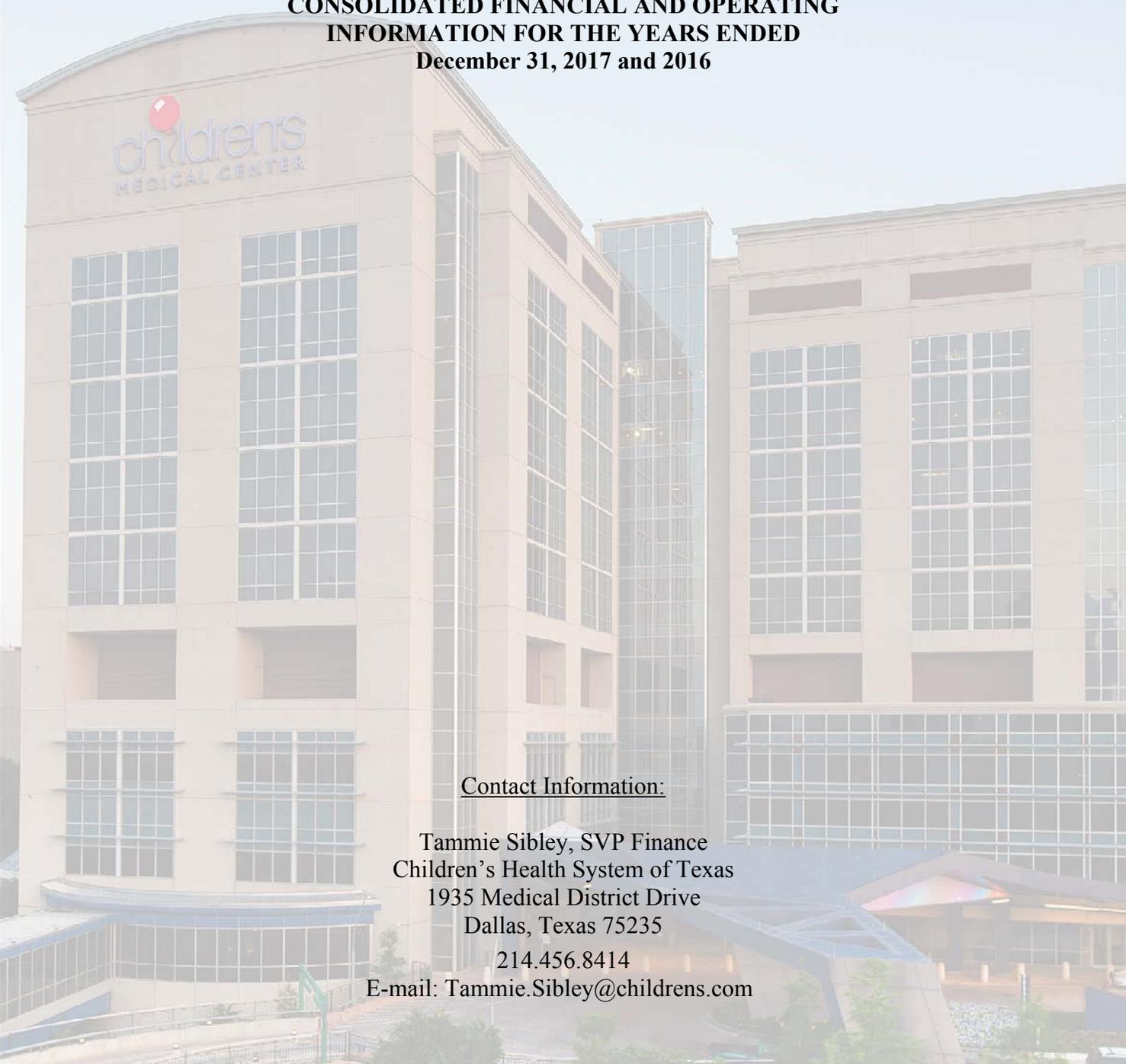




**CHILDREN'S HEALTH SYSTEM OF TEXAS AND AFFILIATES
CONSOLIDATED FINANCIAL AND OPERATING
INFORMATION FOR THE YEARS ENDED
December 31, 2017 and 2016**

A large, multi-story medical center building with a prominent glass facade and a curved entrance. The building is light-colored with many windows. The "children's MEDICAL CENTER" logo is visible on the upper left side of the building.

children's
MEDICAL CENTER

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Management’s Discussion and Analysis of Financial Condition and Results of Operations 42



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Independent Auditor's Report

The Board of Directors
Children's Medical Center Foundation

We have audited the accompanying financial statements of Children's Medical Center Foundation, which comprise the statements of financial position as of December 31, 2017 and 2016, and the related statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Children's Medical Center Foundation at December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Ernst & Young LLP

April 24, 2018



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidated Balance Sheets
(in thousands)

	December 31, 2017	December 31, 2016
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 252,497	\$ 177,869
Short-term investments	109,173	145,621
Patient accounts receivable, net of allowances	147,637	150,447
Pledges receivable, net of allowances	12,787	11,909
Inventories	17,864	16,971
Other current assets	85,053	102,779
TOTAL CURRENT ASSETS	625,011	605,596
Pledges receivable, net of allowances	10,718	17,067
Receivables from remainder trusts	19,143	12,348
Property and equipment, net	970,601	907,743
Assets limited as to use	1,421,189	1,174,329
Other assets	38,214	40,765
TOTAL ASSETS	\$ 3,084,876	\$ 2,757,848
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$ 132,562	\$ 111,000
Accrued liabilities	118,547	100,902
Accrued interest	1,136	7,015
Current portion of long-term debt and capital lease obligations	8,585	8,175
Other current liabilities	10,173	8,991
TOTAL CURRENT LIABILITIES	271,003	236,083
Long-term debt and capital lease obligations, net of current portion	451,595	356,509
Other non-current liabilities	41,008	76,305
NET ASSETS		
Unrestricted	2,097,309	1,892,674
Temporarily restricted	83,121	76,356
Permanently restricted	140,840	119,921
TOTAL NET ASSETS	2,321,270	2,088,951
TOTAL LIABILITIES AND NET ASSETS	\$ 3,084,876	\$ 2,757,848



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidating Statements of Operations
For the Years Ended December 31, 2017 and 2016
(In Thousands)

	2017	2016
OPERATING REVENUE		
PATIENT SERVICES REVENUE, before provision for doubtful accounts	\$ 1,367,355	\$ 1,310,225
Provision for doubtful accounts	(85,339)	(54,928)
NET PATIENT SERVICES REVENUE	1,282,016	1,255,297
Premium revenue	245,065	38,616
Other revenue	141,924	130,069
TOTAL OPERATING REVENUE	1,669,005	1,423,982
OPERATING EXPENSES		
Salaries and benefits	739,819	742,757
Physician and provider costs	148,698	133,338
Medical supplies	155,035	150,819
Medical plan expenses	216,505	26,381
General support	248,398	253,135
Depreciation and amortization	67,992	64,352
Interest	17,488	17,505
TOTAL OPERATING EXPENSES	1,593,935	1,388,287
INCOME FROM OPERATIONS	75,070	35,695
NON-OPERATING INCOME		
Realized investment gains, net	27,665	31,111
Unrealized investment gains, net	123,993	32,046
Other, including loss on extinguishment of debt	(23,532)	1,602
TOTAL NON-OPERATING INCOME	128,126	64,759
NET INCOME	\$ 203,196	\$ 100,454



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidating Statements of Net Assets
For the Years Ended December 31, 2017 and 2016
(In Thousands)

	2017	2016
CHANGES IN UNRESTRICTED NET ASSETS		
Net income	\$ 203,196	\$ 100,454
Net assets released from restrictions	4,569	8,423
Change in minimum pension liability	(1,329)	5,346
Change in donor designation and other	(1,801)	(3,268)
INCREASE IN UNRESTRICTED NET ASSETS	204,635	110,955
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS		
Contributions	14,762	17,344
Change in split-interest agreements	3,759	2,720
Realized investment gains, net	370	356
Unrealized investment gains, net	1,394	770
Net assets released from restrictions for operations	(10,148)	(19,749)
Net assets released from restrictions for capital	(4,569)	(8,423)
Change in donor designation and other	1,197	3,370
INCREASE (DECREASE) IN TEMPORARILY RESTRICTED NET ASSETS	6,765	(3,612)
CHANGES IN PERMANENTLY RESTRICTED NET ASSETS		
Permanently restricted contributions	8,431	2,268
Change in split-interest agreements	(227)	(240)
Gain on sale of assets	2,761	-
Realized investment gains, net	2,702	2,857
Unrealized investment gains, net	11,671	2,527
Net assets released from restrictions	(3,261)	(682)
Change in donor designation and other	(1,158)	(2,573)
INCREASE IN PERMANENTLY RESTRICTED NET ASSETS	20,919	4,157
INCREASE IN NET ASSETS	232,319	111,500
NET ASSETS BEGINNING OF PERIOD	2,088,951	1,977,451
NET ASSETS END OF THE PERIOD	\$ 2,321,270	\$ 2,088,951



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidating Statements of Cash Flows
For the Years Ended December 31, 2017 and 2016
(In Thousands)

	2017	2016
CASH FLOW FROM OPERATING AND NON-OPERATING ACTIVITIES		
Increase in net assets	\$ 232,319	\$ 111,500
Adjustment to reconcile increase in net assets to net cash provided by operating and non-operating activities:		
Provision for doubtful accounts	85,339	54,928
Depreciation and amortization	67,992	64,352
Amortization of financing cost and bond discounts	513	515
Amortization of bond premium	(1,742)	(1,881)
Unrealized gains on investments	(123,993)	(32,046)
(Loss) gain on disposal of property and equipment	(91)	1,096
Receipt of restricted contributions	(27,667)	(19,691)
Loss on extinguishment of debt	23,303	-
Change in pension liability	(34,390)	(12,945)
Changes in operating assets and liabilities:		
Patient and other receivables	(59,790)	(46,081)
Pledges receivable, net	5,472	2,576
Inventory and other current assets	(5,906)	(2,943)
Other assets	2,551	722
Receivables from remainder trusts	(6,795)	(2,721)
Purchases of assets limited as to use and short-term investments	(86,420)	(26,142)
Accounts payable and accrued liabilities	39,078	30,597
Other current liabilities	1,181	(484)
Other non-current liabilities	(867)	(1,832)
NET CASH PROVIDED BY OPERATING AND NON-OPERATING ACTIVITIES	110,087	119,520
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase and construction of property and equipment	(130,759)	(141,229)
NET CASH USED BY INVESTING ACTIVITIES	(130,759)	(141,229)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on annuities and trust obligations, net	(41)	-
Receipt of restricted contributions	27,667	19,691
Issuance of long-term debt	390,810	-
Amounts placed in escrow to extinguish debt	(312,121)	-
Payments of long-term debt	(8,175)	(2,535)
Payment of deferred loan costs	(2,840)	-
NET CASH PROVIDED BY FINANCING ACTIVITIES	95,300	17,156
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	74,628	(4,553)
CASH AND CASH EQUIVALENTS, beginning of period	177,869	182,422
CASH AND CASH EQUIVALENTS, end of period	\$ 252,497	\$ 177,869
Supplement cash flow disclosures:		
Interest paid	\$ 18,846	\$ 19,082



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

Note 1 - Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation

Children's Health System of Texas ("CHST"), incorporated in 1985, is a Texas nonprofit corporation exempt from federal income taxes under Section 501(a) of the Internal Revenue Code ("IRC") of 1986 as an organization described in Section 501(c)(3) of the IRC. CHST and its affiliates (Children's Health) operate two pediatric teaching hospitals licensed for 562 beds, a rehabilitation hospital licensed for 39 beds, ambulatory care clinics, 17 primary care physician clinics, and a foundation.

CHST's wholly-owned operating entities are included in the following table:

<u>Entity</u>	<u>Business Purpose/Activities</u>
Children's Medical Center Dallas ("CMCD")	Nonprofit Texas corporation that owns and operates two pediatric hospitals licensed for a combined total of 562 beds: (i) a 490 bed facility located on a site in Dallas, Texas (the "Dallas Medical Center") and (ii) a 72 bed facility located on a site in Plano, Texas (the "Plano Medical Center")
Children's Medical Center Foundation (the "Foundation")	Nonprofit Texas corporation that fundraises and invests such funds for the benefit of CMCD and its affiliates. The Foundation is exempt from federal income taxation as an organization described in Section 501(c)(3) of the IRC.
OCH Holdings d/b/a Our Children's House ("OCH")	Nonprofit Texas corporation that operates a pediatric hospital specializing in pediatric rehabilitation and therapy programs. OCH was incorporated in 2015.
Physicians for Children d/b/a Children's Health Pediatric Group ("CHPG")	Nonprofit Texas corporation that currently operates 17 primary care physician offices primarily providing care to children in critically underserved areas of Dallas and Collin counties. CHPG was incorporated in 1999 and began operations in 2000. CHPG employs physicians and advanced practice nurses. CHPG's voting board is comprised solely of practicing physicians appointed to the board by CHST.
Anesthesiologists for Children ("AFC")	Nonprofit Texas corporation that provides professional physician and physician extender anesthesiology services. AFC was incorporated in October 2000 and began operations in 2001. AFC's voting board is comprised solely of practicing physicians appointed to the board by CHST.



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

<u>Entity</u>	<u>Business Purpose/Activities</u>
Dallas Physician Medical Services for Children d/b/a Children's Health Medical Group ("DPMSC")	Nonprofit Texas corporation that provides multi-specialty physician services in hospitals, clinics, physician practice and other settings for dental, general pediatric and pediatric sub-specialty services, including emergency department coverage, neurology, hospitalist, orthopedic surgery, and craniofacial services. DPMSC was incorporated and began operations in 2002. DPMSC's voting board is comprised solely of practicing physicians appointed to the board by CHST.
Complex Care Medical Services ("CCMS")	Nonprofit Texas corporation that serves as a medical home for children with complex medical illnesses where a multidisciplinary team of care givers oversee and coordinate patient care. CCMS was incorporated in 2012 and began operations in 2013. CCMS's voting board is comprised solely of practicing physicians appointed to the board by CHST.
Pediatric Partners	Nonprofit Texas corporation that operates as a clinically integrated network (clinically and financially) comprised of more than 360 community based primary care and specialist pediatric physicians to improve outcomes across a spectrum of indicators. Pediatric Partners was incorporated in 2012 and began operations in 2013. Pediatric Partners' voting board is comprised solely of practicing physicians appointed to the board by CHST.
Children's Medical Center Research Institute at The University of Texas Southwestern Medical Center	Nonprofit Texas corporation that is organized to conduct pediatric research. The Research Institute was formed by UTSW and CHST for the purposes of funding and operating a pediatric research program. The entity was formed through a contractual arrangement with UTSW and began operations in 2012. The Research Institute is an organization described in section 501(c)(3) of the IRC with CHST as its sole member. CMCD has committed to providing \$10 million annually to the Research Institute through 2026.
Children's Population Health ("CPH")	Nonprofit Texas corporation that was established to find ways to improve the health of children across the continuum of care. CPH was incorporated and began operations in 2013. CPH was dissolved effective December 31, 2017.
Children's Medical Center Health Plan ("CMCHP")	Nonprofit Texas corporation that operates a health plan and engages in health maintenance organization activities. CMCHP was incorporated in 2013, received licensure in May 2014, and was awarded the contract to manage Texas Medicaid STAR Kids in November 2016, covering Collin, Dallas, Hunt, Rockwall, Kaufman, Ellis, and Navarro, Texas counties. CMCHP is also licensed as both a third party administrator and a utilization review agency, which allows CMCHP to market administrative and medical management services.



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

<u>Entity</u>	<u>Business Purpose/Activities</u>
Texas Bluebonnet Insurance Company ("TBIC")	For-profit Texas organization that was formed to provide commercial health insurance and health maintenance organization products. Texas Bluebonnet Health Plan, Inc. merged into TBIC in 2015. TBIC currently has a license to sell commercial HMO and Medicare Advantage products to large group employers in 48 counties. No operational activity is currently planned for TBIC.
The Health and Wellness Alliance for Children ("H&W")	Nonprofit Texas corporation that collaborated with communities, businesses, advocates, and other nonprofits to improve the health and wellness of children in underserved areas. H&W was incorporated and began operations in 2013. H&W was dissolved effective December 31, 2017.
Texas Trinity River Assurance Company ("TTRAC")	For-profit captive insurance organization domiciled in Grand Cayman which underwrites Children's Health's professional liability and medical stop loss insurance. Children's Insurance Company, previously a for-profit Vermont captive insurance company that underwrote Children's Health's professional liability insurance, merged into TTRAC in 2016.
Children's BMG d/b/a Connect 2 Care ("Children's BMG")	Nonprofit Texas corporation that was formed to operate family health clinics. Children's BMG was incorporated and began operations in 2015. The Children's BMG's voting board is comprised solely of practicing physicians appointed to the board by CHST. Children's BMG was dissolved effective December 31, 2017.
Physician Quality Alliance of North Texas d/b/a Pediatric Alliance ("PQA")	Nonprofit Texas corporation that participates in healthcare collaborative care activities. PQA was incorporated and began operations in 2013. The PQA's voting board is comprised solely of practicing physicians appointed to the board by CHST.
NTPSS, Inc. ("NTPSS")	Nonprofit Texas corporation that functions as an aggregator and supplier of goods and back-office services to community physicians. NTPSS was incorporated and began operations in 2014.
Alternative Care Systems Inc. ("ACS")	For-profit Texas corporation that was formed to participate in ventures that have included investments in companies that brought new medical supplies and pharmaceuticals to market and participation in a medical device consortium. ACS was incorporated in 1988.
Pediatric Imaging Associates, LLC ("PIA")	Texas limited liability company that provides a broad range of diagnostic imaging services, tailored for children newborn to 18 years. PIA was formed and began operations in 2015.

Children's Health, with over 7,000 employees, is the leading pediatric health care system in North Texas, the eighth largest pediatric healthcare provider in the nation, and the second busiest in terms of admissions and pediatric emergency department visits. The Dallas Medical Center presently offers care in more than 50



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

specialties, houses 77 pediatric intensive care beds, a 74-bed neonatal intensive care unit, and has state-of-the-art diagnostic technology tailored specifically for children. Additionally, the Dallas Medical Center is the only designated Level I trauma center for pediatrics in North Texas. The Plano Medical Center currently provides service in acute care, emergency, surgery, psychiatry services such as eating disorders, outpatient specialty care, radiology, and lab services.

CMCD is the primary pediatric teaching hospital for The University of Texas Southwestern Medical Center ("UTSW").

Basis of Presentation

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

The consolidated financial statements include all subsidiaries of CHST.

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

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments with initial maturities of three months or less when purchased. Carrying values of cash and cash equivalents approximate fair value due to the short-term nature of these instruments.

Concentration of Credit Risk

Children's Health grants credit without collateral to its patients, most of whom are area residents and many of whom are insured under third-party payer agreements. Management does not believe these receivables represent any concentrated credit risk; furthermore, management continually monitors and adjusts its reserves and allowances associated with these receivables.

The mix of receivables from patients and third-party payers (excluding affiliates) at December 31, 2017 and 2016, is as follows:

	2017	2016
Commercial	50%	49%
Managed Medicaid	38	28
Medicaid	9	21
Other	3	2
	100%	100%

Patient Accounts Receivable and Net Patient Service Revenue

Net patient service revenue is recorded at the estimated net realizable amounts due from guarantors, third-party payers, and others for services rendered. Reimbursement for inpatient services for Traditional Medicaid, Children with Special Healthcare Needs ("CSHCN"), Children's Health Insurance Program



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

("CHIP") and certain Managed Medicaid contracts are based on All Patient Refined Diagnosis Related Groups ("APR-DRG"). Children's Health's base rate under APR-DRG's was approximately \$12,500 for 2017 and 2016. For outpatient services these same payers are fixed fee or cost-based reimbursed. Commercial and certain managed care payers are reimbursed based on a percent of charges. For all services related to Medicare patients reimbursement is cost-based. Net patient accounts receivable arising from all government programs were approximately \$64.0 million at December 31, 2017, and \$82.4 million at December 31, 2016.

For cost-based reimbursement, Children's Health is reimbursed for their actual audited allowable cost of providing care to Medicaid enrollees using the Tax Equity and Fiscal Responsibility Act of 1982 cost principles. Children's Health files an annual cost report that is subject to administrative review and audit by third parties. As a result, there is a reasonable possibility that recorded estimates may change by a material amount as interpretations are clarified and cost reports are settled. The initial estimates are revised as needed until the cost report is final settled. Children's Health believes that the balance sheet amounts recorded are adequate to cover any such adjustments. At December 31, 2017 and 2016, Children's Health had a liability of \$6.1 million and \$9.7 million, respectively, recorded in accrued liabilities in the accompanying consolidated balance sheets. Net patient service revenue increased by approximately \$4.9 million and \$0.7 million for the years ended December 31, 2017 and 2016, respectively, due to the change in cost report allowances previously estimated, as a result of interim and final settlements.

Allowance for Doubtful Accounts

Patient accounts receivable is presented net of allowances for doubtful accounts of approximately \$83.5 million and \$43.1 million in 2017 and 2016, respectively. Children's Health does not require collateral or other security to support patient accounts receivable balances.

Children's Health maintains allowances for doubtful accounts to reserve for potential write-offs relating to a payer's inability to make payments on an account. Accounts are written off when collection efforts have been exhausted. Children's Health routinely monitors its accounts receivable balances and utilizes historical collection experience to support the basis for its estimates of the provision for doubtful accounts.

Charity Care

Children's Health maintains records of the value of services and supplies furnished to financially and medically indigent patients under its charity policy. Financially indigent patients are uninsured or underinsured patients accepted for care with no obligation, or a discounted obligation, to pay. Medically indigent patients are those whose medical obligations exceed a certain percentage of their family's annual gross income.

In 1993, the Texas legislature passed Senate Bill 427, which established annual reporting requirements and certain standards for the delivery of community benefits, charity care, and government-sponsored indigent healthcare. Nonprofit hospitals must meet these standards in order to maintain their exemption from state and local taxes. Children's Health meets these state standards with respect to charity care. Charity care is not included in net patient service revenue in the accompanying consolidated statements of operations.

Community Service

Children's Health is an active, caring member of the communities it serves. Children whose families meet the criteria of its charity care policy are provided care without charge or at amounts less than established rates. Children's Health participates in the Medicaid, Medicare, CSHCN, and CHIP government programs,



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

and provides services to the indigent children of Dallas County under an agreement with the Dallas County Hospital District.

Responding to community needs, Children's Health operates a Level I Trauma Center, provides speakers to community organizations to convey information about child health, participates in major community health fairs, and provides support to numerous family support groups and other community organizations serving children.

Disproportionate Share Hospital Program and 1115 Waiver Programs

Children's Health participates in the Disproportionate Share Hospital Program ("DSH") and the Uncompensated Care Program ("UCP") administered by the Texas Department of Human Services. Under these programs, local, state, and federal funds are accessed and distributed to hospitals providing a high volume of services to Medicaid and indigent patients.

Children's Health also participates in the Delivery System Reform Incentive Payment ("DSRIP") pool. The DSRIP program provides incentives to hospitals and other providers to enhance access to care and patient health.

See Note 17 for a further description of supplemental payments.

Health Plan

CMCHP earns premium revenue from the Medicaid State of Texas Access Reform ("STAR") program. For the year ended December 31, 2017, CMCHP received 100% of its premium from the STAR Kids program in the Dallas service area. The program started November 1, 2016 so there is not a complete year of premiums for comparison. CMCHP recognizes revenue during the coverage period of the member agreement. Under these agreements, CMCHP receives monthly payments from the Health and Human Services Commission ("HHSC") based on the number of members enrolled in the CMCHP plan, regardless of the actual medical claims incurred. For the year ended December 31, 2017 and 2016, respectively, CMCHP recognized \$245.1 million and \$38.6 million in premium revenues which are included in premium revenue in the accompanying consolidated statements of operations.

CMCHP is subject to an experience rebate if operating income, as a percentage of revenue, is greater than the percentage set forth by the State of Texas. As of December 31, 2016 and 2017, CMCHP had no estimated experience rebate liability.

A liability was recorded on CMCHP financials for incurred but not reported ("IBNR") medical claims for the year ending December 31, 2017 and 2016, of \$9.0 million and \$10.5 million, respectively. In addition, at December 31, 2017, CMCHP recorded a premium deficiency reserve of \$21.5 million. The IBNR and premium deficiency reserve are included in accrued liabilities. These reserves were prepared by CMCHP in-house actuary and a report was filed with the Texas Department of Insurance on the methodology used.



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

Pledge Discounts and Allowances

The Foundation receives pledges on behalf of Children's Health and records pledges at fair value using the present value method. For pledges in excess of one year and greater than or equal to \$50,000, the Foundation provides a discount based on the net present value of the pledge receivable. The Foundation uses a discount rate based on U.S. Treasury bonds at the time of the pledge. An allowance for uncollectible pledges is also provided based on historical experience and an analysis of the composition of the donors.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is computed using the straight-line method based on the estimated useful lives of the related assets. Amortization on assets under capital lease is computed using the straight-line method based on the term of the lease or the useful life of the asset, whichever is shorter, and is included in depreciation and amortization expense.

The estimated useful lives of the classes of depreciable assets are as follows:

Land improvements	8 to 20 years
Buildings and improvements	10 to 40 years
Fixed equipment	5 to 25 years
Movable equipment	3 to 20 years

Children's Health evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the carrying value of an asset may not be recoverable. The assessment of possible impairment is based on whether the carrying value of the asset exceeds its fair value. The fair value of impaired assets is estimated based on market value of similar assets at quoted market prices, if available, or the expected total value of the cash flows on a discounted basis. There were no impairments of property and equipment in 2017 or 2016.

Assets Limited as to Use

Assets limited as to use include investments designated by the Board of Directors (the "Board"), which consist primarily of debt securities, marketable equity securities, mutual funds, common/collective trusts, alternative investments, and bond indentures. Investments designated by the Board are held under a custodial agreement, with investments directed by a professional investment management firm. These assets, other than certain alternative investments, are stated at fair value and are held for trading purposes.

Children's Health invests in alternative investments through limited partnerships. Those alternative investments held in the Foundation are reported using fair value "as a practical expedient". During 2017, Children's Health adopted the provisions of Accounting Standard Update 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (Or Its Equivalents)*. The remainder of the alternatives held by Children's Health are reported using the equity method of accounting based on information provided by the respective partnerships. The values provided by the respective partnerships are based on fair value, appraisals, or other estimates of fair value that require varying degrees of judgment. Generally, the net asset value of Children's Health holdings reflects net contributions to the partnership and an allocated share of realized and unrealized investment income and expenses.



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

The Board has adopted a policy that separately designates certain investments for facilities replacement and for strategic planning initiatives. Disbursements from these funds must be approved by the Board.

Other Assets

Other assets include investments in joint ventures, insurance recoveries under insurance policies, physician guarantees, land and improvements, intangibles, and oil and gas investments.

Children's Health investment in joint ventures total \$13.9 million in 2017 and \$12.5 million in 2016. Children's Health accounts for its equity investment in Go Noodle and Pieces Technology under the cost-based method of accounting. Children's Health accounted for its investments in Methodist Health under the equity method of accounting. The Methodist Health joint venture was dissolved during fiscal 2017. In 2016, Children's Health acquired 100% of Pediatric Partners Imaging, which had previously been accounted for as a joint venture.

Physician guarantees were \$5.6 million and \$9.0 million at December 31, 2017 and 2016, respectively. The physician guarantees are amortized on a straight line basis over the guarantee period. See Note 14 for a further description of physician guarantees.

Self-Insurance

Children's Health self-insures professional and general liability risk through its wholly-owned captive insurance company, TTRAC, domiciled in the Cayman Islands. The primary policies are written on an occurrence basis and funded based upon actuarial studies performed twice yearly. Excess insurance for these lines of coverage is also issued by TTRAC but the excess policy is 100% reinsured in the commercial markets. The estimated cost of self-insurance is recognized at the time incidents occur. The accompanying consolidated financial statements include the estimated liability for known claims, as well as incurred but not reported claims, based on actuarial calculations expected to be covered by self-insurance.

All Children's Health entities are covered by policies issued by TTRAC. The policies issued by TTRAC cover claims from the first dollar up to \$3 million for both professional and general liability. Above these policies an excess insurance program is in place with an additional \$100 million in limits.

Children's Health employee health benefits are provided through a self-insurance program that requires the development of a loss reserve to cover claims incurred but not reported. This reserve, in the amount of \$7.2 million and \$6.4 million, is included in accrued liabilities in the accompanying consolidated balance sheets as of December 31, 2017 and 2016, respectively.

Physician Income Guarantees

In the interest of expanding the availability of Children's Health services, Children's Health enters into physician income guarantee contracts (see Note 14). Through these contracts, Children's Health agrees to fund deficits generated between a physician's collections and direct expenses. The guarantees are typically two to three years in duration and are intended to support the physician in the start-up phase of his or her practice.

Employee Retirement Benefit Plan

Children's Health accounts for its Defined Benefit Retirement Plan (the "Defined Retirement Plan") in accordance with the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards



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Codification ("ASC") Topic 715, *Compensation – Retirement Benefits*. This topic requires an employer to (1) recognize, in its statement of financial position, an asset for a plan's overfunded status or a liability for a plan's underfunded status; (2) measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year; and (3) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes are required to be reported in other changes in net assets.

Gifts and Bequests

Unconditional unrestricted gifts and bequests of cash and other assets are included in unrestricted net assets when pledged. Conditional unrestricted gifts and bequests are included in unrestricted net assets when the conditions have been satisfied. Donor-restricted gifts are reported as either temporarily restricted net assets or permanently restricted net assets based upon the donor's intentions. When a time or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. Endowment gifts donated with stipulations that they be invested to provide a permanent source of income are reported as permanently restricted net assets. Reclassifications between net asset classes (i.e., unrestricted, temporarily restricted, or permanently restricted) may occur when a donor changes their designation of a gift or if subsequent review and interpretation of documentation necessitates a change.

Performance Indicator

The performance indicator is net income, which includes all changes in unrestricted net assets other than changes in the pension liability funded status, net assets released from restrictions for property acquisitions, the cumulative effect of changes in accounting principles, discontinued operations, contributions of property and equipment, and other changes not required to be included within the performance indicator under generally accepted accounting principles.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 outlines a single comprehensive model for recognizing revenue and supersedes most existing revenue recognition guidance, including guidance specific to the healthcare industry. This ASU provides companies the option of applying a full or modified retrospective approach upon adoption. This ASU is effective for fiscal years beginning after December 15, 2017. Children's Health has completed a preliminary review of the new revenue standard including a review of sources of revenue and evaluating patient account information to determine the appropriate distribution of accounts into portfolios with similar characteristics that, when evaluated under the new revenue standard, will result in a materially consistent revenue amount for such portfolios as if each patient account was evaluated on a contract-by-contract basis. Accordingly Children's Health does not expect a material change to how net patient revenue is currently recognized.

As part of this review, Children's Health also assessed the impact of the new standard on various reimbursement programs that represent variable consideration, including settlements with third party payors, disproportionate share payments, supplemental state Medicaid programs, and other reimbursement programs in which Children's Health's hospitals participate. Industry guidance is continuing to develop around this issue, and any conclusions in the final industry guidance that is inconsistent with Children's Health's application could result in changes to Children's Health's expectations regarding the impact that this new accounting standard could have on Children's Health's financial statements. Children's Health does not believe such industry guidance will have an impact on its current accounting policies and procedures related



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to third party settlements. Final drafts of industry guidance on these and other reimbursement programs unique to the healthcare industry are expected later in 2018. Children's Health is monitoring the development of such guidance.

Additionally, the adoption of the new accounting standard will impact the presentation on Children's Health's statement of operations for a significant component of its provision for doubtful accounts. After adoption of the new standard, substantially all amounts that are currently classified as the provision for doubtful accounts are expected to be reflected as an implicit price concession as defined in the standard and therefore a reduction to net patient services revenue.

Children's Health plans to adopt the new revenue standard using modified retrospective approach. Based on management's preliminary review, Children's Health does not believe that the implementation of ASC 606 will have a material impact on its consolidated statements of operations, financial position, and cash flows. At this time Children's Health has not identified a material impact of adoption, however, Children's Health has also not completed its review of the impact on interim reporting.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. This guidance requires lease assets and lease liabilities to be recognized on the balance sheet and the disclosure key information. Additionally, the guidance eliminates real-estate specific provisions and changes of the guidance on sale-leaseback transactions, initial direct costs, and lease executory costs for all entities. This pronouncement is effective for periods beginning after December 15, 2018 and interim periods within those years. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is prohibited. Management is evaluating the standard and believes the primary effect of adopting the new standard will be to record right-of-use assets and obligations for current operating leases.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. The intent of this pronouncement is to improve how not-for-profits communicate their financial performance and condition, while reducing certain costs and the complexities of preparing financial statements. The key provisions of this new pronouncement are as follows:

- Net asset classification revised to two classes, net asset with donor restrictions and net assets without donor restrictions
- Net presentation of investment expenses against investment return on statement of activities and elimination of requirement to disclose investment expenses that have been netted
- Requirement to present expenses by nature as well as function, including analysis of expenses showing the relationship between functional and natural classification for all expenses
- Disclosure requirements on liquidity and availability of not-for-profit resources to meet cash needs
- Presentation of operating cash flows may be either direct or indirect methods

This pronouncement is effective for fiscal years beginning after 2017. Management is in the process of evaluating the impact of adoption.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*. This guidance clarifies how entities should present restricted cash and restricted cash equivalents in the statement of cash flows. It requires entities to present the change in restricted cash and restricted cash equivalents with cash and cash equivalents to reconcile amounts on the balance sheet to the statement of cash flows. Entities are required to disclose the nature of the restrictions, as well as reconcile the totals in the statement of cash flows to cash, cash equivalents, restricted cash, and restricted cash equivalents on the



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balance sheet when these are shown in more than one line item. This pronouncement is effective for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. The guidance is to be applied retrospectively and early adoption is permitted. Management is in the process of evaluating the impact of adoption.

In March 2017, the FASB issues ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The ASU amends ASC 715, *Compensation – Retirement Benefits*, to require employers that present a measure of operating income in their statement of income to include only the service cost component of net periodic pension cost and net periodic postretirement benefit cost in operating expenses. The other components of net benefit cost, including amortization of prior service cost/credit, and settlement and curtailment effects, are to be included in nonoperating expenses. The ASU also stipulates that only the service cost component of net benefit cost is eligible for capitalization. The changes are intended to classify costs according to their natures, and better align the effect of defined benefit plans on operating income with International Financial Reporting Standards (“IFRS”). Retrospective application of the change in income statement presentation is required, while the change in capitalized benefit cost is to be applied prospectively. The ASU is effective for fiscal years beginning after December 15, 2018 for non-public entities. Early adoption is permitted in the first financial statements (interim or annual) issued for a fiscal year, provided all provisions of the ASU are adopted. Management is evaluating the impact of adoption.

Reclassifications

During 2017, Children’s Health recategorized investments of unrestricted funds from other current assets to assets limited as to use as these funds are invested in the same manner as the other long term assets. The 2016 balance of \$23.6 million has to be changed to conform to the 2017 presentation. Restricted contributions have been reclassified from operating activities to financing activities on the Statements of Cash Flows. The 2016 amount of \$19.7 million has been changed to conform to the 2017 presentation

Subsequent Events

Children’s Health has evaluated events and transactions occurring subsequent to December 31, 2017, through April 24, 2018, the date the accompanying consolidated financial statements were issued. During this period, there were no subsequent events requiring recognition in the financial statements.

Note 2 – Unconditional Pledges Receivable

Unconditional pledges receivable at December 31, 2017, are as follows (in thousands):

	Less Than 1 Year	1-5 Years	More Than 5 Years	Total
Pledges receivable	\$ 13,306	\$ 10,779	\$ 402	\$ 24,487
Discounts on long-term pledges receivable	(365)	(309)	(25)	(699)
Allowance for uncollectible pledges	(154)	(125)	(4)	(283)
Net pledges receivable	\$ 12,787	\$ 10,345	\$ 373	\$ 23,505

Note 3 – Conditional Pledges Receivable

As of December 31, 2017, the Foundation had \$16.6 million in pledges that contained donor conditions. As of December 31, 2017, \$2.6 million is contingent upon Children’s Medical Center reaching specific



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milestones in the expansion of the Foster Care Program, \$0.7 million is contingent upon the donor's successful fundraising campaign and \$13.3 million is contingent upon submission of a satisfactory progress report. Since these pledges are conditional, they are not recorded as contributions until the donor conditions are met.

Note 4 – Receivables from Remainder Trusts

The Foundation has received, as contributions, split-interest agreements including charitable gift annuities and charitable remainder unitrusts. Trust assets currently consist of cash and cash equivalents, U.S. government securities, common stocks, and mineral rights. As of December 31, 2017 and 2016, the fair value of the receivables from remainder trusts is \$19.1 million and \$12.3 million, respectively.

Under the charitable gift annuity arrangements for which the Foundation is the trustee of the assets, the Foundation records the assets at fair value and the liabilities to the beneficiaries at the present value of the estimated future payments to be distributed by the Foundation to such beneficiaries. The amount of the contribution is the difference between the asset and the liability and is recorded as temporarily restricted contributions unless otherwise restricted by the donor.

Under the charitable remainder unitrust arrangements for which the Foundation is the trustee of the assets, the Foundation records as donor-restricted contributions, the present value of the residual interest in the trust in the period in which the trust is established. The assets held in trust are recorded at fair value when received, and the liabilities to the beneficiaries are recorded at the present value of the estimated future payments to be distributed by the Foundation to such beneficiaries. The amount of the contribution is the difference between the asset and the liability and is recorded as temporarily restricted or permanently restricted contributions, as applicable. Subsequent changes in fair value for charitable remainder unitrusts are recorded as changes in value of split-interest agreements in the appropriate net asset class.

Under the charitable gift annuity and charitable remainder unitrust arrangements for which the Foundation is not the trustee of the assets, the Foundation records a receivable and restricted contribution revenue at the present value of the estimated future distributions expected to be received by the Foundation over the expected term of the agreement.

The discount rates used are commensurate with the risks involved at the time the contributions are initially recognized and are adjusted annually. At December 31, 2017, the Internal Revenue Service discount rate, which is used to determine the charitable deduction for planned gifts, was 2.6%.



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Note 5 - Property and Equipment

Property and equipment consist of the following as of December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Land and improvements	\$ 67,154	\$ 60,466
Buildings and improvements	953,366	844,434
Leasehold improvements	40,056	32,810
Fixed equipment	23,414	20,906
Moveable equipment	412,116	378,585
	<u>1,496,106</u>	<u>1,337,201</u>
Accumulated depreciation and amortization	(654,265)	(588,213)
Construction in progress	128,760	158,755
Property and equipment, net	<u>\$ 970,601</u>	<u>\$ 907,743</u>

Note 6 - Assets Limited as to Use

Assets limited as to use consist of the following as of December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Investments designated by the Board for the consolidated group	\$ 1,219,340	\$ 1,052,854
Project fund escrow	54,002	-
Investments of temporarily restricted funds	21,281	20,163
Investments of permanently restricted funds	126,566	101,312
	<u>\$ 1,421,189</u>	<u>\$ 1,174,329</u>

Project fund escrow, at December 31, 2017, of \$54.0 million represents funds to be used to finance or refinance certain capital projects. These capital expenditures at the Dallas Medical Center include, but are not limited to, expanding, and renovating the emergency department; expanding and renovating the Specialty Center; expanding and renovating Pediatric Intensive Care Unit; and remodeling the 11th and 12th floors of the hospital facility.

Note 7 - Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e., an exit price). To measure fair value, a hierarchy has been established that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs. As such, the hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:



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Level 1: Unadjusted quoted prices in active markets that are accessible to the reporting entity at the measurement date for identical assets or liabilities. Level 2: Inputs other than quoted prices in active markets for identical or similar assets and liabilities that are observable either directly or indirectly for substantially the full term of the asset or liability. Level 2 inputs include the following:

- quoted prices for identical or similar assets and liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- observable inputs other than quoted prices that are used in the valuation of the asset or liabilities (e.g., interest rate and yield curve quotes at commonly quoted intervals)
- inputs that are derived principally from or corroborated by observable market data by correlation or other means

Level 3: Unobservable inputs for the asset or liability (i.e., supported by little or no market activity). Level 3 inputs include management's own assumption about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The level in the fair value hierarchy within which the fair value measurement is classified is determined based on the lowest level input that is significant to the fair value measure in its entirety.

Following is a description of the valuation techniques and inputs used for each major class of assets and liabilities measured at fair value.

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments when purchased with initial maturities of three months or less. The carrying amount approximates fair value because of the short maturity of these instruments.

U.S. Government Securities, Common Stocks, Mutual Funds, Common/Collective Trusts, and Debt Securities

The fair values of the investments included in Level 1 were determined through quoted market prices, while the fair values of Level 2 investments were determined primarily using a market approach, with inputs such as evaluated bid prices provided by third-party pricing services where quoted market values are not available.

The underlying investments of common/collective trusts and pooled investment funds consist of marketable debt and equity securities with readily determinable market values without any lock-up or gate provisions.

Alternative Investments

Children's Health alternative investments have similar risks as traditional fixed income and equity securities, although there may be some additional risk. The alternative investment strategy is to invest in hedge funds in order to obtain attractive risk-adjusted returns that are uncorrelated with equities and fixed income. These funds are invested through limited partnerships that employ various investment strategies, including long-term and short-term equity, multi-strategy, private equity, and credit. Performance is driven by individual manager selection and their ability to obtain superior results. Certain alternative investments have lock-up periods and other liquidity limitations that are generally one year from the date of the original investment. Earlier redemptions are allowed with an early redemption penalty.



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The net asset values (“NAV”) of alternative investments are based on valuations provided by the managers of the specified funds. Children's Health accounts for its alternative investments held outside the Foundation and Defined Retirement Plan using the equity method of accounting; accordingly, these investments are excluded from the fair value hierarchy in ASC 820, *Fair Value Measurements and Disclosures*. The tables also do not include Level 3 alternative investments held at the Foundation of \$500.7 million and \$464.9 million at December 31, 2017 and 2016, respectively, which were measured at fair value using net asset value as a practical expedient, as allowed under ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (Or Its Equivalents)*. Valuations provided by the respective investment's management considers variables, such as the financial performance of underlying investments, recent sales prices of underlying investments, and other pertinent information. In addition, actual market exchanges at year-end provide additional observable market inputs of the exit price. The majority of these funds have restrictions on the timing of withdrawals, which may reduce liquidity, in some cases for up to 12 months.

Estimated fair values of financial instruments were as follows at December 31, 2017 (in thousands):

	<u>Total</u>	<u>Assets at Fair Value</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment portfolio:				
Cash and cash equivalents	\$ 97,137	\$ 97,137	\$ -	\$ -
US government securities	94,229	94,229	-	-
Common stocks	44,331	44,331	-	-
Debt securities:				
Corporate bonds	148,825	-	148,825	-
Mortgaged-backed securities	30,004	-	30,004	-
Mutual funds:	-			
Registered:	-			
Domestic equity	18,654	18,654	-	-
International equity	73,437	73,437	-	-
Fixed income	35,247	35,247	-	-
Common / collective trusts:	-			
Domestic equity	187,307	-	187,307	-
International equity	258,264	-	258,264	-
Fixed income	42,213	-	42,213	-
Total investments at fair value	<u>1,029,648</u>	<u>363,035</u>	<u>666,613</u>	<u>-</u>
Investments recognized at net asset value:				
Hedge funds	438,445			
Private equity	<u>62,269</u>			
Total investment portfolio	1,530,362			
Included in short-term investments	<u>109,173</u>			
Total assets limited as to use	<u>\$ 1,421,189</u>			
Receivables from remainder trusts	<u>\$ 19,143</u>	<u>\$ -</u>	<u>\$ 19,143</u>	<u>\$ -</u>



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Estimated fair values of financial instruments were as follows at December 31, 2016 (in thousands):

	<u>Total</u>	<u>Assets at Fair Value</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment portfolio:				
Cash and cash equivalents	\$ 33,892	\$ 33,892	\$ -	\$ -
US government securities	205,051	205,051	-	-
Common stocks	26,757	26,757	-	-
Debt securities:				
Corporate bonds	65,555	-	65,555	-
Mortgaged-backed securities	14,054	-	14,054	-
Mutual funds:	-			
Registered:	-			
Domestic equity	27,333	27,333	-	-
International equity	55,900	55,900	-	-
Fixed income	22,668	22,668	-	-
Common / collective trusts:	-			
Domestic equity	182,697	-	182,697	-
International equity	168,456	-	168,456	-
Fixed income	52,661	-	52,661	-
Total investments at fair value	855,024	371,601	483,423	-
Investments recognized at net asset value:				
Hedge funds	431,196			
Private equity	33,730			
Total investment portfolio	1,319,950			
Included in short-term investments	145,621			
Total assets limited as to use	\$ 1,174,329			
Receivables from remainder trusts	\$ 12,348	\$ -	\$ 12,348	\$ -

Children's Health currently has no other material financial instruments subject to fair value measurement on a recurring basis.

Long-Term Debt

ASC Topic 825, *Financial Instruments*, requires disclosure of fair value information, whether or not recognized on the balance sheet, for which it is practicable to estimate that value. Certain financial instruments and all nonfinancial instruments are excluded from these disclosure requirements. Accordingly, the aggregate carrying value amounts presented do not represent the underlying value of the long-term debt. The fair value of long-term debt is \$503.5 million at December 31, 2017, compared to \$400.1 million at December 31, 2016. The carrying value of long-term debt was \$460.2 million at December 31, 2017, compared to \$364.7 million at December 31, 2016. Estimates are based on available market quotes, which constitute a Level 2 estimate.



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Note 8 - Operating Leases

Children's Health leases office space and certain equipment under operating lease agreements that extend through 2023. The minimum future obligations under these agreements are as follows (in thousands):

	As of December 31, 2017
2018	\$ 15,295
2019	12,127
2020	11,267
2021	10,920
2022	8,960
Thereafter	27,496
	<u>\$ 86,065</u>

Operating lease and rental expense of approximately \$19.5 million in 2017 and \$17.0 million in 2016 is included in general support in the accompanying consolidated statements of operations.



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Note 9 - Long-Term Obligations

Long-term obligations consist of the following as of December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
North Central Texas Health Facilities Development Corporation Hospital Revenue Bonds, Series 2009, secured by Children's Health revenue		
Serial Bonds payable August 15, 2018 through 2019 in amounts ranging from \$1,600 to \$1,780, 5.00% interest	\$ 3,380	\$ 16,415
Term bonds payable, 5.50% interest	-	14,620
Term bonds payable, 5.75% interest	-	168,965
North Central Texas Health Facilities Development Corporation Hospital Revenue Bonds, Series 2012, secured by Children's Health revenue		
Serial Bonds payable August 15, 2018 through 2022 in amounts ranging from \$3,875 to \$8,200, 3.250% to 5.00% interest	37,525	91,580
Term bonds payable, 5.00% interest	-	40,625
Term bonds payable August 15, 2031 through 2032, 4.125% interest	20,000	20,000
New Hope Cultural Education Facilities Finance Corporation Hospital Revenue Bonds, Series 2017A, secured by Children's Health revenue		
Serial Bonds payable August 15, 2020 through 2030 in amounts ranging from \$2,480 to \$15,395, 5.00% interest	115,215	-
Serial Bonds payable August 15, 2031 through 2032 in amounts ranging from \$6,165 to \$6,775, 3.125% and 3.25% interest	12,940	-
Serial Bonds payable August 15, 2033 through 2037 in amounts ranging from \$19,675 to \$23,020, 4.00% interest	106,565	-
Term bonds payable August 15, 2040, 4.00% interest	53,590	-
Term bonds payable August 15, 2047, 5.00% interest	42,500	-
Children's Health System of Texas Taxable Bonds, Series 2017		
Term bonds payable August 15, 2027, 3.383% interest	25,000	-
Other, a \$10.2 million note, 1.00% interest	10,185	10,185
Face value of long-term debt	<u>426,900</u>	<u>362,390</u>
Unamortized bond premium/discount, net of issue costs	33,280	2,294
Current portion of long-term debt	<u>(8,585)</u>	<u>(8,175)</u>
Long-term debt	<u>\$ 451,595</u>	<u>\$ 356,509</u>

In December 2017, Children's Health issued \$330.8 million non-taxable hospital revenue bonds with a final maturity date of August 15, 2047 (Series 2017A). The Series 2017A bonds were issued for the purpose of providing funds to i) establish a project escrow fund of \$54.0 million to finance and/or refinance new projects and ii) to refund certain Series 2009 and Series 2012 bonds outstanding which financed and/or refinanced the cost of acquisition, construction, renovation, furnishing remodeling and /or equipping of health facilities on the Dallas and Plano Campuses. The Series 2017A bonds refunded \$194.9 million of the Series 2009 bonds and \$88.2 million of the Series 2012 bonds.



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In addition, in December 2017, Children's Health issued \$25.0 million in taxable term bonds with a final maturity of August 15, 2027 (Series 2017). The Series 2017 bond proceeds will be used to provide funds for general corporate purposes.

In December 2017, Children's Health entered into a transaction to legally cash defease outstanding municipal debt related to its Series 2009 and Series 2012 by establishing an irrevocable escrow account to fund the debt service until the applicable maturity or redemption dates. The defeased debt has been accounted for as if it were extinguished at December 31, 2017.

Children's Health, CMC and the Foundation comprise the Children's Health Medical Center Obligated Group (the "Obligated Group") for the outstanding Series 2017A bonds, 2012 bonds and 2009 bonds. Children's Health is not in default on any debt covenants, which include certain financial ratios, insurance coverage minimums, and revenue adequate to cover debt service.

As part of these bond transactions, Children's Health paid \$2.8 million in deferred financing costs, received \$35.0 in premium on the issue of the Series 2017A bonds and recorded a loss on extinguishment of debt of \$23.3 million included in non-operating other expense.

Unamortized bond premium/discount, net of issue costs of \$33.2 million and \$2.3 million at December 31, 2017 and 2016 respectively, are amortized over the terms of the respective bonds using the effective interest method.

Scheduled principal payments on long-term debt over the next five years are as follows (in thousands):

	<u>Long-Term Debt Bonds</u>	<u>Long-Term Other</u>	<u>Long-Term Total</u>
2018	\$ 8,585	\$ -	\$ 8,585
2019	8,745	-	8,745
2020	10,555	-	10,555
2021	6,983	575	7,558
2022	6,997	378	7,375
Thereafter	374,850	9,232	384,082
	<u>\$ 416,715</u>	<u>\$ 10,185</u>	<u>\$ 426,900</u>

Note 10 - Employee Retirement Benefit Plans

Children's Health's noncontributory cash balance pension plan covers full-time employees of Children's Health hired before December 24, 2006, at which time the pension plan was frozen to new participants. The pension plan was further amended, effective December 31, 2013, to curtail the accrual of benefits for all active participants and to freeze any future service benefits.

Benefits are based on the employee's years of service and compensation during the years immediately preceding the earlier of their termination of employment or December 31, 2013. Employees did not make contributions to the Defined Retirement Plan. Children's Health's policy is to contribute funds sufficient to meet or exceed the minimum annual funding standards under Section 412 of the Employee Retirement Income Security Act of 1974. Plan assets are held in a separate trust under a custodial agreement, with investments directed by the investment committee. Plan assets consist of U.S. government securities, high-



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grade debt securities, mutual funds, alternative investments, and marketable equity securities. Benefit plans are accounted for in accordance with ASC Topic 715, *Compensation – Retirement Benefits*.

Effective January 1, 2014, Children's Health increased the matching contributions under The Children's Medical Center 401a Employee Savings Plan ("Savings Plan") and it became the primary retirement program for all employees. The Savings Plan offers a common matching scale for all participants and normalizes Children's Health's retirement contribution for all employees. Employees who choose to participate in the Savings Plan receive a matching contribution of 4.0% to 7.5% based on years of service. Substantially all employees may participate in Children's Health Savings Plan. In 2017 and 2016, Children's Health made contributions to the Savings Plan of \$25.2 million and \$22.6 million, respectively.

The information reflected below sets forth the defined benefit plan's benefit obligation, fair value of plan assets, and the funded status as of December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	\$ 230,419	\$ 242,914
Interest costs	9,903	10,454
Actuarial loss (gain)	18,039	(1,955)
Benefits paid	<u>(13,135)</u>	<u>(20,994)</u>
Projected benefit obligation, end of year	<u>245,226</u>	<u>230,419</u>
Change in plan assets:		
Fair value of plan assets, beginning of year	170,781	170,331
Actual return on plan assets	25,832	7,920
Employer contributions	36,500	13,524
Benefits paid	<u>(13,135)</u>	<u>(20,994)</u>
Fair value of plan assets, end of year	<u>219,978</u>	<u>170,781</u>
Funded status, end of year	<u>\$ (25,248)</u>	<u>\$ (59,638)</u>

Amounts recognized in the consolidated balance sheets as of December 31, 2017 and 2016, consist of (in thousands):

	<u>2017</u>	<u>2016</u>
Other non-current liabilities	\$ 25,248	\$ 59,638



Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016

The net periodic pension cost as of December 31, 2017 and 2016, includes the following components (in thousands):

	2017	2016
Net periodic benefit expense:		
Interest costs	\$ 9,903	\$ 10,455
Expected return on plan assets	(12,742)	(12,710)
Amortization of net actuarial loss	3,619	4,022
Net periodic benefit expense:	\$ 780	\$ 1,767

Fair values of plan assets by asset category (see Note 7) as of December 31, 2017 and 2016, were (in thousands):

	Target Asset Allocation	Plan Assets at December 31,			
		2017		2016	
Cash and cash equivalents	-	\$ 230	0.1%	\$ 208	0.1%
Common stocks ¹	-	2,391	1.1	2,788	1.6
US government securities ²	-	49,128	22.2	-	-
Debt securities	35	73,857	33.4	48,158	31.4
Common / collective trusts	50	56,234	26.1	89,192	52.2
Hedge funds	15	38,138	17.2	30,435	17.8
	100%	\$ 219,978	100%	\$ 170,781	100%

¹ Common stocks target allocation is included in the common / collective trusts.

² U.S. government securities target allocation is included with debt securities.



Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016

At December 31, 2017 and 2016, the Plan's investment in alternative investments of \$38.1 million and \$30.4 million, respectively, is included in hedge funds. As described in Note 7, management has elected to use the net asset value per share, or its equivalent, as a practical expedient for fair value of the plan's interest in alternative investments. The majority of these funds have restrictions on the timing of withdrawals, which may reduce liquidity, in some cases up to 12 months.

Fair values of plan assets by asset category at December 31, 2017, were as follows (in thousands):

	<u>Total</u>	<u>Assets at Fair Value</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash - interest bearing	\$ 230	\$ 230	\$ -	\$ -
Common stocks	49,128	49,128	-	-
US Government securities	2,391	2,391	-	-
Corporate bonds - investment grade	73,604	-	73,604	-
Mortgage backed securities - investment grade	253	-	253	-
Mutual funds:				
Liquid assets / money market	2,721	2,721	-	-
Domestic equities	2,526	2,526	-	-
International equities	5,491	5,491	-	-
Common / collective trusts				
Domestic equities	18,104	-	18,104	-
International equities	23,558	-	23,558	-
Fixed income	3,834	-	3,834	-
Subtotal	181,840	\$ 62,487	\$ 119,353	\$ -
Investments recognized at net asset value:				
Hedge funds	38,138			
Total	\$ 219,978			

Fair values of plan assets by asset category at December 31, 2016, were as follows (in thousands):

	<u>Total</u>	<u>Assets at Fair Value</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash - interest bearing	\$ 208	\$ 208	\$ -	\$ -
Common stocks	2,788	2,788	-	-
Common / collective trusts				
Domestic equities	42,096	34,146	7,950	-
International equities	47,096	9,002	38,094	-
Fixed income	48,158	48,158	-	-
Subtotal	140,346	\$ 94,302	\$ 46,044	\$ -
Investments recognized at net asset value:				
Hedge funds	30,435			
Total	\$ 170,781			



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

Pension assets are managed by professional managers based on an investment policy recommended by investment consultants and approved by the Board. The pension asset allocation is weighted toward equity investments, which reflect the long-term nature of the pension plan. The strategy behind the asset allocation is for the largest holdings to reflect the broad U.S. equity markets, while providing some potential for the enhanced returns that can be provided by small cap, mid cap, and international equities. The fixed income portion provides some protection from the risks of equity investments. Common/collective trusts are used to gain access to liquid investment instruments through a vehicle with lower fees and enhanced diversification. The alternative investment strategy is to invest in hedge funds in order to obtain attractive risk-adjusted returns that are uncorrelated with equities and fixed income. The expected long-term rate of return on plan assets of 7.7% is based on a long-range investment model developed during an asset allocation study performed by investment consultants.

The accumulated benefit obligation was \$245.2 million and \$230.4 million at December 31, 2017 and 2016, respectively.

As of December 31, 2017, benefits expected to be paid for each of the following five fiscal years and in aggregate for the next five fiscal years are as follows (in thousands):

	As of	
	December 31, 2018	
2018	\$	10,200
2019		11,935
2020		12,353
2021		12,728
2022		12,753
Thereafter		62,648
	\$	<u>122,617</u>

Other changes in plan assets and benefit obligations recognized in changes in unrestricted net assets for the years ended December 31, 2017 and 2016, are (in thousands):

	2017	2016
Net gain (loss)	\$ 4,948	\$ (1,324)
Amortization of net actuarial loss	<u>(3,619)</u>	<u>(4,022)</u>
Total recognized changes in unrestricted net assets	<u>\$ 1,329</u>	<u>\$ (5,346)</u>

The net loss for the defined benefit pension plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year is \$3.6 million.

Amounts in unrestricted net assets that have not been recognized in net periodic benefit cost, as of December 31, 2017 and 2016, consist of (in thousands):

	2017	2016
Net actuarial loss	\$ 57,883	\$ 56,553



Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016

Weighted-average assumptions used in the accounting for net periodic benefit costs and the benefit obligation and funded status were:

	2017	2016
Net periodic benefit costs:		
Discount rate	3.90%	4.40%
Expected long-term rate of return on plan assets	7.70%	7.70%
Compensation increase rate	N/A	N/A
	2017	2016
Benefit obligations and funded status:		
Discount rate	4.40%	4.40%
Expected long-term rate of return on plan assets	7.70%	7.70%
Compensation increase rate	N/A	N/A

Note 11 - Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following purposes (in thousands):

	2017	2016
Patient care	\$ 30,751	\$ 29,237
Construction	1,674	2,873
Research	17,124	17,176
Education	2,142	1,923
Equipment	2,277	4,672
Time-restricted	16,547	12,784
Plano campus	10,436	5,537
Other	2,170	2,154
	\$ 83,121	\$ 76,356

Note 12 - Permanently Restricted Net Assets

Permanently restricted net assets at December 31 are restricted to (in thousands):

	2017	2016
Patient care	\$ 46,928	\$ 40,542
Research	64,416	54,876
Education	4,463	4,036
Plano campus	278	209
General operations	24,755	20,258
	\$ 140,840	\$ 119,921

The Foundation adopted *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds* under ASC Topic 958, *Not for Profit Entities*, on December 31, 2008. This guidance provides for the proper net asset classification of donor-restricted endowment funds for not-



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

for-profits in states that have adopted an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006.

All permanently restricted funds are donor-restricted endowment funds established primarily to fund specific activities at Children's Health. Board designated endowments classified as unrestricted were \$32.8 million as of December 31, 2017 compared to \$27.9 million at December 31, 2016. As required by generally accepted accounting principles, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The State Prudent Management of Institutional Funds Act provides statutory guidelines for the management, investment, and expenditure of endowment funds held by charitable organizations in the absence of explicit donor stipulations.

The Foundation classifies the historic value of donor-restricted gifts to be held in perpetuity as permanently restricted net assets. The intent of the Foundation is to preserve the historic value of permanently restricted gifts. The endowment distribution policy allows a 0% to 5% distribution of the endowment asset, which is defined as the simple average of the previous 12 fiscal quarters' ending values. At December 31, 2017 and 2016, permanently restricted net assets representing donor-restricted perpetual endowment funds were approximately \$140.8 million and \$119.9 million, respectively.

Note 13 - Accrued Liabilities

Accrued liabilities consist of the following as of December 31 (in thousands):

	<u>2017</u>	<u>2016</u>
Accrued salaries and benefits	\$ 35,798	\$ 37,912
Accrued paid time-off	42,216	41,760
Accrued medical claims payable, including premium deficiency reserve	30,515	10,540
Third-party settlement payable	6,137	9,713
Other	3,881	977
	<u>\$ 118,547</u>	<u>\$ 100,902</u>

Note 14 - Physician Income Guarantees

Physician income guarantees are accounted for in accordance with ASC Topic 460, *Guarantees*. Children's Health records an asset and liability for the estimated payments to be made under physician income guarantees. The assets are amortized using the straight-line amortization method for the guarantee period, and the liabilities are released as payments are made. The unamortized portion of these physician guarantees, included in other assets, is \$5.6 million and \$9.0 million, as of December 31, 2017 and December 31, 2016, respectively. The current portion of the guarantees is included in other current liabilities and the noncurrent portion of the guarantees is included in other noncurrent liabilities on the consolidated balance sheets. Total guarantees were \$10.4 million and \$10.2 million as of December 31, 2017 and December 31, 2016, respectively. The maximum amount that could be paid under Children's Health's physician income guarantees was approximately \$10.6 million as of December 31, 2017.



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

Note 15 - Commitments and Contingencies

Under terms of an agreement, as amended, originally dated October 29, 1964, and most recently renewed on October 1, 2000, Children's Health and UT Southwestern ("UTSW") affiliated to provide for the delivery of preeminent pediatric medical and surgical services. The agreement specifies that Children's Health and its affiliate centers will serve as the primary pediatric clinical service and teaching sites for the delivery of such services. Children's Health's expenditures under this and related agreements are determined each year working with UTSW during its annual budgeting process.

Children's Health is involved in certain litigation and is subject to claims that may arise in the normal course of its operations. It is the opinion of management, based on consultation with legal counsel, that such litigation and claims will be resolved without a material adverse effect on Children's Health's consolidated financial position or results of operations.

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has continued with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed.

Management believes that Children's Health is in compliance with government laws and regulations related to fraud and abuse, and other applicable areas. While no material regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

Children's Health continues to upgrade and improve its facilities as well as its Information Technology capabilities and infrastructure. For the year ended December 31, 2017, outstanding commitments for construction are approximately \$17.6 million, outstanding commitments for equipment are approximately \$1.3 million, and outstanding commitments for IT-related projects are approximately \$0.8 million.

At December 31, 2017, Children's Health had commitments to fund private equity investments totaling \$156.4 million.

The Tax Cuts and Jobs Act (Act) was enacted on December 22, 2017. The Act reduces the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that was previously tax deferred and creates new taxes on certain foreign sourced earnings. For tax-exempt entities, the Act also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on remuneration above certain thresholds that is paid to executives by the organization, and report income or loss from unrelated business activities on an activity-by-activity basis, among other provisions. Certain regulatory guidance provides for a measurement period of up to one year during which the accounting for the tax effects of the Act may be completed. Children's Health may record further adjustments in future periods upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of the date of enactment that would have affected the income tax effects initially reported. Children's Health will continue to revise and refine the calculations as additional IRS guidance is issued.



**Children's Health System of Texas and Affiliates
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Note 16 - Professional Liability

The net amount of Children's Health's professional liability was \$8.0 million and \$5.8 million as of December 31, 2017 and 2016, respectively. ASU 2010-24, *Presentation of Insurance Claims and Related Recoveries*, requires professional liabilities to be reported at gross, without the consideration of insurance recoveries. Accordingly, Children's Health has recorded professional liabilities of \$10.1 million and \$8.2 million, discounted at 3%, in other noncurrent liabilities in the consolidated balance sheet and an asset representing insurance recoveries of \$2.1 million and \$2.4 million in other assets in the consolidated balance sheets at December 31, 2017 and 2016, respectively.

Note 17- Medicaid and Supplemental Payment Programs

Medicaid is the commonly used name for the combined federal and state program designed to pay providers for health care given to the medically indigent (including children of low-income families). It is funded by federal and state appropriations and administered by the states. For the periods of operations described in these consolidated financial statements, the Texas Medicaid program required residents of some geographic areas (including most of the areas in which Children's Health's primary service areas are located) to enroll in Texas Medicaid managed care programs, known as the STAR program (the primary managed care program) and the STAR+PLUS program (the managed care program for disabled and chronically ill patients) and Star Kids program (managed care program, that began on November 1, 2016, to provide Medicaid benefits to children and adults 20 and younger who have disabilities). Under these programs, the state pays capitated health insurance premiums to insurers for eligible Medicaid-eligible insureds who elect or are required to obtain coverage, and the insurers negotiate payment rates with and pay hospitals and others for care provided to the insured patients.

Children's Health also receives funding from the Children's Health Insurance Program ("CHIP") which provides health coverage to eligible children and is jointly funded by the State and the federal government.

In addition to payments for patient services, Children's Health also received supplemental payments under the Disproportionate Share ("DSH"), Uncompensated Care Program ("UCP"), Delivery System Reform Incentive Payment ("DSRIP") and Children's Health Graduate Medical Education ("CHGME") programs.

The DSH program provides supplemental payments to hospitals that serve a disproportionately large share of Medicaid and other low-income patients.

In 2011, the State of Texas secured a waiver from certain federal Medicaid requirements for the five-year period ending September 1, 2016. The State of Texas subsequently secured an amendment to the waiver to extend the waiver for another 15 months to December 31, 2017. In granting the extension, CMS stated that no further extension of the state's UCP program should pay for costs that would be paid by an expansion of Medicaid in Texas, so any extension should be limited to low-income individuals who are not eligible for Medicaid or other insurance programs, and that absent agreeable revisions, funding would be reduced by 25% per year beginning in 2018. In December 2017, The State of Texas and the Centers for Medicare and Medicaid Services ("CMS") agreed to an 1115 waiver extension effective January 1, 2018 through September 30, 2022. Under the terms of the agreement, CMS will provide Texas five additional years of UCP funding. However, the new 1115 waiver changes the methodology for calculating eligible uncompensated care to a model based upon charity care. This change in methodology could significantly redistribute uncompensated care reimbursement between hospitals participating in the UCP program. DSRIP will continue for four additional years with two years of level funding followed by two years of funding which will decrease each year. The fifth year of the agreement will not provide any funding for the DSRIP program. Children's Health is continuing to evaluate the potential financial impact of the new 1115 Waiver over the five-year period.



**Children's Health System of Texas and Affiliates
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For the years ended December 31, 2017 and 2016**

The waiver funds the UCP and DSRIP pools from which modified supplemental payments are made to providers.

The UCP program provides funding for hospitals which have substantial uncompensated care costs or unreimbursed costs for Medicaid patients, reduced by DSH payments to the hospitals.

The DSRIP program provides funding incentives to hospitals and other providers to enhance access to care for and the health of patients. Under the program, hospitals make proposals to receive payments to defray costs of innovations in their delivery systems to achieve these goals. Funds are available within four areas: infrastructure development, program innovation and redesign, quality improvements, and population focused improvements. Funds for CMCD's primary service area are allocated by the Dallas County Hospital District (dba Parkland Health and Hospital System) in collaboration with area health care providers under protocols approved by the State and CMS. The State's funding, of the UCP and DSRIP programs, has shifted dollars from the UCP program to the DSRIP program over the five-year term of the waiver. Consequently, CMCD's access to supplemental payments under the Medicaid program depend upon its ability to compete for DSRIP payments and to achieve any patient access or health objectives on which they may be conditioned.

The CHGME program provides federally funded, state-administered supplemental payments to children's hospitals based on the number of residents trained at each hospital.

The following summary presents supplemental funding received or receivable under these programs for the years ended December 31, 2017 and 2016, (in thousands)

	<u>2017</u>	<u>2016</u>
DSH	\$ 24,628	\$ 20,779
UCP	20,161	23,275
DSRIP	52,611	55,152
CHGME	6,197	6,842

Children's Health reflects DSH and UCP in net patient services revenue and DISRIP and CHGME in other revenues in the accompanying consolidated statement of operations.

Note 18 - Provision for Doubtful Accounts

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, Children's Health analyzes its past history and identifies trends for each of its major payer sources to estimate the appropriate allowance for doubtful accounts and provision for doubtful accounts. Management regularly reviews data for these major payer sources in evaluating the sufficiency of the allowance. For receivables associated with services provided to patients who have third-party coverage, Children's Health analyzes contractually due amounts and provides an allowance for doubtful accounts. For receivables associated with self-pay patients (which includes both patients without insurance and those patients with insurance where deductible and copayment balances exist), Children's Health records a provision for doubtful accounts in the period of service on the basis of its past experience. The difference between the standard rates (or the discounted rates if applicable) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

Children's Health's allowance for doubtful accounts increased from \$43.1 million or 12.5% of total gross accounts receivable at December 31, 2016 to \$83.5 million or 21.4% of total gross accounts receivable as of December 31, 2017. During 2017, Children's Health reduced the upfront discounts for self-pay individuals.



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

Previously, this discount was reflected as a reduction to net patient revenue, before the provision for doubtful accounts. This change in policy has resulted in an increase in the 2017 provision for doubtful accounts and the allowance for doubtful accounts as of and for the year ending December 31, 2017. Children's Health does not maintain a material allowance for doubtful accounts from third-party payers, nor did it have significant write-offs from third-party payers during 2017 or 2016.

A summary of activity of for the allowance for doubtful accounts follows (in thousands):

	Balance at Beginning of Year	Provision for Doubtful Accounts	Accounts Written-off, Net of Recoveries	Balance at End of Year
Year ended December 31, 2017	(43,100)	(85,339)	44,924	(83,515)
Year ended December 31, 2016	(34,118)	(54,928)	45,946	(43,100)

Children's Health recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, Children's Health recognized revenue on the basis of its standard rates for services provided, or on the basis of discounted rates if negotiated, and as provided by policy. On the basis of historical experience, Children's Health records a provision for doubtful accounts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and charity care (but before the provision for doubtful accounts), recognized year-to-date from these major payer sources is as follows (in thousands):

	Government	Commercial	Other	Total All Payers
Patient services revenue less contractuals:				
Year ended December 31, 2017	\$ 655,550	\$ 681,518	\$ 30,287	\$ 1,367,355
Year ended December 31, 2016	633,203	660,688	16,334	1,310,225

Note 19 - Functional Expenses

FASB ASC Topic 958, *Not for Profit Entities*, requires the presentation of information about expenses reported by their functional classification, such as program services and supporting activities. Program services are those activities that fulfill the mission of Children's Health, which is to make life better for children. Supporting services include management, general, and fundraising activities.

Program and supporting services expenses were as follows (in thousands):

	2017	2016
Program services	\$ 1,055,919	\$ 869,521
Management and general	536,639	516,316
Fundraising	1,377	2,450
	<u>\$ 1,593,935</u>	<u>\$ 1,388,287</u>



**Children's Health System of Texas and Affiliates
Notes to Consolidated Financial Statements
For the years ended December 31, 2017 and 2016**

Note 20 - Charity Care

The value of charity care provided by Children's Health, excluding subsidiaries, based upon its established rates, was approximately \$18.2 million in 2017 and \$42.6 million in 2016. Children's Health utilizes the cost to charge ratios, as calculated based on its most recent cost reports filed with the Centers for Medicare and Medicaid Services, to determine the total cost. The reduction was due in part to of the reduction of discounts for self-pay customers as previously discussed in Note 18. Children's Health's cost of providing charity care was \$6.6 million and \$13.2 million for the years ended December 31, 2017 and 2016, respectively.

Note 21 - Volunteer Services

Volunteers contribute significantly to Children's Health's mission by enabling the organization to multiply its resources to exceed the needs of patients and their families. Services performed by volunteers include delivering flowers and mail, escorting visitors throughout the hospital, assisting in playrooms during activities, tutoring patients, sitting with patients whose parents are away from the hospital, assisting patient families in ambulatory care and critical care areas, and working in the gift shop. The value of these services has not been included in the accompanying consolidated financial statements as it is not readily determinable.

Supplementary Information



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Report of Independent Auditors on Supplementary Information

The Board of Directors
Children's Health System of Texas

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying combining balance sheet and statement of operations of Children's Health Medical Center Obligated Group are presented for purposes of additional analysis 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. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Ernst & Young LLP

April 24, 2018



CHILDREN'S HEALTH OBLIGATED GROUP
Combining Balance Sheet
As of December 31, 2017
(In Thousands)

	CHST	CMCD	Foundation	Eliminations	Combined
ASSETS					
CURRENT ASSETS					
Cash and cash equivalents	\$ 178,700	\$ (5,905)	\$ 13,861	\$ -	\$ 186,656
Short-term investments	-	109,173	-	-	109,173
Patient accounts receivable, net of allowances	(485)	150,349	-	-	149,864
Pledges receivable, net of allowances	-	-	12,787	-	12,787
Inventories	1,808	15,972	-	-	17,780
Other current assets	26,831	13,116	572	-	40,519
TOTAL CURRENT ASSETS	206,854	282,705	27,220	-	516,779
Pledges receivable, net of allowances	-	-	10,718	-	10,718
Receivables from remainder trusts	-	-	19,143	-	19,143
Property and equipment, net	91,243	844,917	53	(104)	936,109
Assets limited as to use	-	-	1,367,187	-	1,367,187
Net assets of the Foundation	-	1,419,509	-	(1,419,509)	-
Other Assets	113,298	61,547	9,264	-	184,109
TOTAL ASSETS	\$ 411,395	\$2,608,678	\$1,433,585	\$ (1,419,613)	\$3,034,045
LIABILITIES AND NET ASSETS					
CURRENT LIABILITIES					
Accounts payable	\$ 83,722	\$ 36,996	\$ 552	\$ -	\$ 121,270
Accrued liabilities	21,205	53,807	1,142	-	76,154
Accrued interest	-	1,136	-	-	1,136
Current portion of long-term debt and capital lease obligations	-	8,585	-	-	8,585
Other current liabilities	10,172	-	-	-	10,172
TOTAL CURRENT LIABILITIES	115,099	100,524	1,694	-	217,317
Long-term debt and capital lease obligations, net of current portion	-	451,595	-	-	451,595
Other non-current liabilities	12,812	25,660	2,173	-	40,645
Intercompany	1,039,718	(1,309,932)	9,538	150,275	(110,401)
NET ASSETS					
Unrestricted	(756,234)	1,921,102	1,298,971	(150,379)	2,313,460
Temporarily restricted	-	1,279,058	81,932	(1,278,838)	82,152
Permanently restricted	-	140,671	39,277	(140,671)	39,277
TOTAL NET ASSETS	(756,234)	3,340,831	1,420,180	(1,569,888)	2,434,889
TOTAL LIABILITIES AND NET ASSETS	\$ 411,395	\$2,608,678	\$1,433,585	\$ (1,419,613)	\$3,034,045



CHILDREN'S HEALTH OBLIGATED GROUP
Combining Statement of Operations
For the Year Ended December 31, 2017
(In Thousands)

	CHST	CMCD	Foundation	Eliminations	Combined
OPERATING REVENUE					
PATIENT SERVICES REVENUE	\$ 44,790	\$ 1,306,411	\$ -	\$ -	\$ 1,351,201
Provision for doubtful accounts	-	80,451	-	-	80,451
NET PATIENT SERVICES REVENUE	44,790	1,225,960	-	-	1,270,750
Other revenue	21,716	60,823	9,428	(1,080)	90,887
TOTAL OPERATING REVENUE	66,506	1,286,783	9,428	(1,080)	1,361,637
OPERATING EXPENSES					
Salaries and benefits	175,734	450,240	5,927	-	631,901
Physician and provider costs	140,686	6,277	-	-	146,963
Medical supplies	(644)	151,355	2	-	150,713
Medical plan expenses	-	-	-	-	-
General support	145,941	47,977	3,131	(1,080)	195,969
Depreciation and amortization	15,449	48,908	-	(10)	64,347
Interest	-	17,488	-	-	17,488
Shared services	(440,080)	410,968	-	-	(29,112)
TOTAL OPERATING EXPENSES	37,086	1,133,213	9,060	(1,090)	1,178,269
INCOME FROM OPERATIONS	29,420	153,570	368	10	183,368
NON-OPERATING INCOME LOSS					
Realized investment gains (losses)	(693)	5,599	22,759	-	27,665
Unrealized investment gains (losses)	-	30,179	93,801	-	123,980
Other	-	(23,303)	-	-	(23,303)
TOTAL NON-OPERATING INCOME (LOSS)	(693)	12,475	116,560	-	128,342
NET INCOME (LOSS)	\$ 28,727	\$ 166,045	\$ 116,928	\$ 10	\$ 311,710

Children's Health Obligated Group
Note to Combining Obligated Group
December 31, 2017

Note 1 – Basis of Presentation

Children's Health Obligated Group (the "Obligated Group"), as defined in the Master Trust Indenture dated September 1, 1988, as supplemented, and further supplemented by Supplemental Indenture Number 20, dated December 1, 2017, comprises Children's Health System of Texas ("CHST"), Children's Medical Center ("CMCD"), and Children's Medical Center Foundation ("Foundation").



CHST is providing the following quantitative financial information and operating data as required by a Continuing Disclosure Agreement related to its outstanding bonds. This financial information includes utilization statistics, debt service coverage calculations, liquidity and capital ratios, and payor mix by campus.

Utilization Statistics

	Years Ended December 31,	
	2017	2016
Weighted Average Beds in Service ¹	505	461
Discharges (including observations)	36,696	34,975
Average Length of Stay (days)	3.45	3.67
Patient Days (including observations)	126,645	128,418
Average Daily Census	347	351
Percentage Occupancy	69%	76%
Clinic Visits ²	845,139	809,745
Surgeries	29,344	29,658

¹ Average number of beds in service throughout a full year; calculated as the sum of each 12-month number of beds in service, divided by 12. Each monthly number of beds in service is based on the number of beds in service on the last day of the month.

² Includes CHPG's clinic visits.

Coverage of Debt Service Requirements

(In thousands of dollars)

	Years Ended December 31,	
	2017	2016
Operating income	\$75,070	\$35,695
Depreciation and amortization expense	67,992	64,352
Interest expense	17,488	17,505
Realized investment gains	27,665	31,111
Consolidated revenues available for debt service ¹	\$188,215	\$148,663
Historical maximum annual debt service ²	29,813	28,827
Historical coverage of maximum annual debt service ³	6.3x	5.2x

¹ Excludes unrealized gain (loss) on investments.

² Historical maximum annual debt service requirements in any subsequent fiscal year on debt then outstanding.

³ Historical coverage of maximum annual debt service is calculated as net consolidated revenues available for debt service divided by historical maximum annual debt service requirements.



**Summary of Cash and Investments and Liquidity
and Capitalization Ratios**
(In thousands of dollars)

	As of December 31,	
	2017	2016
Cash and cash equivalents	\$252,497	\$177,869
Short-term Investments	109,173	169,200
Board Designated Investments	1,216,648	1,029,275
Total available cash and investments	<u>\$ 1,578,318</u>	<u>\$ 1,376,344</u>
Total debt and capital lease obligations ¹	460,180	364,684
Total operating expenses	\$1,594,936	\$1,388,287
Less: depreciation and amortization	67,992	64,352
Adjusted total operating expenses	<u>\$1,526,944</u>	<u>\$1,323,935</u>
Average daily operating expense ²	\$4,183	\$3,617
Days cash on hand ³	377	380
Debt-to-capitalization ⁴	18.0%	16.2%
Cash-to-debt ⁵	343.0%	377.4%

¹ Total debt and capital lease obligations include unamortized bond premium/discount and other deferred financing costs of \$33.3 million and \$2.3 million as of December 31, 2017 and 2016, respectively.

² Average daily operating expense is calculated as adjusted total operating expenses divided by calendar days in the preceding 12 months for the Fiscal Years ended December 31, 2017 and 2016.

³ Days cash on hand is calculated as total available cash and investments multiplied by calendar days in the preceding 12 months for the Fiscal Years ended December 31, 2017 and 2016, divided by adjusted total operating expenses less depreciation and amortization for such months.

⁴ Debt-to-capitalization is calculated as total debt and capital lease obligations divided by the sum of total debt and capital lease obligations and unrestricted net assets.

⁵ Cash-to-debt is calculated as total available cash and investments divided by total debt.



**Payor Mix
All Campus**

	Years Ended December 31,	
	2017	2016
Medicare	1%	1%
Medicaid (Traditional)	14	26
Medicaid (Managed Care)	49	37
Commercial	33	33
Self-Pay	2	2
All Other	1	1

**Payor Mix
Dallas Campus**

	Years Ended December 31,	
	2017	2016
Medicare	1%	1%
Medicaid (Traditional)	15	27
Medicaid (Managed Care)	51	39
Commercial	30	30
Self-Pay	2	2
All Other	1	1

**Payor Mix
Plano Campus**

	Years Ended December 31,	
	2017	2016
Medicare	0%	0%
Medicaid (Traditional)	10	15
Medicaid (Managed Care)	39	33
Commercial	48	49
Self-Pay	2	2
All Other	1	1

**Management's Discussion and Analysis of Financial Condition and
Results of Operations (Unaudited)**



Children's Health System of Texas and Affiliates
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(Unaudited)

The following discussion and analysis should be read in conjunction with the Children's Health Consolidated Financial Statements and the Notes thereto.

Summary of Utilization
Quarters and Years Ended December 31, 2017 and 2016

	Fourth Quarter		Year Ended	
	2017	2016	2017	2016
Inpatient discharges	4,254	4,060	15,723	15,561
Patient days	27,215	26,490	105,672	109,004
- ICU days	9,278	8,354	34,847	34,722
ED visits	49,660	44,359	174,838	167,923
Ambulatory visits	111,335	99,609	426,644	396,563
Professional services visits	92,522	90,843	343,084	330,649
- CHPG visits	70,133	69,940	253,648	254,326
Surgeries	7,087	7,207	29,344	29,658
Case mix index	2.36	2.50	2.38	2.29
- Medicaid case mix index	2.58	2.75	2.66	2.59
Payor mix:				
Commercial	34%	31%	33%	33%
Medicaid (Traditional)	14%	32%	14%	26%
Medicaid (Managed Care)	49%	33%	49%	37%
Medicare			1%	1%
Self pay			2%	2%
Other	3%	4%	1%	1%

Volumes

Inpatient discharges increased by 194 (5%) and 162 (1%) for the quarter and year ended December 31, 2017, respectively, compared to the same period in the prior year.

Patient days increased by 725 days (3%) and decreased 3,332 days (3%) for the quarter and year ended December 31, 2017, respectively, compared to the same period in the prior year.

ICU days increased by 924 days (11%) and increased 125 (less than 1%) for the quarter and year ended December 31, 2017, respectively, compared to the same period in the prior year.

ED visits increased by 5,301 (12%) and 6,915 (4%) for the quarter and year ended December 31, 2017, respectively, compared to the same period in 2016.

Ambulatory visits increased by 11,726 (12%) and 30,081 (8%) for the quarter and year ended December 31, 2017, respectively, compared to the same period in the prior year.

Professional services visits increased by 1,679 (2%) and 12,435 (4%) for the quarter and year ended December 31, 2017, compared to the same period in the prior year. CHPG clinic visits increased by 193 (less than 1%) and decreased by 678 (less than 1%) for the quarter and year ended December 31, 2017, respectively, compared to the same periods in 2016. CHPG operated 17 clinics for the year ended December 31, 2017 compared to 18 clinics for the year ended December 31, 2016.



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Surgeries decreased 120 (2%) and decreased 314 (1%) for the quarter and year ended December 31, 2017, respectively, compared to the same period in the prior year.

Net Patient Service Revenue

Patient service revenue is derived from charges for services provided to patients. Physicians order all services provided to patients such as inpatient care and ancillary services, lab tests, drugs, radiology procedures, and surgical procedures. Children's Health records charges as revenue at the time the service is provided.

Children's Health has contractual agreements with third-party payers including managed care health plans, such as HMOs and PPOs, and government programs, such as Medicaid and the Children's Health Insurance Program (CHIP), which are both administered by the state of Texas. Payments from these payers are based on charges, fixed per diem rates, the costs of providing services, and discounts from established charges. Children's Health reports revenue at net realizable value after reflecting adjustments provided for in these contracts.

Children's Health provides financial counseling to assist patients with no third-party coverage to qualify for government programs. Children's Health records revenue for these patients at net realizable value based on historical qualification rates. Charges for patients that do not qualify for government assistance, but fall within Children's Health charity guidelines, are recorded as charity care and excluded from net patient service revenue.

Accounts receivable on Children's Health balance sheets is recorded net of allowances for contractual adjustments, doubtful accounts, and charity care.

The volume of inpatient, outpatient and day surgery patients, as well as the acuity or intensity of care required, drives the level of Children's Health revenue. Volumes in intensive care units have a disproportionately large influence on the level of revenue due to the very high acuity and resource consumption of these patients and because contractual arrangements provide an adequate level of reimbursement for these cases.

Expenses

Healthcare is a very labor-intensive industry. For the quarters ended December 31, 2017 and 2016, salaries and benefits were 43% and 51% of Children's Health operating expenses, respectively. Salaries and benefits were 46% and 54% of operating expenses for the years ended December 31, 2017 and 2016, respectively. The salaries and benefits expense category represents salaries for all employees and all employee benefits and payroll-related taxes.

Professional services, which includes the costs associated with residents and the cost of contract labor including medical administrative and physician coverage fees, were 9% of the operating expenses for the quarters ended December 31, 2017 and 2016. For the years ended December 31, 2017 and 2016, professional services were 9% and 10% of operating expenses, respectively.

Supplies and other expenses, the cost of supplies, pharmaceuticals, and services directly related to patient care, were 9% and 10% of the operating expenses for the quarters ended December 31, 2017 and 2016, respectively. For years ended December 31, 2017 and 2016, supplies and other expenses were 10% and 11% of operating expenses, respectively.



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Plan medical expenses, which represent claims paid under the STAR Kids program were 17% and 7% of the operating expenses for quarters ended December 31, 2017 and 2016, respectively. For the years ended December 31, 2017 and 2016, plan medical expenses were 14% and 2% of operating expenses, respectively.

The general support expense category represents non-clinical supply and service costs in areas such as information services, medical records, and billing and collections. For the quarters ended December 31, 2017 and 2016, general support expense was 17% of operating expenses. For the years ended December 31, 2017 and 2016, general support expense was 16% and 18% of operating expenses, respectively.

The depreciation and amortization expense category represents the cost of property and equipment and capital leases recognized over the estimated useful lives of the assets and terms of the leases. Depreciation expense, as a percentage of operating expenses, for the quarters and years ended December 31, 2017 and 2016, was 4% and 5% of operating expenses, respectively. Depreciation and amortization is computed using the straight-line method over a period of 3 to 40 years based on the asset classification or terms of the leases.

The interest expense category represents the cost of financing the outstanding bond issues and capital leases. Interest expense was 1% of operating expenses for the quarters and years ended December 31, 2017 and 2016. No interest was capitalized for the years ended December 31, 2017 and 2016.

Results of Operations

Operating income of \$25.0 million for the quarter ended December 31, 2017, represents a \$21.4 million increase over the same period in 2016. Operating income for the year ended December 31, 2017, increased \$38.4 million to \$75.1 million, from the same period in 2016.

Net patient service revenue increased \$42.8 million (14%) for the quarter ended December 31, 2017, compared to the same period in 2016. For the year ended December 31, 2017, net patient service revenue increased \$26.7 million (2%) over 2016. Additional components of net patient service revenue are the provision for doubtful accounts, disproportionate share, and uncompensated care.

The provision for doubtful accounts represents the charges for patient services that are not recovered from patients that are deemed able to pay (and therefore do not qualify for Children's Health charity). These amounts include account balances from uninsured patients and unpaid deductible and co-pay amounts from insured patients. The provision for doubtful accounts decreased \$4.6 million (24%) for the quarter ended December 31, 2017, and increased \$30.4 million (55%) for the year ended December 31, 2017, when compared to the same periods in 2016. As a percentage of net patient service revenue, the provision for doubtful accounts was 7% and 4% for the years ended December 31, 2017 and 2016, respectively. For the quarters ended December 31, 2017 and 2016, the provision for doubtful accounts was 4% and 6% of net patient service revenue, respectively.

Children's Health's portion of the DSH program administered by the Texas Department of Human Services increased \$4.3 million (79%) and increased \$3.8 million (19%) for the quarter and year ended December 31, 2017, compared to the same period in 2016. Under the program, local, state, and federal funds are accessed and distributed to hospitals providing a high volume of services to Medicaid and indigent patients.

Children's Health's portion of the UCP program administered by the Texas Department of Human Services increased \$1.5 million (57%) and decreased \$3.1 million (13%) for the quarter and year ended December 31, 2017, compared to the same period in 2016.



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Children's Health provided charity care of \$5.1 million and \$18.2 million, based on charges, in the quarter and years ended December 31, 2017, respectively, compared to \$3.3 million and \$42.6 million in the quarter and year ended December 31, 2016.

The Children's Hospital Graduate Medical Education ("CHGME") program receipts increased \$20,000 to \$1.3 million for the quarter ended December 31, 2017 as compared to the same quarter in 2016. Program receipts decreased \$0.6 million to \$6.2 million for year ended December 31, 2017, as compared to the year ended 2016.

Premium revenue from the Medicaid STAR Kids program of \$67.6 million increased by \$28.9 million (75%) and increased by \$206.4 million (535%) to \$245.1 million for the quarter and year ended December 31, 2017, compared to the same time period in 2016.

Other operating revenue of \$47.7 million increased by \$8.6 million (22%) and increased \$11.9 million (9%) to \$141.9 million for the quarter and year ended December 31, 2017, compared to the same time period in 2016. DSRIP revenue was \$11.0 million and \$52.6 million for the quarter and year ended December 31, 2017, respectively, compared to \$10.2 million and \$55.2 million in the quarter and year ended December 31, 2016.

Salaries and benefits decreased \$6.8 million (3%) for the quarter ended December 31, 2017, and decreased \$1.9 million (less than 1%) for the year ended December 31, 2017, compared to the same periods in the prior year. Salaries and benefits are 54% of net patient service revenue for the quarter ended December 31, 2017, compared to 64% for the same period in 2016. For the years ended December 31, 2017 and 2016, salaries and benefits were 58% and 59% of net patient service revenue, respectively.

Professional services increased \$5.2 million (16%) for the quarter ended December 31, 2017, and increased \$15.4 million (12%) for the year ended December 31, 2017, compared to the same periods in 2016. As a percentage of net patient service revenue for the quarters ended December 31, 2017 and 2016, professional services were 11%. For the years ended December 31, 2017 and 2016, professional services were 12% and 11% of net patient service revenue, respectively.

Supply costs increased \$1.9 million (5%) for the quarter ended December 31, 2017, and increased \$4.2 million (3%) for the year ended December 31, 2017, over the same periods in 2016. Supply costs as a percentage of net patient service revenue were 12% and 13% for the quarters ended December 31, 2017 and 2016, respectively. For the years ended December 31, 2017 and 2016, supply costs were 12%.

Plan medical expenses increased \$50.0 million (190%) for the quarter ended December 31, 2017, and increased \$190.1 million (721%) for the year ended December 31, 2017, over the same periods in 2016. These represent claims paid under the STAR Kids program, which started on November 1, 2016. Plan medical expenses as a percentage of net patient service revenue were 22% and 9% for the quarters ended December 31, 2017 and 2016, respectively. For the years ended December 31, 2017 and 2016 plan medical expenses were 17% and 2% of net patient service revenue, respectively.

General support increased \$8.2 million (12%) for the quarter ended December 31, 2017, and decreased \$4.7 million (2%) for the year ended December 31, 2017, over the same periods in 2016. General support costs were 21% and 30% of net patient service revenue for the quarters ended December 31, 2017 and 2016, respectively. For the years ended December 31, 2017 and 2016, general support costs were 19% and 22% of net patient service revenue, respectively. This increase is primarily due to consulting and professional fees, software maintenance fees, contract services and facilities costs.



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Depreciation and amortization expense increased \$0.04 million (2%) for the quarter ended December 31, 2017, and \$3.6 million (6%) for the year ended December 31, 2017, over the same periods in 2016. As a percentage of net patient service revenue, depreciation and amortization expense was 5% and 6% for the quarters ended December 31, 2017 and 2016, respectively. For the years ended December 31, 2017 and 2016, depreciation and amortization expense was 5% of net patient service revenue.

Interest expense increased less than \$0.1 million (1%) for the quarter ended December 31, 2017, and decreased less than \$0.1 million (less than 1%) for the year ended December 31, 2017, compared to the same periods in 2016.

Investment income (realized and unrealized investment gains and losses) was a gain of \$42.2 million for the quarter ended December 31, 2017 and a gain of \$2.8 million for the quarter ended December 31, 2016. For the year ended December 31, 2017, investment income was a gain of \$151.6 million compared to a gain of \$63.2 million for the year ended December 31, 2016. Market conditions drove the gains and losses in 2017 as well as in 2016.

Liquidity and Capital Resources

Children's Health continues to experience strong financial liquidity, with cash and investments of \$1.6 billion, at December 31, 2017 or 377 days of cash on hand.

Net cash provided by operating and nonoperating activities was \$110.1 million for the year ended December 31, 2017, compared to net cash used in operating activities of \$119.5 million for the same period in 2016.

Net cash used in investing activities was \$130.8 million for the year ended December 31, 2017, compared to \$141.2 million for the year ended December 31, 2016.

Net cash provided by financing activities was \$95.3 million for the year ended December 31, 2017, compared to net cash provided by financing of \$17.2 million for the same period in 2016.

Off-Balance Sheet Financing

Children's Health does not have any debt of material guarantee obligations that are not reflected on the accompanying consolidated balance sheets and does not have an ownership stakes in any special purpose entities.