of Washington", and GHO was renamed "Kaiser Foundation Health Plan of Washington Options, Inc."

The Group contracts with Washington Permanente Medical Group P.C. (WPMG), which is an independent medical group, to provide medical services that include primary, specialty, and inpatient care for members. Contract payments to WPMG represent a substantial portion of operating expense of the Group and substantially all of the revenue of WPMG. Because WPMG is independent and not controlled by the Group, its financial statements are not combined or consolidated with KFHPWA.

At December 31, 2017, the percentage of the Group's total labor force covered under collective bargaining agreements was approximately 62%. At December 31, 2017, 21% of the Group's workforce was covered under collective bargaining agreements that were scheduled to expire within one year.

KFHPWA strives to improve the health and welfare of the communities it serves through its Community Benefit investment programs. Community Benefit expenditures provide funding for programs that serve communities through research, community-based health partnerships, the provision of charity care to low income patients, direct health coverage for low income families, and collaboration with community clinics, health departments, and public hospitals.

Cost-based methods are used to account for losses incurred under the care and coverage lines of business qualifying for treatment as Community Benefit. Patients assigned to these lines of business must first prove eligibility based upon family income relative to the Federal Poverty Guidelines. Most costs determined to be Community Benefit are allocated across the lines of business following pre-determined allocation rules applied within the organization's cost accounting systems. Certain Community Benefit costs are determined using the out of pocket costs directly billed to patients or a cost to charge ratio applied to uncompensated charges associated with care provided to these patients.

For the periods ended January 31, 2017 and December 31, 2017, Community Benefit expenditures (at cost, net of approximately $6.1 million and $64.2 million of related revenues, respectively) were $5.1 million and $58.0 million, respectively.

## (2) Summary of Significant Accounting Policies

### *(a) Basis of Presentation*

In the accompanying financial information, Successor refers to the consolidated financial statements of KFHPWA and Subsidiaries and Predecessor refers to the consolidated financial statements of Group Health Cooperative and Subsidiaries. The term Group is used throughout the consolidated financial statements and applies to either the Predecessor or the Successor. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All significant intercompany accounts and transactions have been eliminated. Management has evaluated subsequent events through August 14, 2018, which is the date that these consolidated financial statements were issued.

### *(b) Cash and Cash Equivalents*

Cash and cash equivalents include interest bearing deposits purchased with an original or remaining maturity of three months or less. Cash and investments that are restricted per contractual or regulatory requirements are classified as noncurrent investments and excluded from cash and cash equivalents.

### *(c) Investments*

Investments include equity, U.S. Treasury, government agencies, money market funds, and other marketable debt securities and are reported at fair value. Investments are categorized as current assets if they are intended to be available to satisfy current liabilities. Alternative investments are reported under the equity method. Certain investments are illiquid and are valued based on the most current information available. Other than temporary impairment and recognized gains and losses, which are recorded on the first-in-first-out basis, and interest, dividend income, and income from equity method alternative investments are included in investment income – net.

Investments are regularly reviewed for impairment and a charge is recognized when the fair value is below cost basis and is judged to be other than temporary. In its review of assets for impairment that is deemed other than temporary, management generally follows these guidelines:

- Substantially all investments are managed by outside investment managers who do not need the Group's management's preapproval for sales; therefore, substantially all declines in value below cost are recognized as impairment that is other than temporary.
- For other securities, losses are recognized for known matters, such as bankruptcies, regardless of ownership period, and investments that have been continuously below book value for an extended period of time are evaluated for impairment that is other than temporary.

All other unrealized losses and all unrealized gains on investments are included as other changes in net worth.

Interest income is calculated under the effective interest method and included in investment income – net. Dividends are included in investment income – net on the ex-dividend date, which immediately follows the record date.

The Group's investment transactions are recorded on a trade date basis.

### *(d) Broker Receivables and Payables*

Broker receivables and payables represent current amounts for unsettled securities sales or purchases.

### *(e) Accounts Receivable*

Accounts receivable are comprised of members' premiums, Medicare receivables, patient receivables, and other receivables. The Group provides an allowance for potential uncollectible accounts receivable. The accounts receivable allowances are estimated based on the aging of accounts receivable, historical collection experience, retroactive enrollment changes, and other economic factors.

### *(f) Inventory*

Inventories consist of pharmaceuticals and supplies and are valued at the lower of weighted average cost or net realizable value.

### *(g) Land, Buildings, Equipment, and Software*

Land, buildings, equipment, and software are stated at cost less accumulated depreciation and amortization. Interest is capitalized on facilities construction and internally developed software work in progress and is added to the cost of the underlying asset. Software, which includes internal and external costs incurred in developing or obtaining computer software for internal use, is capitalized. Qualifying costs incurred during the application development stage are capitalized. Depreciation and amortization begin when the project is substantially complete and ready for its intended use. Software is amortized on a straight-line basis over the estimated useful lives, generally ranging from 3 to 7 years. Buildings and equipment are depreciated on a straight-line basis over the estimated useful lives of the various classes of assets, generally ranging from 3 to 40 years, or for leasehold improvements, over the term of the related lease, whichever is shorter.

Management evaluates alternatives for delivering services that may affect the current and future utilization of existing and planned assets and could result in an adjustment to the carrying values or remaining lives of such land, buildings, equipment, and software in the future. Management evaluates and records impairment losses or adjusts remaining lives, where applicable, based on expected utilization, projected cash flows, and recoverable values.

Maintenance and repairs are expensed as incurred. Major improvements that increase the estimated useful life of an asset are capitalized. Upon the sale or retirement of assets, recorded cost and related accumulated depreciation are removed from the accounts, and any gain or loss or disposal is reflected in operations.

Management estimates the fair value of asset retirement obligations that are conditional on a future event if the amount can be reasonably estimated. Estimates are developed through the identification of applicable legal requirements, identification of specific conditions requiring incremental cost at time of asset disposal, estimation of costs to remediate conditions, and estimate of remaining useful lives or date of asset disposal.

### *(h) Goodwill and Other Acquired Intangible Assets*

Goodwill and other acquired intangible assets arise from acquisition related activity. Goodwill represents the excess of the purchase price over the fair value of net assets acquired when accounted for using the acquisition method of accounting. Goodwill is required to be tested for impairment at least annually, or sooner, whenever events or circumstances indicate that the asset may be impaired.

Other acquired intangible assets are recognized at fair value on the date of purchase and are amortized on a straight-line basis or accelerated basis over periods from 5 to 16 years. These intangible assets are subject to impairment tests whenever events or circumstances indicate that these assets may be impaired.

### *(i) Medical Claims Payable*

The cost of health care services is recognized in the period in which services are incurred. Medical claims payable consists of unpaid health care expenses to third party providers, which include an estimate of the cost of services provided to the Group’s members by the third party providers that have been incurred but not reported. The estimate for incurred but not reported claims is based on actuarial projections of costs using historical paid claims and other relevant data. Estimates are monitored and reviewed and, as claim payments are received, adjudicated, and paid, estimates are revised and are reflected in current operations. Such estimates are subject to actual utilization of medical services, changes in membership and product mix, claim submission and processing patterns, medical inflation, and other relevant factors. Given the inherent variability of such estimates, the actual liability could differ significantly from the amounts provided. While the ultimate amount of paid claims is dependent on future developments, management believes the reserves for claims are adequate to cover such claims.

The Group records anticipated reinsurance recoveries for high cost claims eligible for reimbursement under the Patient Protection and Affordable Care Act (PPACA), as described in the *PPACA Health Insurance Providers Fee and Risk Adjustment Programs* note.

### *(j) Due to Associated Medical Group*

Due to associated medical group consists primarily of unpaid medical expenses owed to WPMG for medical services provided to members under medical services agreements. The cost of medical services is recognized in the period in which the services are provided.

### *(k) Self-Insured Risks*

KFHPWA is self-insured for industrial accident claims and unemployment benefits. On October 1, 2017, KFHPWA joined an affiliated captive insurance company, Lokahi Assurance, LTD. (Lokahi) for self-insured risks under their indemnification program for professional liability, errors and omissions liability, general and contractual liability, and personal injury liability. As part of this arrangement, KFHPWA entered into an agreement for professional liability whereby the captive insurance company assumed all losses prior to October 1, 2017. Until October 1, 2017, KFHPWA was self-insured for professional liability, the retention level for professional liability was $7.0 million per claim with an annual aggregate of $22.0 million. KFHPWA purchased excess insurance coverage to limit its exposure for industrial accident claims, while maintaining excess insurance on a claims-made basis. The retention level for industrial accident claims was $750 thousand for all of 2017. Industrial accident claims liability is determined using case-based estimates for reported claims and actuarial estimates for incurred but not reported claims. These estimates are based on historical information along with certain assumptions about future events. Changes in assumptions related to expected claims development as well as changes in actual experience could cause these estimates to change. At December 31, 2017, the estimated liability for professional liability claims was $43.4 million which is fully recoverable from Lokahi. At December 31, 2017, the estimated liability for industrial accident claims was $6.6 million. At December 31, 2017, the estimated liability for unemployment claims was $2.4 million. Insurance recovery receivable for 2017 is $46.0 million and is a component of due from affiliated organizations and other long-term assets.

### *(l) Premium Deficiency Reserves*

Premium deficiency reserves and the related expense are recognized when it is probable that expected future health care and maintenance costs under a group of existing contracts will exceed anticipated future premiums and reinsurance recoveries over the contract period. If applicable, premium deficiency reserves extending beyond one year are shown as a long-term liability. Expected investment income and interest expense are included in the calculation of premium deficiency reserves, as appropriate.

The methods for making such estimates and for establishing the resulting reserves are reviewed and updated, and any resulting adjustments are reflected in current operations. At December 31, 2017, the need for premium deficiency reserves was assessed and management believes that no premium deficiency reserve was required. Given the inherent variability of such estimates, the actual liability could differ significantly from the calculated amount.

### *(m) Revenue Recognition*

Members' premium revenue includes premiums from employer groups and individuals. Members' premium revenue is recognized over the period in which the members are entitled to health care services.

The Group estimates accrued retrospective premium adjustments for certain group health insurance contracts based on claims experience and the provisions of the contract. The Group records accrued retrospective premiums as an adjustment to members' premiums. For the periods ended January 31 and December 31, 2017, the amounts of premiums written by the Group subject to the retrospective rating feature were $22.2 million and $239.1 million, respectively. During the periods ended January 31 and December 31, 2017, revenue derived under these contracts was 7% of total premium dues. During the periods ended January 31 and December 31, 2017, retrospective premium reductions derived under these contracts were $60 thousand and $8.9 million, respectively.

The majority of the Group's Medicare revenue is received from the Medicare Advantage Program (Part C). Revenue for Part C includes capitated payments, which vary based on health status, demographic status, and other factors. Medicare revenue also includes accruals for estimates resulting from changes in health risk factor scores. Such accruals are recognized when the amounts become determinable and collection is reasonably assured. Part C revenue is finalized after all data is submitted to Medicare and the final settlement is made after the end of the year.

In addition, Medicare benefits include a voluntary prescription drug benefit (Part D). Revenue for Part D includes capitated payments made from Medicare adjusted for health risk factor scores. Revenue also includes amounts to reflect a portion of the health care costs for low-income Medicare beneficiaries and a risk-sharing arrangement to limit the exposure to unexpected expenses. Related accruals are recognized monthly based on cumulative experience and membership data. Part D revenue is finalized after all data is submitted to Medicare and the final settlement is made after the end of the year.

Medicare Part C and D revenue is subject to governmental audits and potential payment adjustments. The Centers for Medicare & Medicaid Services (CMS) performs coding audits to validate the supporting documentation maintained by the Group and its care providers.

Certain Medicare revenues are paid under cost reimbursement plans based on pre-established rates and the final settlement is made after the end of the year. Estimates of final settlements of the cost reports are recorded by the Group in current operations.

Estimates of retrospective adjustments resulting from coding audits and other contractual adjustments are recorded in the time period in which members are entitled to health care services. Actual retrospective adjustments may differ from initial estimates.

Premiums collected in advance are deferred and recorded as dues collected in advance or Medicare payments received in advance. Revenue is adjusted to reflect estimates of collectibility, including retrospective membership adjustment trends and economic conditions. Revenue and related receivables are exclusive of charity care. A portion of revenues derived under contracts with the United States Office of Personnel Management (USOPM) is subject to audit and potential retrospective adjustments.

Clinical services revenue is generated through the provision of certain medical and pharmacy services not fully covered under existing benefit policies and from services provided to nonmembers who receive care at the Group's facilities. Clinical services revenue is recognized as services are rendered. Bad debt expense related to clinical services revenue is calculated based on historical bad debt experience and recorded as an offset to clinical services revenue (net of contractual allowances, charity care, and discounts).

The Group has agreements with third party payors that provide for payments of amounts different from established charges. The Group's clinical services revenue, net of contractual allowances and discounts, came from major payor sources that include commercial, private, Medicare, and Medicaid.

The table below presents the amounts of the significant operating revenue types for the periods ended January 31 and December 31 (in thousands):

| | January 31, 2017 (Predecessor) | December 31, 2017 (Successor) |
|---|---|---|
| Premiums: | | |
| Group | $ 184,758 | $ 2,028,172 |
| Medicare | 89,442 | 978,825 |
| Individual and family | 27,747 | 260,394 |
| Total premiums | 301,947 | 3,267,391 |
| Clinical services revenue, net of contractual allowances and discounts | 35,687 | 370,139 |
| Less provision for bad debt | (1,133) | (15,090) |
| Total clinical services – net | 34,554 | 355,049 |
| Other revenue: | | |
| Grants | 4,251 | 45,023 |
| Administrative service fees to self-funded plans | 3,382 | 37,253 |
| Sales | 1,329 | 14,733 |
| Other | 1,329 | 9,337 |
| Total other | 10,291 | 106,346 |
| Total operating revenues | $ 346,792 | $ 3,728,786 |

The Group has entered into payment agreements with certain commercial insurance carriers including employer groups under self-funded plans. The basis for payment to the Group under these agreements includes prospectively determined rates per unit of service and discounts from established charges.

Most arrangements provide for payment or reimbursement to the Group at amounts different from established rates. Contractual discounts represent the difference between established rates for services and amounts paid or reimbursed by these third party payors.

The Group has estimated payments for services rendered to Medicare and Medicaid fee for service patients during the year by applying the payment principles of the applicable governmental agencies and believes that an adequate provision has been made in the accompanying consolidated financial statements for final settlement.

Most outpatient services provided to Medicare patients are reimbursed based on prospectively determined rates. Medicaid patients are also reimbursed based on a combination of prospectively determined rates and cost reimbursement methodology. Continuation of these reimbursement programs at the present level, and on the present basis, is dependent upon future policies of the federal and state governmental agencies.

Other revenue includes grants awarded to the Kaiser Permanente Washington Health Research Institute, a division of KFHPWA, optical sales, and self-funded administrative service fees.

### *(n) Pension and Other Postretirement Benefits*

The Group's defined benefit pension and other postretirement benefit plans are actuarially evaluated and involve various assumptions. Critical assumptions include the discount rate and the expected rate of return on plan assets, and the rate of increase for health care costs (for postretirement benefit plans other than pension), which are important elements of expense and/or liability measurement. Other assumptions involve demographic factors, such as retirement age, mortality, turnover, and the rate of compensation increases. The Group evaluates assumptions annually, or when significant plan amendments occur, and modifies them as appropriate. Pension and other postretirement costs are allocated over the service period of the employees in the plans.

The Group uses a discount rate to determine the present value of the future benefit obligations. The discount rate is established based on rates available for high-quality fixed-income debt securities at the measurement date whose maturity dates match the expected cash flows of the retirement plans.

Differences between actual and expected plan experience and changes in actuarial assumptions, in excess of a 10% corridor around the larger of plan assets or plan liabilities, are recognized into benefits expense over the expected average future service of active participants. Prior service costs and credits arise from plan amendments and are amortized into postretirement benefits expense over the expected average future service to full eligibility of active participants.

### *(o) Donations and Grants Made or Received*

Donations and grants made are recognized at fair value in the period in which a commitment is made, provided the payment of the donation or grant is probable and the amount is determinable. Donations or grants received, including research grants, are recognized at fair value in the period the donation or grant was committed unconditionally by the grantor or in the period the donation or grant requirements are met, if later.

### *(p) Income Taxes*

KFHPWA is exempt from federal income taxes under Section 501(a) of the Internal Revenue Code (the Code) as a charitable organization under Section 501(c) (3) of the Code, except for unrelated business income tax. KFHPWAO is subject to federal income taxes and is not subject to any state income tax filing requirements. CMA is considered a disregarded entity for federal tax purposes and is included with any KFHPWA federal income tax filing.

Deferred income taxes are recognized for the tax consequences in future years of the differences between the tax basis of assets and liabilities and the financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods 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 upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities (including the impact of available carryback and carryforward periods), projected future taxable income, and tax planning strategies in making this assessment.

### *(q) Use of Estimates*

The preparation of these consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts. Allowance for uncollectible accounts receivable; estimated fair value of investments; fair value of assets acquired and liabilities assumed via acquisition; recoverability of goodwill and other acquired intangible assets – net; Medicare revenue accruals; Medicare reserves; incurred but not reported medical claims payable; pension and other retirement liabilities; premium deficiency reserves; self-insured professional liabilities; self-insured general and workers’ compensation liabilities; land, buildings, equipment, and software impairment and useful lives; investment impairment; and certain amounts accrued related to the PPACA Risk Adjustment Program represent significant estimates. Actual results could differ materially from those estimates. As occurs from time to time, negotiations with labor partners may result in changes to compensation and benefits. These changes are reflected in the financial statements as appropriate when agreements are finalized.

### *(r) The PPACA Health Insurance Providers Fee and Risk Adjustment Programs*

The PPACA requires the Group to pay a Health Insurance Providers (HIP) fee that is assessed based on prior year net premiums as a percentage of total premiums for all U.S. health plans. The HIP fee was suspended for the 2017 calendar year but it is expected to recommence in 2018.

The PPACA Risk Adjustment Program is permanent, and provides for retrospective adjustment of revenue for non-grandfathered individual and small group market plans, whether inside or outside PPACA exchanges. The PPACA Risk Adjustment Program is designed such that payments to plans with higher relative risk are funded by transfers from plans with lower relative risk. For the periods ended January 31 and December 31, 2017, the Group recorded zero and $75.2 million, respectively, in net revenue reductions related to the PPACA Risk Adjustment Program.

At December 31, 2017, the net payable for PPACA Risk Adjustment totaled $66.0 million.

### *(s) Recently Issued Accounting Standards*

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09 *Revenue from Contracts with Customers (Topic 606)*. The ASU replaces most existing revenue recognition guidance in U.S. GAAP. Topic 606 was adopted January 1, 2018. The standard permits the use of either the retrospective or cumulative effect transition method. Management selected the cumulative effect transition method.

Management will include new disclosures in 2018 in accordance with Topic 606. The adoption of Topic 606 did not have a significant impact on the results of operations.

In July 2015, the FASB issued ASU No. 2015-11 *Inventory – Simplifying the Measurement of Inventory (Topic 330)*. The amendments in this update change the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. The new standard was adopted by the Group in 2017. The standard requires the application of the prospective transition method. The adoption of this standard did not have a significant effect on the consolidated financial statements and related disclosures.

In January 2016, the FASB issued ASU No. 2016-01 *Financial Instruments – Overall (Subtopic 825 10)*. The standard requires entities to measure equity investments that are not accounted for under the equity method or do not result in consolidation to be recorded at fair value and recognize any changes in fair value to net income. Investments that qualify for a practicability exception would not require a change in accounting. The disclosure of fair value of investments held at amortized cost will no longer be required. The new standard is effective for the Group on January 1, 2019. Early application is permitted but not earlier than January 1, 2018. The standard requires the use of the cumulative effect transition method, except for equity securities without readily determinable fair values, for which the standard requires the application of the prospective transition method. The impact of adoption will result in the change in fair value of available for sale equity securities being reflected in net income and a reduction in the fair value disclosures for certain securities carried at amortized cost.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842).* The standard introduces new requirements to increase transparency and comparability among organizations for leasing transactions for both lessees and lessors. ASU No. 2016-02 requires a lessee to record a right-of-use asset and a lease liability for all leases with terms longer than 12 months. These leases will be classified as either operating or finance, with classification affecting the pattern of expense recognition. The new standard is effective for the Group on January 1, 2019. Early application is permitted. The standard requires the application of the modified retrospective transition method. Additional disclosures will be added as required by the standard.

Management is in the process of evaluating necessary changes to information technology systems, accounting policies, and processes to support the adoption of the standard. Management expects to record significant amounts for right-of-use assets and lease liabilities on its consolidated balance sheets from a lessee perspective. The Group does not have significant lessor activity.

In August 2016, the FASB issued ASU No. 2016-14 *Not-for-Profit Entities (Topic 958).* The amendments in this update make certain improvements that address many, but not all, of the identified issues about the current financial reporting for not-for-profits. The new standard is effective for the Group for the annual period beginning on January 1, 2018. The standard requires the use of the retrospective transition method. The impact of adoption will result in enhanced disclosures about the classification of expenses and management of liquid resources.

In January 2017, the FASB issued ASU No. 2017-04 *Intangibles – Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment*. The amendments in this update eliminate Step 2 from the goodwill impairment test in an effort to simplify the subsequent measurement of goodwill. The new standard is effective for the Group on January 1, 2022. Early application is permitted. Management is evaluating the effect that ASU No. 2017-04 will have on its consolidated financial statements and related disclosures. Management has not determined the effect of the standard on its ongoing financial reporting.

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*. The amendments in this update require that an employer disaggregate the service cost component from the other components of net benefit cost and provide explicit guidance on how to present the service cost component and the other components of net benefit cost in the income statement. The new standard is required to be adopted by January 1, 2019 but early application is permitted. The Group has elected to early adopt the standard effective January 1, 2018. The standard requires the use of the retrospective transition method. The impact of adoption results in the non-service cost components of pension and postretirement benefit costs, previously classified as an operating expense, being reported as other income and expense.

### (3) Acquisition of Group Health Cooperative

The following table summarizes the fair value measurement of the assets acquired and liabilities assumed as of the date of the acquisition that are reflected in the consolidated financial statements (in thousands):

| | | |
|---|---|---|
| Current investments | $ | 274,198 |
| Accounts receivable | | 199,153 |
| Other current assets | | 179,124 |
| Noncurrent investments | | 777,300 |
| Land, buildings, equipment, and software | | 794,549 |
| Goodwill | | 297,299 |
| Other acquired intangible assets | | 250,800 |
| Other noncurrent assets | | 25,749 |
| Medical claims payable | | (277,226) |
| Other current liabilities | | (451,112) |
| Pension and other retirement liabilities | | (110,394) |
| Other noncurrent liabilities | | (159,440) |
| Total purchase price | $ | 1,800,000 |

Goodwill represents the excess of the purchase price over the fair value of net tangible and intangible assets acquired and primarily relates to expected contributions of KFHPWA to the overall corporate strategy.

For the periods ended January 31, 2017 and December 31, 2017, acquisition related costs of $394 thousand and $3.4 million were recognized in operating expenses.

### (4) Fair Value Estimates

The carrying amounts reported in the balance sheet for cash and cash equivalents, broker receivables, accounts receivable – net, accounts payable and accrued expenses, medical claims payable, due to associated medical groups, payroll and related charges, and broker payables approximate fair value.

Investments, other than alternative investments, as discussed in the *Investments* note, are reported at fair value. The fair values of investments are based on quoted market prices, if available, or estimated using quoted market prices for similar investments. If listed prices or quotes are not available, fair value is based upon other observable inputs or models that primarily use market-based or independently sourced market parameters as inputs. In addition to market information, models also incorporate transaction details such as maturity. Fair value adjustments, including credit, liquidity, and other factors, are included, as appropriate, to arrive at a fair value measurement. Certain investments are illiquid and are valued based on the most current information available, which may be less current than the date of these consolidated financial statements.

The carrying value of alternative investments is reported under the equity method, which management believes to approximate fair value. The fair values of alternative investments have been estimated by management based on all available data.

The Group utilizes a three-level valuation hierarchy for fair value measurements. An instrument's categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. For instruments classified in level 1 of the hierarchy, valuation inputs are quoted prices for identical instruments in active markets at the measurement date. For instruments classified in level 2 of the hierarchy, valuation inputs are directly observable but do not qualify as level 1 inputs. Examples of level 2 inputs include: quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in inactive markets; other observable inputs such as interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates; and market-correlated inputs that are derived principally from or corroborated by observable market data. For instruments classified in level 3 of the hierarchy, valuation inputs are unobservable inputs for the instrument. Level 3 inputs incorporate assumptions about the factors that market participants would use in pricing the instrument.

## (5) Information Concerning Affiliated Organizations

Effective February 1, 2017, KFHPWA entered into an Intercompany Lending Agreement with Kaiser Foundation Hospitals (KFH), a nonprofit public benefit corporation and an affiliate of KFHP, whereby KFHPWA agrees to make loans to, and accept loans from KFH. The loans to KFH will occur in the form of KFH's daily cash sweeps of KFHPWA's concentration account. Funds in KFH corporate concentration account will be transferred to KFHPWA as needed for KFHPWA's working capital needs. At December 31, 2017, KFHPWA has a payable to KFH of $11.0 million which is reported as a component of due to affiliated organizations.

KFHPWA manages professional liabilities and other risks using captive risk pooling vehicles, primarily Lokahi Assurance, Ltd., a not-for-profit insurance provider and a subsidiary of KFHP. For the periods ended January 31, 2017 and December 31, 2017, KFHPWA's premium expense under these arrangements was zero and $3.5 million.

The Group is a beneficiary of a Guaranty Agreement, by and among KFHP and KFH, and the remaining KFHP subsidiary health insurance carriers. Under the Guaranty Agreement, KFHP and KFH guarantee all of the liabilities, debts, and obligations of each other and substantially all of the liabilities, debts, and obligations of the other subsidiary health insurance carriers.

Effective February 1, 2017, the Group was added to the Intercompany Technology Services Agreement, dated January 1, 2000 and as such receives a variety of information technology services from KFH and KFHP. Effective February 1, 2017, the Group entered into an Administrative Service Agreement with KFHP for various administrative services. Services provided include, but are not limited to, the following: treasury, general management, administrative support, and transaction processing. During the eleven month period ended December 31, 2017, charges for costs of information technology and administrative services provided by KFHP and KFH were $54.4 million.

At December 31, 2017, the amount due from affiliated organizations was $12.8 million and the amount due to affiliated organizations was $22.4 million.

## (6) Investments

Management's methods for estimating fair value of financial instruments are discussed in the *Fair Value Estimates* note.

At December 31, 2017, the estimated fair value of current investments by level was as follows (in thousands):

| | Quoted prices in active markets for identical assets level 1 | Significant other observable inputs level 2 | Significant unobservable inputs level 3 | Total |
|---|---|---|---|---|
| Debt securities issued by the U.S. government | $ - | $ 29,983 | $ - | $ 29,983 |
| Debt securities issued by U.S. government agencies and corporations | - | 1,564 | - | 1,564 |
| Debt securities issued by U.S. states and political subdivisions of states | - | 26,105 | - | 26,105 |
| Foreign government debt securities | - | 1,013 | - | 1,013 |
| U.S. corporate debt securities | - | 80,370 | - | 80,370 |
| Foreign corporate debt securities | - | 24,157 | - | 24,157 |
| U.S. agency mortgage-backed securities | - | 102,556 | - | 102,556 |
| Other asset-backed securities | - | 20,710 | - | 20,710 |
| Short-term investment funds | - | 17,226 | - | 17,226 |
| Total | $ - | $ 303,684 | $ - | $ 303,684 |

At December 31, 2017, the estimated fair value of noncurrent investments by level was as follows (in thousands):

| | Quoted prices in active markets for identical assets level 1 | Significant other observable inputs level 2 | Significant unobservable inputs level 3 | Total |
|---|---|---|---|---|
| U.S. equity securities | $ 93,527 | $ - | $ - | $ 93,527 |
| Foreign equity securities | 34,163 | - | - | 34,163 |
| Debt securities issued by the U.S. government | - | 54,141 | - | 54,141 |
| Debt securities issued by U.S. government agencies and corporations | - | 3,107 | - | 3,107 |
| Debt securities issued by U.S. States and political subdivisions of states | - | 14,775 | - | 14,775 |
| Foreign government debt securities | - | 2,187 | - | 2,187 |
| U.S. corporate debt securities | - | 249,017 | - | 249,017 |
| Foreign corporate debt securities | - | 85,514 | - | 85,514 |
| U.S. agency mortgage-backed securities | - | 96,860 | - | 96,860 |
| Non-U.S. agency mortgage-backed securities | - | 15,072 | - | 15,072 |
| Other asset-backed securities | - | 39,606 | - | 39,606 |
| Short-term investment funds | - | 8,247 | - | 8,247 |
| Total | 127,690 | 568,526 | - | 696,216 |
| Alternative Investment: | | | | |
| Private equity | | | | 79,228 |
| Total | | | | $ 775,444 |

Transfers between fair value input levels, if any, are recorded at the end of the reporting period. Transfers between fair value input levels occur when valuation inputs used to record or disclose assets or liabilities change from one level of the valuation hierarchy to another. During the period ended December 31, 2017, there were no transfers between assets with inputs with quoted prices in active markets for identical assets (level 1) and assets with inputs with significant other observable inputs (level 2).

Alternative investments consist of funds that make direct investments in private companies. Management meets with alternative investment fund managers periodically to assess portfolio performance and reporting and exercises oversight over fund managers. At December 31, 2017, there were no outstanding fund commitments.

At December 31, 2017, debt and equity securities available-for-sale were as follows (in thousands):

| | Amortized cost | Gross unrealized gains | Gross unrealized loss | Fair value |
|---|---|---|---|---|
| U.S. equity securities | $ 77,790 | $ 15,737 | $ - | $ 93,527 |
| Foreign equity securities | 28,736 | 5,428 | - | 34,164 |
| Debt securities issued by the U.S. government | 83,015 | 1,109 | - | 84,124 |
| Debt securities issued by U.S. government agencies and corporations | 4,664 | 7 | - | 4,671 |
| Debt securities issued by U.S. states and political subdivisions of states | 40,018 | 862 | - | 40,880 |
| Foreign government debt securities | 3,177 | 23 | - | 3,200 |
| U.S. corporate debt securities | 324,311 | 5,076 | - | 329,387 |
| Foreign corporate debt securities | 108,526 | 1,145 | - | 109,671 |
| U.S. agency mortgage-backed securities | 198,547 | 869 | - | 199,416 |
| Non-U.S. agency mortgage-backed securities | 14,826 | 246 | - | 15,072 |
| Other asset-backed securities | 59,795 | 520 | - | 60,315 |
| Short-term investment funds | 25,473 | - | - | 25,473 |
| Total | $ 968,878 | $ 31,022 | $ - | $ 999,900 |

At December 31, 2017, available-for-sale debt securities by contractual maturity and mortgage-backed and other asset-backed debt securities were as follows (in thousands):

| | Amortized cost | Fair value |
|---|---|---|
| Due in one year or less | $ 49,000 | $ 49,096 |
| Due after one year through five years | 289,193 | 290,897 |
| Due after five years through ten years | 200,185 | 203,764 |
| Due after ten years | 50,806 | 53,649 |
| U.S. agency mortgage-backed securities | 198,547 | 199,416 |
| Non-U.S. agency mortgage-backed securities | 14,826 | 15,072 |
| Other aset-backed securities | 59,795 | 60,315 |
| Total | $ 862,352 | $ 872,209 |

For the periods ended January 31 and December 31, investment income – net was comprised of the following (in thousands):

| | | January 31, 2017 (Predecessor) | | December 31, 2017 (Successor) |
|---|---|---|---|---|
| Interest and dividends | $ | 2,496 | $ | 30,230 |
| Realized gains on sale | | 19,045 | | 15,407 |
| Other-than-temporary loss impairment | | - | | (9,613) |
| Realized losses on sale | | (435) | | (5,007) |
| Amortization, accretion and other | | 49 | | (3,935) |
| Divestiture of investment in Group Health Foundation | | (21,927) | | - |
| Total investment income – net | $ | (772) | $ | 27,082 |

For the periods ended January 31 and December 31, 2017 the Group recorded impairment of certain investments in accordance with the policy described in the *Summary of Significant Accounting Policies – Investments* note. During the periods ended January 31 and December 31, 2017, there was zero and $7.0 million of impairment of alternative investments, respectively.

Private equity agreements do not include provisions for redemption. Distributions will be received as the underlying investments are liquidated.

The majority of debt and equity securities can be redeemed within 10 days. Debt and equity investment funds of $35.4 million are redeemable between 10 and 30 days. No debt or equity investments require a redemption period of greater than 30 days.

## (7) Accounts Receivable – Net

At December 31, 2017, accounts receivable were as follows (in thousands):

| | | |
|---|---|---|
| Patient services | $ | 99,342 |
| Members' dues | | 68,740 |
| US OPM experience-rated contract receivable | | 16,776 |
| Federal grants | | 10,309 |
| Other | | 8,941 |
| Medicare | | 7,525 |
| Risk adjustment receivable | | 6,000 |
| Pharmacy rebates | | 4,977 |
| Reinsurance recoveries | | 2,129 |
| | | 224,739 |
| Allowances and provisions for uncollectible amounts | | (62,233) |
| Total | $ | 162,506 |

## (8) Inventories and Other Current Assets

At December 31, 2017, inventories and other current assets were as follows (in thousands):

| | | |
|---|---|---|
| Inventories - net | $ | 21,477 |
| Federal tax receivable | | 16,470 |
| Prepaid expenses | | 13,185 |
| Other | | 8,697 |
| Total | $ | 59,829 |

## (9) Land, Buildings, Equipment, and Software – Net

At December 31, 2017, land, buildings, equipment, and software – net were as follows (in thousands):

| | | |
|---|---|---|
| Land | $ | 152,600 |
| Buildings and improvements | | 582,499 |
| Furniture, equipment, and software | | 152,703 |
| Construction and software development in progress | | 31,559 |
| | | 919,361 |
| Accumulated depreciation and amortization | | (62,415) |
| Total | $ | 856,946 |

The Group capitalizes interest costs on borrowings incurred during the construction, upgrade, or development of qualifying assets. Capitalized interest is added to the cost of the underlying assets and is depreciated or amortized over the useful lives of the assets. During the period ended December 31, 2017, the Group capitalized zero interest in connection with various capital projects.

Asset retirement obligations relate primarily to the following: leased building restoration, building demolition, building materials containing asbestos, leaded wall shielding, storage tanks (above ground and below ground), chillers or cooling tower chemicals, mercury in large fixed components, polychlorinated biphenyl window caulk, and hard drives requiring data wiping prior to disposal. At December 31, 2017, the liability for asset retirement obligations was $9.5 million and is a component of other long-term liabilities. At December 31, 2017, the unamortized asset related to these retirement obligations was $9.5 million.

## (10) Goodwill and Other Acquired Intangible Assets – Net

The carrying amount of goodwill as of December 31, 2017 was $297.3 million. There was no impairment loss in 2017.

At December 31, 2017, other acquired intangible assets – net were as follows (in thousands):

| | Weighted average amortization period | | Gross carrying amount | | Accumulated amortization | | Net carrying amount |
|---|---|---|---|---|---|---|---|
| Provider network | 16 years | $ | 34,500 | $ | (1,977) | $ | 32,523 |
| Intellectual property | 15 years | | 38,700 | | (2,365) | | 36,335 |
| External provider network | 10 years | | 18,600 | | (1,705) | | 16,895 |
| Member relations | 9 years | | 132,700 | | (24,858) | | 107,842 |
| Internally developed software | 5 years | | 26,300 | | (4,828) | | 21,472 |
| Total other acquired intangible assets | | $ | 250,800 | $ | (35,733) | $ | 215,067 |

Intangible assets subject to amortization are amortized on a straight-line or accelerated basis over their useful lives. For the periods ended January 31 and December 31, 2017, aggregate amortization expense related to amortizing intangible assets was zero and $35.7 million, respectively.

The estimated amortization expense for the next five calendar years at December 31, 2017 is as follows (in thousands):

| | | |
|---|---|---|
| 2018 | $ | 39,831 |
| 2019 | | 33,473 |
| 2020 | | 27,964 |
| 2021 | | 22,661 |
| 2022 | | 18,252 |

## (11) Other Long-Term Assets

At December 31, 2017, other long-term assets were as follows (in thousands):

| | | |
|---|---|---|
| Professional liability insurance receivable | $ | 32,685 |
| Notes receivable | | 14,009 |
| Deferred compensation | | 5,887 |
| Other | | 3,117 |
| Total | $ | 55,698 |

## (12) Medical Claims Payable

For the periods ended January 31, 2017 and December 31, 2017, activity in the liability for medical claims payable was as follows (in thousands):

| | | January 31, 2017 (Predecessor) | | December 31, 2017 (Successor) |
|---|---|---|---|---|
| Beginning balance | $ | 254,372 | $ | 277,226 |
| Incurred related to: | | | | |
| Current period | | 168,598 | | 1,978,365 |
| Prior period | | 969 | | (455) |
| Total incurred | | 169,567 | | 1,977,910 |
| Paid related to: | | | | |
| Current period | | (31,143) | | (1,734,019) |
| Prior period | | (117,618) | | (254,893) |
| Total paid | | (148,761) | | (1,988,912) |
| Ending balance | $ | 275,178 | $ | 266,224 |

Amounts incurred related to prior periods vary from previously estimated liabilities as the claims are ultimately adjudicated and paid. Liabilities are reviewed and revised as information regarding actual claims payments becomes known. Negative amounts reported for incurred related to prior periods result from claims being adjudicated and paid for amounts less than originally estimated.

## (13) Medical Loss Ratio

Effective January 1, 2011, as part of the PPACA, minimum medical loss ratios were mandated for all commercial fully insured medical plans with annual rebates owed to policyholders if the actual loss ratios, calculated in a manner prescribed by the U.S. Department of Health and Human Services (HHS) fall below certain targets (85% for large employer groups and 80% for small employer groups and individuals). In the 2014 contract year, Part C and Part D became subject to medical loss ratio requirements similar to the commercial fully insured medical plans. The target medical loss ratio for the Medicare plans is 85%. HHS issued guidance specifying the types of costs that should be included in benefit expense for purposes of calculating medical loss ratios. The Group's medical loss ratios were above the minimum target levels and no liability for rebates was recorded.

## (14) Other Liabilities

At December 31, 2017, other current liabilities were as follows (in thousands):

| | | |
|---|---|---|
| Deferred revenues | $ | 92,027 |
| US OPM special reserve | | 15,801 |
| Other | | 4,101 |
| Postretirement guarantees | | 3,886 |
| Total | $ | 115,815 |

At December 31, 2017, other long-term liabilities were as follows (in thousands):

| | | |
|---|---|---|
| Build-to-suit financing obligation | $ | 45,872 |
| Asset retirement obligations | | 9,500 |
| Deferred compensation | | 6,383 |
| Deferred taxes | | 4,034 |
| Deferred rent | | 3,644 |
| Other | | 2,571 |
| Total | $ | 72,004 |

## (15) Pension Plans

### *(a) Defined Benefit Plans*

The Group has two defined benefit pension plans (Plans). Benefits are based on age at retirement, years of credited service, and average compensation for a specified period prior to retirement. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

For financial reporting purposes, the projected unit credit method is used. At December 31, substantially all pension fund assets were held in a group trust. At December 31, 2017, trust assets were invested primarily in fixed-income and equity securities, with approximately 13% of trust assets invested in alternative investments.

At December 31, 2017 the funded status of the Plans was as follows (in thousands):

| | | |
|---|---|---|
| Change in projected benefit obligation (PBO): | | |
| Benefit obligation at beginning of year | $ | 799,793 |
| Change in actuarial assumptions | | 37,696 |
| Service cost | | 16,520 |
| Interest cost | | 28,475 |
| Net actuarial loss | | 89,500 |
| Benefits paid | | (49,061) |
| Expenses paid | | (38) |
| Benefit obligation at end of year | $ | 922,885 |
| Accumulated benefit obligation at end of year | $ | 887,716 |
| Change in the Group's share of trust assets: | | |
| Fair value of plan assets at beginning of year | $ | 635,012 |
| Change in actuarial assumptions | | (15,318) |
| Actual return on plan assets | | 93,271 |
| Contributions | | 143,000 |
| Benefits paid | | (49,061) |
| Expenses paid | | (38) |
| Fair value of plan assets at end of year | $ | 806,866 |
| Funded status | $ | (116,019) |
| Amounts recognized in the balance sheet consist of: | | |
| Pension and other retirement liabilities | | (116,019) |
| | $ | (116,019) |
| Amounts recognized in net worth: | | |
| Net actuarial loss | | 48,486 |
| | $ | 48,486 |

The measurement date used to determine pension valuations was December 31, 2017.

For the year periods ended January 31 and December 31, 2017, pension expense (benefit) was as follows (in thousands):

| | January 31, 2017 (Predecessor) | December 31, 2017 (Successor) |
|---|---|---|
| Service cost | $ 1,469 | $ 15,051 |
| Interest cost | 2,932 | 25,542 |
| Expected return on plan assets | (4,876) | (46,810) |
| Amortization of net gain | 2,148 | - |
| Amortization of prior service cost | (143) | - |
| Net pension expense (benefit) | 1,530 | (6,217) |
| Other changes in plan assets and PBO recognized in net worth: | | |
| Net actuarial loss | (2,719) | 48,486 |
| Prior service cost | 143 | - |
| Change in actuarial assumptions | 2,576 | - |
| Total recognized in net worth | - | 48,486 |
| Total recognized in net periodic benefit cost and net worth | $ 1,530 | $ 42,269 |

During 2018, no net loss will be amortized from net worth into net pension expense.

Actuarial assumptions used were as follows:

| | |
|---|---|
| Discount rates at January 1 through January 31 for calculating pension expense | 4.55% - 4.60% |
| Discount rates at February 1 through December 31 for calculating pension expense | 4.15% - 4.35% |
| Discount rate for calculating December 31 PBO | 3.60% - 3.75% |
| Discount rates for calculating February 1 PBO | 4.15% - 4.35% |
| Salary scale for calculating pension expense | 3.00% - 4.50% |
| Salary scale for calculating December 31 PBO | 3.50% - 4.50% |
| Salary scale for calculating February 1 PBO | 3.50% - 4.50% |
| Expected long-term rates of return on plan assets for calculating pension expense | 5.25% - 7.00% |

During 2018, management expects to contribute approximately $23.9 million to the Plan.

The following benefit payments, which reflect expected future service, are expected to be paid (in thousands):

| | | |
|---|---|---|
| 2018 | $ | 59,000 |
| 2019 | | 63,000 |
| 2020 | | 63,000 |
| 2021 | | 63,000 |
| 2022 | | 61,000 |
| 2023-2027 | | 299,000 |

The Group has adopted investment policies for its Plans that incorporate a strategic, long-term asset allocation mix designed to best meet its long-term pension obligations. Plan fiduciaries set the investment policies and strategies for the pension trust. This includes the following:

- Selecting investment managers
- Setting long-term and short-term target asset allocations
- Periodic review of the target asset allocations, and, if necessary, to make adjustments based on changing economic and market conditions
- Monitoring the actual asset allocations, and, when necessary, rebalancing to the current target allocation

The investment policy emphasizes the following key objectives:

- Maintain a diversified portfolio among various asset classes and investment managers
- Invest in a prudent manner for the exclusive benefit of plan participants
- Preserve the funded status of the plan
- Balance between acceptable level of risk and maximizing returns
- Maintain adequate control over administrative costs
- Maintain adequate liquidity to meet expected benefit payments

The Group uses a “building block” approach to determine the expected rate of return on plan assets assumption for the Plans. This approach analyzes historical long-term rates of return for various investment categories, as measured by appropriate indices. The rates of return on these indices are then weighted based upon the percentage of plan assets in each applicable category to determine a composite expected return. The Group reviews its expected rate of return assumption annually. However, this is considered to be a long-term assumption and hence not anticipated to change annually, unless there are significant changes in economic and market conditions.

At December 31, 2017, the estimated fair value of total pension trust assets – net by level was as follows (in thousands):

| | Quoted prices in active markets for identical assets level 1 | Significant other observable inputs level 2 | Total |
|---|---|---|---|
| Assets | | | |
| Cash and cash equivalents | $ 537,079 | $ - | $ 537,079 |
| U.S. equity securities | 71,946 | - | 71,946 |
| Foreign equity securities | - | 47,497 | 47,497 |
| U.S. corporate debt securities | - | 8,630 | 8,630 |
| Non-U.S. corporate debt securities | - | 45,359 | 45,359 |
| Fair value of pension trust assets | $ 609,025 | $ 101,486 | 710,511 |
| Investments measured at net asset value (NAV): | | | |
| Alternative investments: | | | |
| Absolute return | | | 18,887 |
| Private equity | | | 91,041 |
| Total pension trust assets – net | | | $ 820,439 |

At December 31, 2017, the Group's share of pension trust assets was 98%, or $806.9 million. The remaining share of pension trust assets of $13.6 million is for WPMG.

During the year ended December 31, 2017, there were no significant transfers of assets with inputs with quoted prices in active markets for identical assets (level 1) and assets with inputs with significant other observable inputs (level 2).

As of December 31, 2017, the following table summarizes the target asset allocation range defined in the investment policies:

| | Target range |
|---|---|
| Cash and cash equivalents | 0 - 5% |
| Equity securities | 32 - 67% |
| Debt securities | 14 - 41% |
| Alternative investments | 4 - 44% |

Alternative investments, which include absolute return and private equity, held in the pension trust are reported at NAV as a practical expedient for fair value. Absolute return investments use advanced investment strategies to generate positive long-term risk adjusted returns. Private equity investments consist of funds that make direct investments in private companies. At December 31, 2017, the trust had original commitments related to alternative investments of $178.4 million, of which $116.6 million was invested, leaving $61.8 million of remaining commitments.

Absolute return and private equity investments include redemption restrictions. Absolute return investments require 10 to 90 day written notice of intent to withdraw and are often subject to the approval and capital requirements of the fund manager. Private equity agreements do not include provisions for redemption. Distributions will be received as the underlying investments of the funds are liquidated, which is expected over the next 11 years.

The majority of debt and equity securities can be redeemed within 10 days. At December 31, 2017, debt and equity investment funds of $56.2 million are redeemable between 10 and 30 days. Debt investment funds of $17.4 million have a redemption period of up to 120 days.

### *(b) Defined Contribution Plans*

The Group has defined contribution plans for eligible employees. Employer contributions and costs are typically based on a percentage of covered employees' eligible compensation. During 2017, there were no required employee contributions. For the periods ended January 31 and December 31, 2017, plan expense, primarily employer contributions, was $2.6 million and $30.5 million, respectively.

### *(c) Multi-Employer Plans*

The Group participates in a number of multi-employer defined benefit pension plans under the terms of collective bargaining agreements that cover some union-represented employees. Some risks of participating in these multi-employer plans that differ from single-employer plans include:

- Assets contributed to the multi-employer plan by one employer may be used to provide benefits to employees of other participating employers.
- If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers.
- If the Group chooses to stop participating in a multi-employer plan the Group may be required to pay the plan an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

The Group participates in the Sound Retirement Trust, formerly Retail Clerks Pension Trust (Federal Identification Number 91-6069306), which includes Pharmacy and Optical employees under the UFCW union. The collective bargaining agreement with Pharmacy employees expires October 31, 2020 and the Optical employees expires April 30, 2018. The most recent Pension Protection Act (PPA) status available is for the plan's year end of September 30, 2017. The zone status has been designated red. The zone status is based on information that the Group obtained from publicly available information provided by the United States Department of Labor. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are between 65% and 80% funded, and plans in the green zone are at least 80% funded. The Plan has a financial improvement plan (FIP) or rehabilitation plan that has been implemented. The contributions to the plan were zero and $1.3 million for the periods ended January 31, and December 31, 2017, respectively. The Group's contributions represent less than 5% of total contributions to the plan. The Group paid rehabilitation surcharges in 2017.

## (16) Postretirement Benefits Other than Pensions

KFHPWA provides certain medical benefits for eligible retired employees. Employees become eligible for these benefits upon retirement, attainment of a specified age, and upon completion of a certain number of years of service.

In 2009, KFHPWA completed the curtailment of this benefit. The contribution to the premiums for collective bargaining active employees was discontinued. This resulted in the final pay out of the benefit. In 2008, the phase out of the benefit occurred for the non-union active employees.

At December 31, 2017, the accrued liability for postretirement benefits was as follows (in thousands):

| | | |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $ | 37,358 |
| Change in actuarial assumptions | | 2,900 |
| Service cost | | 1 |
| Interest cost | | 1,274 |
| Plan amendments | | (1,583) |
| Benefits paid | | (3,993) |
| Net actuarial loss | | 1,391 |
| Benefit obligation at end of year | $ | 37,348 |
| Change in plan assets: | | |
| Contributions | | 3,993 |
| Benefits paid | | (3,993) |
| Fair value of plan assets at end of year | $ | - |
| Funded status | | (37,348) |
| Amounts recognized in the balance sheet consist of: | | |
| Other current liabilities | | (3,886) |
| Pension and other retirement liabilities | | (33,462) |
| | $ | (37,348) |
| Amounts recognized in net worth: | | |
| Net actuarial loss | | 1,273 |
| Prior service credit | | (1,318) |
| | $ | (45) |

The measurement date used to determine postretirement benefits valuations was December 31, 2017.

For the periods ended January 31 and December 31, 2017 postretirement benefits expense was as follows (in thousands):

| | | January 31, 2017 (Predecessor) | | December 31, 2017 (Successor) |
|---|---|---|---|---|
| Service cost | $ | - | $ | 1 |
| Interest cost | | 121 | | 1,153 |
| Amortization of net (gain)/loss | | 16 | | - |
| Postretirement benefits expense | | 137 | | 1,154 |
| Other changes in plan assets and benefit obligations recognized in net worth: | | | | |
| Net actuarial loss/(gain) | | 118 | | 1,273 |
| Prior service cost/(credit) | | (265) | | (1,318) |
| Amortization of net actuarial gain | | (16) | | - |
| Change in actuarial assumptions | | 163 | | - |
| Total recognized in net worth | | - | | (45) |
| Total recognized in net periodic benefit cost and net worth | $ | 137 | $ | 1,109 |

During 2018, $115 thousand in estimated prior service credit will be amortized from net worth into postretirement benefits expense.

During 2017, the employer contributions and benefits paid or provided were $4.0 million and $4.0 million, respectively. During 2017, there were no participant contributions from active employees.

Actuarial assumptions used were as follows:

| | |
|---|---|
| Discount rates used for calculating post retirement benefits expense from January 1 to December 31 | 3.70% |
| Discount rate for calculating December 31 accumulated postretirement benefit obligation | 3.35% |
| Discount rate for calculating February 1 accumulated postretirement benefit obligation | 3.70% |
| Expected long-term rates of return on plan assets for calculating benefits expense | N/A |

The following were the assumed health care cost trend rates used to determine the December 31, 2017 benefit obligation and postretirement benefits expense for the year ended December 31, 2017:

| | |
|---|---|
| Initial trend rate - benefit obligation | 6.26% |
| Ultimate trend rate | 4.70% |
| First year at ultimate trend rate | 2038 |

A 1% increase in the health care medical trend rate would increase the benefit obligation by $2.2 million and the service cost plus interest by $1,000. A decrease of 1% in the health care medical trend rate would decrease the benefit obligation by $2.0 million and the service cost plus interest by $54 thousand.

The following benefit payments, which reflect expected future service, are expected to be paid or provided (in thousands):

| | | |
|---|---|---|
| 2018 | $ | 3,886 |
| 2019 | | 3,745 |
| 2020 | | 3,578 |
| 2021 | | 3,445 |
| 2022 | | 3,293 |
| 2023-2027 | | 13,743 |

## (17) Commitments and Contingencies

### *(a) Leases*

The Group leases primarily land and buildings under various leases that expire through 2032. Certain leases contain rent escalation clauses and renewal options for additional periods.

At December 31, 2017, minimum commitments under noncancelable leases extending beyond one year were as follows (in thousands):

| | | |
|---|---|---|
| 2018 | $ | 16,615 |
| 2019 | | 14,433 |
| 2020 | | 13,529 |
| 2021 | | 11,418 |
| 2022 | | 10,846 |
| Thereafter | | 64,261 |
| Total | $ | 131,102 |

Total rent expense was $2.6 million and $24.2 million for the periods ended January 31 and December 31, 2017, respectively, and is recorded as a component of other expenses. Total sublease rental revenue was $328 thousand and $3.1 million for the periods ended January 31 and December 31, 2017, respectively and is recorded as a component of other revenue.

### *(b) Regulatory*

KFHPWA and KFHPWAO are required to periodically file financial statements with regulatory agencies in accordance with statutory accounting and reporting practices. These entities must comply with the minimum regulatory net worth requirements under the regulations of the Washington State Office of the Insurance Commissioner (OIC). At December 31, 2017, the regulatory net worth, so defined, was $803.6 million and $125.4 million for KFHPWA and KFHPWAO, respectively. The amount of statutory net worth in excess of regulatory requirements was $775.6 million and $114.3 million for KFHPWA and KFHPWAO, respectively.

The Group is subject to numerous and complex laws and regulations of federal, state, and local governments, and accreditation requirements. Compliance with such laws, regulations, and accreditation requirements can be subject to retrospective review and interpretation, as well as regulatory actions. These laws and regulations include, but are not necessarily limited to, requirements of tax exemption, government reimbursement, government program participation, privacy and security, false claims, anti-kickback, accreditation, healthcare reform, controlled substances, facilities, and professional licensure. In recent years, government activity has increased with respect to compliance and enforcement actions.

In the ordinary course of business operations, the Group is subject to periodic reviews, investigations, and audits by various federal, state, and local regulatory agencies and accreditation agencies, including, without limitation, CMS, Department of Managed Health Care, US OPM, Occupational Safety and Health Administration, Drug Enforcement Administration, State Boards of Pharmacy, Food and Drug Administration, Internal Revenue Service, National Committee for Quality Assurance, and state departments of insurance.

The Group's compliance with the wide variety of rules and regulations and accreditation requirements applicable to its business may result in certain remediation activities and regulatory fines and penalties, which could be substantial. Where appropriate, reserves have been established for such sanctions. While management believes these reserves are adequate, the outcome of legal and regulatory matters is inherently uncertain, and it is possible that one or more of the legal or regulatory matters currently pending or threatened could have a material adverse effect on the financial position or results of operations.

### *(c) Litigation*

The Group is involved in lawsuits and various governmental investigations, audits, reviews, and administrative proceedings arising, for the most part, in the ordinary course of business operations. Lawsuits have been brought under a wide range of laws and include, but are not limited to, business disputes, employment and retaliation claims, claims alleging professional liability, improper disclosure of personal information, labor disputes, administrative regulations, the False Claims Act, information privacy and Health Insurance Portability and Accountability Act laws, mental health parity laws, and consumer protection laws. In addition, the Group indemnifies WPMG against various claims, including professional liability claims.

The Group records reserves for legal proceedings and regulatory matters where available information indicates that, at the date of the financial statements, a loss is probable and the amount can be reasonably estimated. While such reserves reflect management's best estimate of the probable loss for such matters, the Group's recorded amount may differ materially from the actual amount of any such losses.

After consultation with legal counsel, management estimates accruals, if any, that are necessary related to these matters. Management believes the recorded amounts are adequate and the ultimate outcome of the matters will not have a material adverse effect on the Group's consolidated financial position.

### *(d) Joint Partnerships and New Administrative Buildings*

In 2015, GHC signed two separate joint venture agreements with Ryan Companies US, Inc., a national commercial real estate firm, to form Ryan-GHC One, LLC and Ryan-GHC Two, LLC. GHC held a 50% interest in Ryan-GHC One, LLC and Ryan-GHC Two, LLC at $3.7 million and $4.8 million, respectively. Under the agreements, the joint ventures' plan was to develop an operations and administrative campus involving four adjacent buildings located in Renton, Washington. GHC became the major tenant of the new campus with two 15 year build-to-suit lease agreements. GHC moved certain administrative, lab and pharmacy operations in 2016 and additional administrative operations in 2017 to the new campus.

In December 2017, KFHPWA acquired the remaining 50% interest of Ryan Companies US, Inc. in Ryan-GHC One, LLC. As the sole member, KFHPWA transferred the land and two buildings from Ryan-GHC One, LLC to KFHPWA and recorded within land, buildings, equipment, and software – net at fair value of $72.4 million.

KFHPWA is deemed, for accounting purposes, to be the owner of the remaining two leased buildings held by Ryan-GHC Two, LLC even though it is not the legal owner. In connection with KFHPWA's accounting for the transaction, KFHPWA capitalized the costs of construction as build-to-suit property within land, buildings, equipment and software– net, and recognized a corresponding build-to-suit lease obligation for the same amount. At December 31, 2017, $45.9 million of costs were capitalized in buildings with a corresponding build-to-suit lease obligation recognized related to this lease.

### *(e) Government Contracts*

In February 2013, the Group received a subpoena from the United States Attorney's Office, Western District of New York, requesting information related to the Group's Medicare Advantage Risk Adjustment submissions made for payment years 2008 through 2012. The Group is continuing to respond to intermittent requests for additional information. No amounts have been accrued in the accompanying consolidated balance sheet related to this matter because management believes the amount is not material.

## (18) Federal Income Taxes

The components of income tax expense for the Group related to continuing operations and the change in net worth for the periods ended January 31 and December 31, 2017 are summarized as follows (in thousands):

| | January 31, 2017 (Predecessor) | December 31, 2017 (Successor) |
|---|---|---|
| Federal income tax expense (benefit) on operations | $ 3,013 | $ (8,738) |
| Federal income tax expense included in the change in net worth | — | 492 |
| Federal income tax expense (benefit) | $ 3,013 | $ (8,246) |

Federal income tax expense (benefit) on operations is recognized as a component of other expenses in the consolidated statements of operations and changes in net worth. Federal income tax expense (benefit) included in the change in net worth is recognized as a component of changes in net unrealized gains (losses) on investments and the change in pension and other retirement liability charges in the consolidated statements of operations and changes in net worth.

New tax legislation, commonly referred to as the Tax Cuts and Jobs Act, was enacted on December 22, 2017. ASC 740, *Accounting for Income Taxes*, requires companies to recognize the effect of tax law changes in the period of enactment even though the effective date for most provisions is for tax years beginning after December 31, 2017, or in the case of certain other provisions, January 1, 2018. New tax regulation reduced the U.S corporate income tax rate to 21%, which resulted in the Group reporting an income tax benefit of $332 thousand in the eleven month period ended December 31, 2017.

A summary of deferred tax assets and liabilities is as follows (in thousands):

| | |
|---|---|
| Deferred tax asset | $ 3,535 |
| Deferred tax liability | (4,034) |
| | (499) |
| Valuation allowance | — |
| Net deferred tax liability | $ (499) |

Deferred tax assets primarily relate to the tax effects of temporary differences associated with pension liabilities, buildings and improvements, and postretirement accruals. The deferred tax liability results primarily from temporary differences in unrealized investment gains and an intangible asset.

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# Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Board of Directors
Kaiser Foundation Health Plan of Washington:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the consolidated financial statements of Kaiser Foundation Health Plan of Washington and Subsidiaries, which comprise the consolidated balance sheet as of December 31, 2017, and the related consolidated statements of operations and changes in net worth and cash flows for the period February 1, 2017 to December 31, 2017, and the Group Health Cooperative and Subsidiaries (Predecessor) consolidated statements of operations and changes in net worth and cash flows for the period January 1, 2017 to January 31, 2017, and the related notes to the consolidated financial statements, and have issued our report thereon dated August 14, 2018.

## Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements, we considered Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control. Accordingly, we do not express an opinion on the effectiveness of Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as described in the accompanying schedule of findings and responses, we identified certain deficiencies in internal control that we consider to be significant deficiencies and a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described in the accompanying schedule of findings and responses to be a material weakness (2017-01).

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying schedule of findings and responses to be significant deficiencies (2017-02 and 2017-03).

KPMG

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether Kaiser Foundation Health Plan of Washington and Subsidiaries' consolidated financial statements are free from material misstatement, we performed tests of their compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

## Kaiser Foundation Health Plan of Washington's Response to Findings

Kaiser Foundation Health Plan of Washington and Subsidiaries' responses to the findings identified in our audit are described in the accompanying schedule of findings and responses. Kaiser Foundation Health Plan of Washington and Subsidiaries' responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the responses.

## Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Kaiser Foundation Health Plan of Washington and Subsidiaries' internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Seattle, Washington
August 14, 2018

KPMG LLP
Suite 2900
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**Independent Auditors' Report on Compliance for Each Major Federal Program; Report on Internal Control Over Compliance; and Report on Schedule of Expenditures of Federal Awards Required by the Uniform Guidance**

The Board of Directors
Kaiser Foundation Health Plan of Washington:

## Report on Compliance for Each Major Federal Program

We have audited Kaiser Foundation Health Plan of Washington and Subsidiaries' (the Company) compliance with the types of compliance requirements described in the *OMB Compliance Supplement* that could have a direct and material effect on each of the Company's major federal programs for the year ended December 31, 2017. The Company's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs.

*Management's Responsibility*

Management is responsible for compliance with federal statutes, regulations, and the terms and conditions of its federal awards applicable to its federal programs.

*Auditors' Responsibility*

Our responsibility is to express an opinion on compliance for each of the Company's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit requirements of Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Guidance)*. Those standards and the Uniform Guidance require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of the Company's compliance.

*Opinion on Each Major Federal Program*

In our opinion, the Company complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended December 31, 2017.

## Report on Internal Control over Compliance

Management of the Company is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered the Company's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with the Uniform Guidance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this Section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Uniform Guidance. Accordingly, this report is not suitable for any other purpose.

**Report on Schedule of Expenditures of Federal Awards Required by the Uniform Guidance**

We have audited the consolidated financial statements of the Company as of and for the year ended December 31, 2017, and have issued our report thereon August 14, 2018, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by the Uniform Guidance and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

Seattle, Washington
September 24, 2018

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON**
**AND SUBSIDIARIES**

Schedule of Expenditures of Federal Awards

Year ended December 31, 2017

| CFDA | Federal Grantor/Pass-Through Grantor/Program Title | Pass-through Grantor's number (only for pass-through awards) | Expenditures to Subrecipients | Total SEFA Expenditures |
|---|---|---|---|---|
| | Research and Development Cluster: | | | |
| | US Department of Health and Human Services: | | | |
| 93.226 | Agency For Healthcare Research | | $ 1,641,304 | 4,426,267 |
| 93.185 | Centers For Disease Control | | 39,975 | 450,204 |
| 93.27 | Centers For Disease Control | | — | 152,056 |
| 93.RD | Centers For Disease Control | | 858,382 | 4,126,175 |
| 93.121 | National Institutes Of Health | | 129,839 | 543,458 |
| 93.172 | National Institutes Of Health | | 162,210 | 446,963 |
| 93.213 | National Institutes Of Health | | 10,612 | 207,356 |
| 93.242 | National Institutes Of Health | | 2,940,885 | 4,837,600 |
| 93.273 | National Institutes Of Health | | 31,092 | 489,749 |
| 93.279 | National Institutes Of Health | | — | 826,382 |
| 93.307 | National Institutes Of Health | | 17,387 | 27,748 |
| 93.393 | National Institutes Of Health | | 447,355 | 2,697,388 |
| 93.397 | National Institutes Of Health | | 1,000 | 687,785 |
| 93.399 | National Institutes Of Health | | — | 73,685 |
| 93.837 | National Institutes Of Health | | 418,072 | 903,275 |
| 93.847 | National Institutes Of Health | | — | 62,764 |
| 93.865 | National Institutes Of Health | | 28,001 | 568,749 |
| 93.866 | National Institutes Of Health | | 1,198,583 | 3,609,069 |
| 93.135 | University Of Washington | | — | 10,395 |
| 93.31 | University Of Washington | | — | 116,290 |
| 93.35 | University Of Washington | | — | 102,973 |
| 93.853 | University Of Washington | | — | 318,676 |
| 93.310 | University Of Washington | | — | 33,119 |
| 93.311 | University Of Washington | | — | 1,450 |
| 93.350 | University Of Washington | | — | 48,206 |
| 93.396 | University Of Washington | | — | 5,029 |
| 93.855 | University Of Washington | | — | 66,798 |
| | Prime Subtotal | | 7,924,697 | 25,839,609 |

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON**
**AND SUBSIDIARIES**

Schedule of Expenditures of Federal Awards

Year ended December 31, 2017

| CFDA | Federal Grantor/Pass-Through Grantor/Program Title | Pass-through Grantor's number (only for pass-through awards) | Expenditures to Subrecipients | Total SEFA Expenditures |
|---|---|---|---|---|
| | Pass-through awards from: | | | |
| 93.RD | Abt Associates Inc. | GS-10F-0086K/BPA 200-2013-M-53 | $ — | 10,249 |
| 93.RD | Abt Associates Inc. | HHSM-500-2014-00026I/HHSM-50 | — | 78,412 |
| 93.RD | Abt Associates Inc. | GS00F252CA/200-2016-F-92356 | — | 23,085 |
| 93.393 | Center For Health Research, Kaiser Foundation Hospitals | 5UH3CA188640-04 | — | 212 |
| 93.RD | Center For Health Research, Kaiser Foundation Hospitals | HHSA290201500007I | — | 276,513 |
| 93.RD | Center For Health Research, Kaiser Foundation Hospitals | HHSA290201200015I | — | 96,702 |
| 93.RD | Center For Health Research, Kaiser Foundation Hospitals | GS-10F0086K/BPA 200-2013M53890 | — | 57,252 |
| 93.RD | Crosby Marketing | HHSA2990201200019I | — | 114,037 |
| 93.213 | Duke University | 4U54AT007748-05 | — | 151,188 |
| 93.279 | Duke University | 1R01DA040056-01 | — | 22,459 |
| 93.393 | Fred Hutchinson Cancer Research Center | R01CA168758 | — | 6,896 |
| 93.393 | Fred Hutchinson Cancer Research Center | 4R01CA166646-04 | — | 1,460 |
| 93.393 | Fred Hutchinson Cancer Research Center | 4R01CA168338-04 | — | 79,285 |
| 93.393 | Fred Hutchinson Cancer Research Center | 5R01CA192402-02 | — | 10,290 |
| 93.866 | Fred Hutchinson Cancer Research Center | 5R01AG048209-02 | — | 11,158 |
| 93.393 | Georgetown University | 1R01CA190221-01A1 | — | 336,452 |
| 93.393 | Georgetown University | 5U01CA199218-02 | — | 22,924 |
| 93.113 | Harvard Chan School of Public Health | 5R01ES024332-02 | — | 22,003 |
| 93.393 | Harvard Medical School | 5R01CA168959-05 | — | 31,835 |
| 93.RD | Harvard Pilgrim Health Care | HHSF223201000009I | — | 27,538 |
| 93.RD | Harvard Pilgrim Health Care | HHSF223200910006I | — | 58,122 |
| 93.RD | Harvard Pilgrim Health Care | HHSF22320140030I | — | 86,714 |
| 93.RD | Harvard Pilgrim Health Care | HHSF223201400030I | — | 489,150 |
| 93.RD | Harvard Pilgrim Health Care | HHSF223201400042I | — | 317,360 |
| 93.242 | Henry Ford Health System | 1R01MH103530-01A1 | — | 109,073 |
| 93.853 | Icahn School Of Medicine at Mount Sinai | 5U01NS086625-03 | — | 2,387 |
| 93.855 | Id Genomics Inc | 2R42AI116114-02 | — | 7,144 |
| 93.242 | Indiana University | 5R01MH103310-03 | — | 85,636 |
| 93.837 | Kaiser Foundation Health Plan, Oakland, CA | 1R01HL130462-01A1 | — | 19,380 |
| 93.847 | Kaiser Permanente, Pasadena, CA | 5R01DK108522-02 | — | 15,361 |

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON**
**AND SUBSIDIARIES**

Schedule of Expenditures of Federal Awards

Year ended December 31, 2017

| CFDA | Federal Grantor/Pass-Through Grantor/Program Title | Pass-through Grantor's number (only for pass-through awards) | | Expenditures to Subrecipients | Total SEFA Expenditures |
|---|---|---|---|---|---|
| 93.RD | Kaiser Permanente, Oakland, CA | HHSF223201400132C | $ | — | 7,399 |
| 93.279 | Kaiser Permanente Division of Research | 5UG1DA040314-02 | | — | 61,665 |
| 93.279 | Kaiser Permanente Division of Research | 3UG1DA040314-02S1 | | 420,207 | 934,039 |
| 93.393 | Kaiser Permanente Division of Research | 4U24CA171524-05 | | — | 308,626 |
| 93.RD | Mathematica Policy Research | HHSM-500-2010-00026I | | — | 27,518 |
| 93.331 | Merced County Dept Public Health | 5U58DP005710-03 | | — | 26,722 |
| 93.RD | National Committee For Quality Assurance | HHSN316201200139W | | — | 14,714 |
| 93.393 | Nyu School Of Medicine | 5R01CA188353-02 | | — | 21,901 |
| 93.226 | Oregon Health & Science University | 5R01HS023940-02 | | — | 10,804 |
| 93.424 | Public Health Institute | NNPHI/APPALACHIA: 05413-01-01 | | — | 25,440 |
| 93.279 | Research Triangle Institute | 5R01DA034627-02 | | — | 14,849 |
| 93.865 | Seattle Children's Hospital | 4R01HD071986-04 | | 189,021 | 326,347 |
| 93.865 | Seattle Children's Hospital | 5R01HD082141-02 | | 374,788 | 573,221 |
| 93.865 | Seattle Children's Hospital | 5R01HD082141-03 | | 34,000 | 240,672 |
| 93.933 | Southcentral Foundation | U261IHS0079-01-00 | | — | 37,579 |
| 93.866 | Stanford University | 1RF1AG053959-01 | | — | 32,200 |
| 93.RD | Takeda Vaccines, Inc | HHSN272201000034C | | — | 15,452 |
| 93.393 | Ucsf Controller'S Office | 5R01CA185687-02 | | — | 96,009 |
| 93.846 | University Of Alabama | 5R01AR060240-05 | | — | 34,720 |
| 93.393 | University Of Cincinnati | 5R01CA175346-03 | | — | 4,585 |
| 93.866 | University Of Massachussetts | 5R24AG045050-02 | | — | 6,200 |
| 93.866 | University Of Massachussetts | 3R24AG045050-03S1 | | — | 80,217 |
| 93.866 | University Of Utah | 5R01AG023801-10 | | — | 3,952 |
| 93.113 | University Of Washington | 1R01ES026187-01A1 | | — | 52,500 |
| 93.866 | University Of Washington | 1 R01AG053221-01 | | — | 95,750 |
| 93.135 | University Of Washington | 5U48DP005013-03 | | — | 31,817 |
| 93.135 | University Of Washington | 5U48DP005013-04 | | — | 1,988 |
| 93.213 | University Of Washington | 5T90AT008544-02 | | — | 26,681 |
| 93.213 | University Of Washington | 5T90AT008544-02 | | — | 1,435 |
| 93.213 | University Of Washington | 5T90AT008544-03 | | — | 49,716 |
| 93.226 | University Of Washington | 5R01HS022106-04 | | — | 16,720 |

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON**
**AND SUBSIDIARIES**

Schedule of Expenditures of Federal Awards

Year ended December 31, 2017

| CFDA | Federal Grantor/Pass-Through Grantor/Program Title | Pass-through Grantor's number (only for pass-through awards) | Expenditures to Subrecipients | Total SEFA Expenditures |
|---|---|---|---|---|
| 93.226 | University Of Washington | 5K12HS022982-02 | $ — | 149 |
| 93.226 | University Of Washington | 5R01HS023785-02 | — | 6,041 |
| 93.226 | University Of Washington | 5K12HS022982-03 | — | 41,040 |
| 93.393 | University Of Washington | 5R01CA168598-04 | — | 122,554 |
| 93.847 | University Of Washington | 2R01DK076608-08A1 | — | 26,720 |
| 93.847 | University Of Washington | 5U01DK102150-03 | — | 11,504 |
| 93.855 | University Of Washington | 5R01AI106007-05 | — | 75,852 |
| 93.866 | University Of Washington | 5P50AG005136-33 | — | 41,853 |
| | Pass-through Subtotal | | 1,018,016 | 6,077,428 |
| | Total US Department of Health and Human Services | | 8,942,713 | 31,917,037 |
| | Pass-through awards from: | | | |
| 64.RD | Dept Of Veterans Affairs Med | 523D62004 | — | 5,725 |
| 12.RD | Tasso Inc | W31P4Q-14-C-0006 | — | 9,338 |
| | Pass-through Subtotal | | — | 15,063 |
| | Total US Department of Health and Human Services | | — | 15,063 |
| | Total Research and Development Cluster | | 8,942,713 | 31,932,100 |
| | Other Federal Awards: | | | |
| 10.557 | Special Supplemental Nutrition Program for Women, Infants, and Children | 1609 CHS - AM1/CHS3790 | — | 34,347 |
| | Total Federal Awards | | $ 8,942,713 | 31,966,447 |

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES**

Notes to Schedule of Expenditures of Federal Awards

December 31, 2017

## (1) Basis of Presentation

The accompanying schedule of expenditures of federal awards (the Schedule) includes the federal grant activity of Kaiser Foundation Health Plan of Washington and Subsidiaries (the Company) under programs of the federal government for the year ended December 31, 2017. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*. Because the Schedule presents only a selected portion of the operations of the Company, it is not intended to and does not present the financial position, changes in net assets, or cash flows of the Company.

## (2) Summary of Significant Accounting Policies

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in the *Uniform Guidance, Cost Principles for Non-profit Organizations*, wherein certain types of expenditures are not allowable or are limited as to reimbursement. Negative amounts shown on the Schedule represent adjustments or credits made in the normal course of business to amounts reported as expenditures in prior years. Pass-through entity identifying numbers are presented where available.

## (3) Indirect Cost Rate

The Company has negotiated Facilities & Administration rates from the Division of Cost Allocation. The Company has elected not to use the 10% de minimis cost rate.

## KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES

Schedule of Findings and Questioned Costs

December 31, 2017

### (1) Summary of Auditors' Results

*Financial Statements*

| | | | | |
|---|---|---|---|---|
| Type of auditors' report issued: | Unmodified | | | |
| Internal control over financial reporting: | | | | |
| Material weaknesses identified? | X | Yes | | No |
| Significant deficiencies identified that are not considered to be material weaknesses | X | Yes | | None reported |
| Noncompliance material to the financial statements noted? | | Yes | X | No |

*Federal Awards*

| | | | | |
|---|---|---|---|---|
| Internal control over major programs: | | | | |
| Material weaknesses identified? | | Yes | X | No |
| Significant deficiencies identified that are not considered to be material weaknesses | | Yes | X | None reported |
| Type of auditors' report issued on compliance for major programs: | Unmodified | | | |
| Any audit findings disclosed that are required to be reported in accordance with CFR section 200.516 of the Uniform Guidance? | | Yes | X | No |

*Identification of Major Programs*

| CFDA number | Name of federal program |
|---|---|
| Cluster | Research and Development |

| | | | | |
|---|---|---|---|---|
| Dollar threshold used to distinguish between Type A and Type B programs: | $958,993 | | | |
| Auditee qualified as low-risk auditee? | | Yes | X | No |

**KAISER FOUNDATION HEALTH PLAN OF WASHINGTON AND SUBSIDIARIES**

Schedule of Findings and Questioned Costs

December 31, 2017

**(2) Financial Statement Findings Section**

**Finding 2017-001**

*Federal Program:*

NA

*Federal Agency:*

NA

*Federal Award Year:*

January 1, 2017 to December 31, 2017

*Criteria*

The Company's review over subsequent events related to business acquisitions should be designed at a proper level of precision to identify misstatements.

*Statement of Condition*

There was a deficiency in internal control around the consideration of subsequent events giving rise to disclosure or recognition in the financial statements. Subsequent to the issuance of the consolidated financial statements as of and for the year ended December 31, 2016, an error in the recognition of a liability resulting from the acquisition of the Company by KFHPW Holdings was identified. As a result, the December 31, 2016 consolidated financial statements have been restated from the amounts previously reported.

*Cause and Effect*

This error is the result of the Company's controls not designed at an appropriate level of precision to detect subsequent events related to business acquisition activity. As a result of the material misstatement, financial statements were restated for fiscal year 2016.

*Questioned Costs*

None

*Was the sampling statistically valid?*

The error was not found as a part of a sampled population.

*Repeat Finding?*

No

*Recommendation*

We recommend that the Company refine controls over financial reporting, specifically over the review of subsequent events related to business acquisitions.

*View of Responsible Officials and Corrective Action Plan:*

Management concurs with the assessment of controls over subsequent events identified in the prior year. Remediation activities began in 2017 and concluded in 2018.

**Finding 2017-002**

*Federal Program:*

NA

*Federal Agency:*

NA

*Federal Award Year:*

January 1, 2017 to December 31, 2017

*Criteria*

The Company's review over leasing activities should be designed at a proper level of precision to identify misstatements.

*Statement of Condition*

The Company's risk assessment procedures did not identify the risks of misstatement associated with the combination of the formation of new entities, investment in those entities and leasing activities with those entities. Because the risks of misstatement were not identified, management failed to evaluate all accounting guidance applicable to the Ryan One and Ryan Two transactions to identify that build-to-suit and sales leaseback accounting guidance applied.

*Cause and Effect*

This error is the result of the Company's controls not designed at an appropriate level of precision to detect build-to-suit leases. As a result of the significant deficiency, management updated its accounting for two leasing arrangements.

*Questioned Costs*

None

*Was the sampling statistically valid?*

The error was not found as a part of a sampled population.

*Repeat Finding?*

No

*Recommendation*

We recommend that management update its leasing controls to enhance its consideration of build-to-suit leases.

*View of Responsible Officials and Corrective Action Plan:*

Management concurs with the assessment of the controls over leasing transactions. Management has noted that the legacy controls in place at the time the deficiency was identified were not adequately designed to identify build-to-suit transactions. Management is committed to remediation of the deficiency in 2018.

**Finding 2017-003**

*Federal Program:*

NA

*Federal Agency:*

NA

*Federal Award Year:*

January 1, 2017 to December 31, 2017

*Criteria*

User access controls should be designed, implemented, and operating effectively in a general IT environment in order for application and process level controls to operate effectively.

*Statement of Condition*

The suite of application access controls that support the Company's control activities, in aggregate, were not designed appropriately to ensure application and network security objectives were consistently achieved.

*Cause and Effect*

User access control deficiencies, when aggregated, merit the attention of those charged with governance, and therefore a significant deficiency exists.

*Questioned Costs*

None

*Was the sampling statistically valid?*

The error was not found as a part of a sampled population.

*Repeat Finding?*

No

*Recommendation*

We recommend that management monitor and update user access controls to implement adequate controls to address the identified risks.

*View of Responsible Officials and Corrective Action Plan:*

Management concurs with the assessment of application access controls. Management has begun to develop a thorough corrective action plan to address the risks identified. Management is committed to the remediation in 2018.

**(3) Federal Award Findings and Questioned Costs**

No matters reported.