



**CHILDREN'S HEALTH SYSTEM OF TEXAS AND AFFILIATES
CONSOLIDATED FINANCIAL AND OPERATING
INFORMATION FOR THE YEARS ENDED
December 31, 2018 and 2017**

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Report of Independent Auditors

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Independent Auditor's Report

The Board of Directors
Children's Health System of Texas

We have audited the accompanying consolidated financial statements of Children's Health System of Texas and Affiliates, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with 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 consolidated financial position of Children's Health System of Texas and Affiliates at December 31, 2018 and 2017 and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

May 3, 2019



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

	December 31, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 430,405	\$ 252,497
Short-term investments	-	109,173
Patient accounts receivable, net of allowances	137,837	147,637
Pledges receivable, net of allowances	14,819	12,787
Inventories	19,266	17,864
Other current assets	70,943	85,053
TOTAL CURRENT ASSETS	673,270	625,011
Pledges receivable, net of allowances	12,854	10,718
Receivables from remainder trusts	4,456	19,143
Property and equipment, net	977,394	970,601
Assets limited as to use	1,387,092	1,421,189
Other assets	79,596	38,214
TOTAL ASSETS	\$ 3,134,662	\$ 3,084,876
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$ 133,058	\$ 132,562
Accrued liabilities	139,145	118,547
Accrued interest	6,721	1,136
Current portion of long-term debt	9,639	8,585
Other current liabilities	45,042	10,173
TOTAL CURRENT LIABILITIES	333,605	271,003
Long-term debt, net of current portion	443,178	451,595
Other noncurrent liabilities	37,322	41,008
NET ASSETS		
Without donor restrictions	2,082,820	2,097,309
With donor restrictions	237,737	223,961
TOTAL NET ASSETS	2,320,557	2,321,270
TOTAL LIABILITIES AND NET ASSETS	\$ 3,134,662	\$ 3,084,876



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidating Statement of Operations
For the Years Ended December 31, 2018 and 2017
(in thousands)

	2018	2017
OPERATING REVENUE		
PATIENT SERVICES REVENUE	\$ 1,399,765	\$ 1,434,915
Provision for doubtful accounts	-	(85,339)
NET PATIENT SERVICES REVENUE	1,399,765	1,349,576
Premium and capitation revenue	266,100	245,065
Other revenue	83,182	74,364
TOTAL OPERATING REVENUE	1,749,047	1,669,005
OPERATING EXPENSES		
Salaries and benefits	771,041	739,776
Physician and provider costs	148,095	147,961
Medical supplies	168,866	155,035
Medical plan expenses	217,464	216,505
General support	271,163	248,398
Depreciation and amortization	72,556	67,992
Interest	14,723	17,488
TOTAL OPERATING EXPENSES	1,663,908	1,593,155
INCOME FROM OPERATIONS	85,139	75,850
NONOPERATING INCOME (LOSS)		
Realized investment gains, net	42,367	27,665
Unrealized investment (losses) gains, net	(113,640)	123,993
Other	(3,770)	(24,312)
TOTAL NONOPERATING (LOSS) INCOME	(75,043)	127,346
NET INCOME	\$ 10,096	\$ 203,196



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidating Statement of Net Assets
For the Years Ended December 31, 2018 and 2017
(in thousands)

	2018	2017
CHANGES IN NET ASSETS WITHOUT DONOR RESTRICTIONS		
Net income	\$ 10,096	\$ 203,196
Net assets released from restrictions	7,416	4,569
Change in minimum pension liability	(31,019)	(1,329)
Change in donor designation and other	(982)	(1,801)
(DECREASE) INCREASE IN NET ASSETS WITHOUT DONOR RESTRICTIONS	(14,489)	204,635
CHANGES IN NET ASSETS WITH DONOR RESTRICTIONS		
Contributions	34,364	23,193
Change in split-interest agreements	(308)	3,532
Gain on sale of assets	14,848	2,761
Realized investment gains, net	4,843	3,072
Unrealized investment (losses) gains, net	(13,682)	13,065
Net assets released from restrictions for operations	(18,496)	(13,409)
Net assets released from restrictions for capital	(7,416)	(4,569)
Grants for pediatric purposes	(58)	(60)
Change in donor designation and other	(319)	99
INCREASE IN NET ASSETS WITH DONOR RESTRICTIONS	13,776	27,684
(DECREASE) INCREASE IN NET ASSETS	(713)	232,319
NET ASSETS BEGINNING OF PERIOD	2,321,270	2,088,951
NET ASSETS END OF THE PERIOD	2,320,557	2,321,270



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidating Statement of Cash Flows
For the Years Ended December 31, 2018 and 2017
(in thousands)

	2018	2017
CASH FLOW FROM OPERATING AND NONOPERATING ACTIVITIES		
(Decrease) Increase in net assets	\$ (713)	\$ 232,319
Adjustment to reconcile (decrease) increase in net assets to net cash provided by operating and nonoperating activities:		
Provision for doubtful accounts	-	85,339
Depreciation and amortization	72,556	67,992
Amortization of financing cost and bond discounts	289	513
Amortization of bond premium	(3,926)	(1,742)
Unrealized losses (gains) on investments	113,640	(123,993)
Gain (loss) on disposal of property and equipment	106	(91)
Receipt of restricted contributions	(36,888)	(27,667)
Loss on extinguishment of debt	-	23,303
Change in pension liability	8,430	(34,390)
Changes in operating assets and liabilities:		
Patient and other receivables	19,914	(59,790)
Pledges receivable, net	(4,168)	5,472
Inventory and other current assets	2,594	(5,906)
Other assets	(41,382)	2,551
Receivables from remainder trusts	14,687	(6,795)
Assets limited as to use and short-term investments	29,630	(86,420)
Accounts payable and accrued liabilities	26,679	39,078
Other current liabilities	34,869	1,181
Other noncurrent liabilities	(12,185)	(867)
NET CASH PROVIDED BY OPERATING AND NONOPERATING ACTIVITIES	224,132	110,087
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase and construction of property and equipment	(79,455)	(130,759)
NET CASH USED BY INVESTING ACTIVITIES	(79,455)	(130,759)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments of annuities and trust obligations, net	69	(41)
Receipt of restricted contributions	36,888	27,667
Issuance of long-term debt	4,859	78,689
Payments of long-term debt	(8,585)	(8,175)
Payment of deferred loan costs	-	(2,840)
NET CASH PROVIDED BY FINANCING ACTIVITIES	33,231	95,300
INCREASE IN CASH AND CASH EQUIVALENTS	177,908	74,628
CASH AND CASH EQUIVALENTS, beginning of period	252,497	177,869
CASH AND CASH EQUIVALENTS, end of period	\$ 430,405	\$ 252,497
Supplemental cash flow disclosures:		
Interest paid	\$ 12,708	\$ 18,846



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. Collectively known as “Children’s Health”, the organization includes two pediatric teaching hospitals licensed for 562 beds, a rehabilitation hospital licensed for 39 beds, ambulatory care clinics, one primary care physician clinic, 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 Health Clinical Operations (“CHCO”)	Children’s Medical Center of Dallas officially changed its name to Children’s Health Clinical Operations. The organization filed an Amended and Restated Certificate of Formation with the Texas Secretary of State making the name change effective on September 15, 2018. CHCO is a 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”). CHCO is the primary pediatric teaching hospital for The University of Texas Southwestern Medical Center (“UTSW”).
Children’s Medical Center Foundation (the “Foundation”)	Nonprofit Texas corporation that fundraises and invests such funds for the benefit of CHST 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 as of June 4, 2018, operates one primary care physician office primarily providing care to children in critically underserved areas in Dallas county. On June 4, 2018, 16 physician offices were sold to Familia Care, Inc. d/b/a MD Medical Group (“MDMG”). See Note 22. 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.



<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 300 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 ("CRI") at The University of Texas Southwestern Medical Center	Nonprofit Texas corporation that is organized to conduct pediatric research. CRI 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. CRI is an organization described in Section 501(c)(3) of the IRC with CHST as its sole member.
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.
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.
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.



<u>Entity</u>	<u>Business Purpose/Activities</u>
Physician Quality Alliance of North Texas d/b/a Pediatric Alliance (“PQA”)	Nonprofit Texas corporation that participates in health care collaborative care activities. PQA was incorporated 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 health care 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 specialties, houses 44 pediatric intensive care beds, a 47-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.

Basis of Presentation

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the 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 payor 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 net receivables from patients and third-party payors (excluding affiliates) at December 31, 2018 and 2017, is as follows:

	<u>2018</u>	<u>2017</u>
Commercial	49 %	50 %
Managed Medicaid	35	38
Medicaid	10	9
Other	6	3
	<u>100 %</u>	<u>100 %</u>

Net patient accounts receivable arising from all government programs were approximately \$62.0 million at December 31, 2018, and \$64.0 million at December 31, 2017.

Net Patient Accounts Receivable and Net Patient Service Revenue

Net patient accounts receivable and net patient service revenues have been adjusted to the estimated amounts expected to be received based on contractual rates for services rendered, inclusive of the estimated price concession. These estimated amounts are subject to further adjustments upon review by third-party payors. See Note 2 for a further discussion on net patient service revenue.

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 health care. 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, 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 (“UC”) administered by the Texas Department of Human Services. Under these programs, state, and federal funds are accessed and distributed to hospitals providing a high volume of services to Medicaid and indigent, uninsured 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 build programs that enhance access to care and patient health.

See Note 18 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, 2018, CMCHP received 100% of its premium from the STAR Kids program in the Dallas service area. 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. In 2018, CMCHP and CHCO entered into a capitation agreement for services. For the year ended December 31, 2018 and 2017, respectively, CMCHP recognized \$266.1 million and \$245.1 million in premium revenues which are included in premium and capitation 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, 2017 and 2018, 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 ended December 31, 2018 and 2017, of \$17.8 million and \$9.0 million, respectively. In addition, at the year ended December 31, 2018 and 2017, CMCHP recorded a premium deficiency reserve of \$31.3 million and \$21.5 million, respectively. The IBNR and premium deficiency reserve are included in accrued liabilities and are based on actuarial evaluations of claims experience and projections. These estimates are continually reviewed and adjusted as necessary as experience develops or as new information becomes known; such adjustments are included in current operations. CMCHP maintains stop-loss insurance coverage to limit exposure for certain claims.

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 approximately \$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. See Note 3 for further description of pledges receivable.

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 2018 or 2017.

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 net asset value "as a practical expedient". During 2017, Children's Health adopted the provisions of Accounting Standards Update ("ASU") 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.

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, intangibles, and oil and gas investments.

Children's Health investment in joint ventures total \$38.4 million and \$13.9 million in 2018 and 2017, respectively. Children's Health accounts for its equity investment in Go Noodle, Pieces Technology, and MDMG under the cost-based method of accounting.

Physician guarantees were \$2.8 million and \$5.6 million at December 31, 2018 and 2017, respectively. The physician guarantees are amortized on a straight-line basis over the guarantee period (see Note 15).

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 IBNR, 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 \$3.0 million for both professional and general liability. Above these policies an excess insurance program is in place with an additional \$100.0 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 \$8.6 million and \$7.2 million, is included in accrued liabilities in the accompanying consolidated balance sheets as of December 31, 2018 and 2017, respectively.

Employee Retirement Benefit Plan

Children's Health accounts for its Defined Benefit Retirement Plan (the "Plan") in accordance with the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards 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 gifts and bequests of cash and other assets without donor restrictions are included in net assets with donor restrictions when pledged. Conditional gifts with donor restrictions and bequests are included in donor restricted net assets when the conditions have been satisfied. When a time or purpose restriction is accomplished, donor restricted net assets are reclassified to without donor restricted net assets and reported in the 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 donor restricted net assets. Reclasses between net asset classes (i.e., without donor restrictions, or with donor restrictions) may occur when a donor changes its designation of a gift or after further review or clarification of donor restrictions in the gift documentation.

Donor-restricted gifts are expended directly by the Foundation for the intended purpose or are transferred to the appropriate Children's Health affiliate to meet the donor's restriction.

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

Adopted in 2018

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities* ("ASU 2016-14"). 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 ASU 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 the statement of operations 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. Children's Health has adopted ASU 2016-14, effective January 1, 2018. Net Assets previously reported as Temporarily Restricted or Permanently Restricted are now reported as Net Assets with Donor Restrictions. Net Assets previously reported as Unrestricted are now reported as Net Asset without Donor Restrictions.

Children's Health adopted ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the scope and Accounting Guidance for Contributions Received and Contributions Made* ("ASU 2018-08") for fiscal year 2018. ASU 2018-08 clarifies the scope and the accounting guidance for contributions received and contributions made, to address questions stemming from ASU 2014-09, *Revenue from Contracts with Customers*, regarding its implications on the grants and contracts of not-for-profit organizations. Adoption of ASU 2018-08 did not have a material impact on the Company's consolidated financial statements.

Children's Health adopted the Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09") on January 1, 2018. This standard requires revenue to be recognized in a manner depicting the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods and services. Upon adoption, Children's Health utilized the modified retrospective method for transition. An analysis was performed of all revenue streams and transactions which fell under ASU 2014-09. In particular, for net patient service revenue, an analysis into the application of the portfolio approach as a practical expedient to a group patient contracts with similar characteristics, such that revenue for a given portfolio would not be materially different than if evaluated on a contract-by-contract basis. Upon adoption, the majority of amounts that were previously classified as provision for doubtful accounts and presented as a reduction to net patient service revenue on the statement of operations and changes in net assets is treated as an implicit price concession that reduces the transaction price, which is reported as net patient service revenue. The impact of adopting ASU 2014-09 was not material to total unrestricted revenues, excess of revenues over expenses or total net assets. The new standard also requires additional disclosures which are included in Note 2.

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* ("ASU 2017-07"). The ASU amends ASC Topic 715, *Compensation – Retirement Benefits* ("ASC 715"), 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. 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. Children's Health has elected early adoption effective January 1, 2018. Management has elected the use of a practical expedient which allows use of pension cost components disclosed in prior years as the basis for retrospective application. Benefit plans are accounted for in accordance with ASC 715. Children's Health has elected for early adoption of ASU 2017-07. The ASU amends ASC 715. Because the Plan is frozen for any future service benefits, the result of adoption is that all components of net benefit cost are included in nonoperating expenses. This amount was \$4.0 million and \$0.8 million for periods ended December 31, 2018 and December 31, 2017, respectively.

Children's Health adopted ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* ("ASU 2016-15") on January 1, 2018. This ASU made eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows.



Adoption of ASU 2016-15 did not have a material impact on the Company's consolidated financial statements.

Pending Adoption

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). This 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 executed after the beginning of the earliest comparative period in the consolidated financial statements. Full retrospective application is prohibited. Management has evaluated the ASU and determined the primary effect of adopting the new ASU will be to record right-of-use assets and lease liabilities for current operating leases. Children's Health will adopt ASU 2016-02, effective January 1, 2019. Children's Health will utilize a practical expedient which does not require separation of non-lease and associated lease components. Children's Health will also elect a practical expedient for short-term lease exemption. Under this exemption, for leases that meet the definition of short-term lease, lease will not recognize a lease liability or right-of-use asset. Lessee will recognize lease payments as an expense on a straight-line basis. Children's Health is assessing the effects of adoption and believes the most significant changes relate to the recognition of right-of-use assets and significant lease liabilities in its consolidated balance sheet as a result of its operating lease obligations, as well as the impact of new disclosure requirements. Upon initial evaluation, Children's Health believes the adoption will not have a material impact to its consolidated results of operations or liquidity.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*. ASU 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 balance sheet when these are shown in more than one line item. This ASU is effective for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. ASU is to be applied retrospectively and early adoption is permitted. Management is in the process of evaluating the impact of adoption.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement - Disclosure Framework (Topic 820)* ("ASU 2018-13"). ASU 2018-13 modifies the disclosure requirements for fair value measurements. ASU 2018-13 is effective for all entities for fiscal years beginning after December 15, 2019. Early adoption is permitted for any removed or modified disclosures. Management is currently assessing the impact ASU 2018-13 will have on the Company, but it is not expected to have a material impact on the Company's consolidated financial statement disclosures.

Reclassifications

During 2018, Children's Health recategorized certain income related to supplemental payment programs from other revenue into patient services revenue. In 2017 presentation, \$67.5 million has been moved from other revenue to patient services revenue to conform to 2018 presentation. This change did not impact total operating revenue.

Subsequent Events

Children's Health has evaluated events and transactions occurring subsequent to December 31, 2018, through May 3, 2019, the date the accompanying consolidated financial statements were issued. During this period, there were no subsequent events requiring recognition or disclosure in the consolidated financial statements.



Note 2 – Revenue

Children’s Health disaggregates revenue from contracts by payor type and revenue stream. Children’s Health revenue by payor type and major service line for the year ended December 31, 2018 was as follows:

<i>(in thousands)</i>	Payor			Total
	Government	Commercial	Other	Consolidated
Revenue Stream				
Patient Revenue	\$ 708,578	\$ 635,434	\$ 55,753	\$ 1,399,765
Premium Revenue	266,100	-	-	266,100
Graduate Medical Education	7,177	-	-	7,177
Other	-	-	76,005	76,005
Total	\$ 981,855	\$ 635,434	\$ 131,758	\$ 1,749,047

Net patient service revenue is reported at the amount that reflects the consideration Children’s Health expects to be due from patients and third-party payors in exchange for providing patient care. Providing patient care services is considered a single performance obligation, satisfied over time, in both the inpatient and outpatient setting.

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

Generally, patients who are covered by third-party payors are responsible for patient responsibility balances, including deductibles and coinsurance, which vary in amount. Children’s Health estimates the transaction price for patients with deductibles and coinsurance based on historical experience. The initial estimate of the transaction price is determined by reducing the standard charge by any explicit price concessions, discounts and implicit price concessions. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change.

Children’s Health is paid a prospectively determined rate depending on the third-party payor. Reimbursement for inpatient services for Traditional Medicaid, Children with Special Health care Needs (“CSHCN”), Children’s Health Insurance Program (“CHIP”) and certain Managed Medicaid contracts are based on All Patient Refined Diagnosis Related Groups (“APR-DRG”). For outpatient services, these same payors pay based on a fixed fee or cost-based reimbursed. Commercial and certain managed care payors are reimbursed based on a percent of charges.

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, 2018 and 2017, Children’s Health had a liability of \$7.6 million and \$6.1 million, respectively, recorded in accrued liabilities in the accompanying consolidated balance sheets. Net patient service revenue increased by approximately \$7.0 million and \$1.6 million for the years ended December 31, 2018 and 2017, respectively, due to the change in cost report allowances previously estimated, as a result of interim and final settlements.



Patient service revenue, net of contractual allowances, charity care, and implicit price concessions for 2018 and patient service revenue, net of contractual allowances, charity care (but before the provision for doubtful accounts) for 2017, recognized year-to-date from these major payor sources is as follows (in thousands):

	<u>Government</u>	<u>Commercial</u>	<u>Other</u>	<u>Total All Payers</u>
Patient services revenue less contractals:				
Year ended December 31, 2018	\$ 708,578	\$ 635,434	\$ 55,753	\$ 1,399,765
Year ended December 31, 2017	720,729	674,509	39,677	1,434,915

Per ASC 606, the 2018 figures include the Implicit Price Concession while the 2017 figures exclude the provision for doubtful accounts

Note 3 – Unconditional Pledges Receivable

Unconditional pledges receivable at December 31, 2018 are as follows (in thousands):

	<u>Less Than 1 Year</u>	<u>1-5 Years</u>	<u>More Than 5 Years</u>	<u>Total</u>
Pledges receivable	\$ 16,163	\$ 13,044	\$ 298	\$ 29,505
Discounts on long-term pledges receivable	(1,163)	(323)	(9)	(1,495)
Allowance for uncollectible pledges	(181)	(153)	(3)	(337)
Net pledges receivable	<u>\$ 14,819</u>	<u>\$ 12,568</u>	<u>\$ 286</u>	<u>\$ 27,673</u>

Note 4 – Conditional Pledges Receivable

As of December 31, 2018, Children's Health had \$13.9 million in pledges that contained donor conditions. \$5.6 million is contingent upon Children's Health reaching specific milestones in the expansion of the Foster Care Program and in developing and expanding services for underserved teens in the areas of behavioral health, depression, suicide prevention and substance use. \$1.0 million is contingent upon the donor's successful fundraising campaign and \$0.3 million is contingent upon submission of a satisfactory progress reports. A newly established medical research office has committed \$7.0 million over ten years to conduct medical research in conjunction with CRI. This commitment will begin once the medical research office receives its determination letter from the Internal Revenue Service ("IRS"). Since these pledges are conditional, they are not recorded as contributions until the donor conditions are met.

Note 5 – 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, mutual funds, public traded partnerships, real estate, commodities and mineral rights. As of December 31, 2018, and 2017, the fair value of the receivables from remainder trusts are \$4.5 million and \$19.1 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 with donor restricted contributions.

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 with donor restrictions contributions. 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, 2018, the IRS discount rate, which is used to determine the charitable deduction for planned gifts, was 3.6%.

Note 6 - Property and Equipment

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

	<u>2018</u>	<u>2017</u>
Land and improvements	\$ 67,154	\$ 67,154
Buildings and improvements	998,439	953,366
Leasehold improvements	28,353	40,056
Fixed equipment	33,248	23,414
Moveable equipment	452,429	412,116
	<u>1,579,623</u>	<u>1,496,106</u>
Accumulated depreciation and amortization	(709,595)	(654,265)
Construction in progress	107,366	128,760
Property and equipment, net	<u>\$ 977,394</u>	<u>\$ 970,601</u>

Note 7 - Assets Limited as to Use

Assets limited as to use consist of the following as of December 31, 2018 and 2017 (in thousands):

	<u>2018</u>	<u>2017</u>
Investments designated by the Board for the consolidated group	\$ 1,150,744	\$ 1,219,340
Project fund escrow	50,179	54,002
Investments of donor restricted funds	169,819	147,847
Other restricted investments	16,350	-
	<u>\$ 1,387,092</u>	<u>\$ 1,421,189</u>

Project fund escrow, at December 31, 2018, of \$50.2 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 ambulatory clinic building; expanding and renovating the Pediatric Intensive Care Unit; and remodeling the 11th and 12th floors of the hospital facility.



Note 8 – Liquidity and Availability

As of December 31, 2018, Children’s Health has 363 days of cash on hand.

Financial assets available for general expenditure within one year of balance sheet date consist of the following:

Cash and cash equivalents	\$ 429,805
Patient accounts receivable, net of allowances	137,837
Assets limited as to use	703,095
	<u>\$ 1,270,737</u>

Children’s Health has certain board-designated and donor-restricted assets limited to use which are available for general expenditure within one year in the normal course of operations. Accordingly, these assets have been included in the quantitative information above. There are other assets limited to use for donor-restricted purposes and project fund escrow which are more fully described in Note 7 and are not available for general expenditure within the year and are not reflected in the amounts above. However, the remaining Board designated amounts could be made available, if necessary.

Children’s Health cash management plan includes maintaining 66 days cash on hand, which is approximately \$200.0 million, which will be composed of cash and cash equivalents and short-term investments. If cash on hand should drop below \$175.0 million, funds will be transferred from investments.

Note 9 – 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:

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 (i.e., 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.

The 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's 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, 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.

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 \$595.0 million and \$500.7 million at December 31, 2018 and December 31, 2017, 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, 2018 (in thousands):

	Total	Assets at Fair Value		
		Level 1	Level 2	Level 3
Investment portfolio:				
Cash and cash equivalents	\$ 113,802	\$ 113,802	\$ -	\$ -
U.S. government securities	43,394	43,394	-	-
Common stocks	60,149	60,149	-	-
Debt securities:				
Corporate bonds	144,750	4,336	140,414	-
Mortgage-backed securities	4,921	-	4,921	-
Mutual funds:				
Registered:				
Domestic equity	3,439	3,439	-	-
International equity	28,678	28,678	-	-
Total investments at fair value	\$ 399,133	\$ 253,798	\$ 145,335	\$ -
Investments recognized at net asset value:				
Common/collective trusts:				
Domestic equity	147,629			
International equity	203,398			
Fixed income	41,946			
Hedge funds	488,716			
Private equity	106,270			
Total investment portfolio	1,387,092			
Included in short-term investments	-			
Total assets limited to use	\$ 1,387,092			
Receivable from remainder trusts	\$ 4,456			



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

	Total	Assets at Fair Value		
		Level 1	Level 2	Level 3
Investment portfolio:				
Cash and cash equivalents	\$ 97,137	\$ 97,137	\$ -	\$ -
U.S. government securities	94,229	94,229	-	-
Common stocks	44,331	44,331	-	-
Debt securities:				
Corporate bonds	148,825	-	148,825	-
Mortgage-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	-	-
Total investments at fair value	\$ 541,864	\$ 363,035	\$ 178,829	\$ -
Investments recognized at net asset value:				
Common/collective trusts:				
Domestic equity	187,307			
International equity	258,264			
Fixed income	42,213			
Hedge funds	438,445			
Private equity	62,269			
Total investment portfolio	1,530,362			
Included in short-term investments	109,173			
Total assets limited to use	\$ 1,421,189			
Receivable from remainder trusts	\$ 19,143			

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 \$481.6 million at December 31, 2018, compared to \$503.5 million at December 31, 2017. The carrying value of long-term debt was \$452.8 million at December 31, 2018, compared to \$460.2 million at December 31, 2017. Estimates are based on available market quotes, for comparably rated debt instruments, which constitute a Level 2 estimate.



Note 10 - 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, 2018
2019	\$ 14,059
2020	13,874
2021	13,573
2022	13,230
2023	13,113
Thereafter	41,981
	<u>\$ 109,830</u>

Operating lease and rental expense of approximately \$18.5 million and \$19.5 million in 2018 and 2017, respectively is included in general support in the accompanying consolidated statements of operations.

Note 11 - Long-Term Obligations

Long-term obligations consist of the following as of December 31, 2018 and 2017 (in thousands):

	2018	2017
North Central Texas Health Facilities Development Corporation Hospital Revenue Bonds, Series 2009; secured by Children's Health revenue:		
Term bonds payable August 15, 2019; 5.00% interest	\$ 1,600	\$ 3,380
North Central Texas Health Facilities Development Corporation Hospital Revenue Bonds, Series 2012; secured by Children's Health revenue:		
Serial bonds payable August 15, 2019 through 2022, in amounts ranging from \$3,875 to \$8,200; interest rate 3.25% to 5.00%	30,720	37,525
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	115,215
Serial bonds payable August 15, 2031 through 2032; 3.125% and 3.250% interest	12,940	12,940
Serial bonds payable August 15, 2033 through 2037; 4.00% interest	106,565	106,565
Term bonds payable August 15, 2040; 4.00% interest	53,590	53,590
Term bonds payable August 15, 2047; 5.00% interest	42,500	42,500
Children's Health System of Texas Taxable Bonds, Series 2017		
Term bonds payable August 15, 2027; 3.383% interest	25,000	25,000
Other, a \$10.2 million note, 1.00% interest; a \$4.9 million note, 4.17%	15,044	10,185
	<u>423,174</u>	<u>426,900</u>
Unamortized bond premium/issue costs, net	29,643	33,280
Less current portion	(9,639)	(8,585)
	<u>\$ 443,178</u>	<u>\$ 451,595</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.

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.

CHST, CMC and the Foundation comprise the Children’s Health Obligated Group (the “Obligated Group”) for the outstanding Series 2017A bonds, 2012 bonds and 2009 bonds. Children’s Health is in compliance with all applicable 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 in 2017.

Unamortized bond premium/discount, net of issue costs of \$29.6 million and \$33.2 million at December 31, 2018 and 2017 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 Debt-Other</u>	<u>Long-Term Debt-Total</u>
2019	\$ 8,745	\$ 894	\$ 9,639
2020	9,980	634	10,614
2021	10,480	661	11,141
2022	10,940	689	11,629
2023	11,300	719	12,019
Thereafter	356,685	11,447	368,132
	<u>\$ 408,130</u>	<u>\$ 15,044</u>	<u>\$ 423,174</u>

Note 12 – 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.

A resolution to terminate the pension plan was approved by the Board in May 2018. The Plan was terminated October 31, 2018 with full settlement of Plan obligations expected by the end of 2019.



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-grade debt securities, mutual funds, alternative investments, and marketable equity securities.

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 2018 and 2017, Children's Health made contributions to the Savings Plan of \$25.9 million and \$25.2 million respectively.

The information reflected below sets forth the Plan's benefit obligation, fair value of plan assets, and the funded status as of December 31, 2018 and 2017 (in thousands):

	2018	2017
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	\$ 245,226	\$ 230,419
Interest costs	9,367	9,903
Actuarial loss	17,931	18,039
Benefits paid	(14,059)	(13,135)
Projected benefit obligation, end of year	<u>258,465</u>	<u>245,226</u>
Change in plan assets:		
Fair value of plan assets, beginning of year	219,978	170,781
Actual return on plan assets	(7,732)	25,832
Employer contributions	26,600	36,500
Benefits paid	(14,059)	(13,135)
Fair value of plan assets, end of year	<u>224,787</u>	<u>219,978</u>
Funded status, end of year	<u>\$ (33,678)</u>	<u>\$ (25,248)</u>

Amounts recognized in the consolidated balance sheets as of December 31, 2018 and 2017, consist of (in thousands):

	2018	2017
Other current liabilities	\$ 33,678	\$ -
Other noncurrent liabilities	-	25,248



The net periodic pension cost as of December 31, 2018 and 2017, includes the following components (in thousands):

	<u>2018</u>	<u>2017</u>
Net periodic benefit expense:		
Interest costs	\$ 9,367	\$ 9,903
Expected return on plan assets	(12,252)	(12,742)
Amortization of net actuarial loss	<u>3,650</u>	<u>3,619</u>
Net periodic benefit expense:	\$ 765	\$ 780
Recognized settlement loss ¹	<u>3,245</u>	-
Total FASB ASC 715 cost	<u>\$ 4,010</u>	<u>\$ 780</u>

¹ Settlement expense was recognized in 2018 as lump-sum retirement elections exceeded the total service and interest cost for the period.

At December 31, 2018, the Plan's target allocation is 100% liquid debt securities (including US government securities and common/collective trusts).

	Target Asset Allocation	Plan Assets at December 31,			
		2018		2017	
Cash and cash equivalents	0.0 %	\$ 5,468	2.4 %	\$ 230	0.1 %
Common stocks	-	2	0.0	2,391	1.1
US government securities ¹	-	20,323	9.0	49,128	22.3
Debt securities ¹	100.0	105,144	46.8	73,857	33.6
Common / collective trusts ¹	-	86,921	38.7	56,234	25.6
Hedge funds	-	6,929	3.1	38,138	17.3
	<u>100.0 %</u>	<u>\$ 224,787</u>	<u>100.0 %</u>	<u>\$ 219,978</u>	<u>100.0 %</u>

At December 31, 2018 and 2017, the Plan's investment in alternative investments of \$6.9 million and \$38.1 million, respectively, is included in hedge funds. As described in Note 9, 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, 2018 were as follows (in thousands):

	Total	Assets at Fair Value		
		Level 1	Level 2	Level 3
Cash - interest bearing	\$ 5,468	\$ 5,468	\$ -	\$ -
Common stocks	2	2	-	-
US Government securities	20,323	20,323	-	-
Corporate bonds - investment grade	102,010	-	102,010	-
Mortgage backed securities - investment grade	3,134	-	3,134	-
Common / collective trusts				
Liquid assets / money market	<u>86,921</u>	<u>86,921</u>	-	-
Subtotal	217,858	<u>\$ 112,714</u>	<u>\$ 105,144</u>	<u>\$ -</u>
Investments recognized at net asset value:				
Hedge funds	<u>6,929</u>			
Total	<u>\$ 224,787</u>			



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	2,391	2,391	-	-
US Government securities	49,128	49,128	-	-
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			

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 towards fixed income investments which reflect a liability hedging portfolio.

Due to the termination of the Plan all remaining estimated benefits, \$261.8 million, are expected to be paid in 2019.

Other changes in plan assets and benefit obligations recognized in changes in unrestricted net assets for the years ended December 31, 2018 and 2017 are (in thousands):

	<u>2018</u>	<u>2017</u>
Net gain	\$ 37,914	\$ 4,948
Amortization of net actuarial loss	(3,650)	(3,619)
Recognized settlement loss	(3,245)	-
Total recognized changes in net assets without donor restrictions	\$ 31,019	\$ 1,329

Amounts in net assets without donor restrictions that have not been recognized in net periodic benefit cost, as of December 31, 2018 and 2017 consist of (in thousands):

	<u>2018</u>	<u>2017</u>
Net actuarial loss	\$ 88,902	\$ 57,883

The net loss for the defined benefit pension plan that will be amortized from net assets without donor restrictions into net periodic benefit cost over the next fiscal year is \$88.9 million.



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

	2018	2017
Net periodic benefit costs:		
Discount rate	3.90%	4.40%
Expected long-term rate of return on plan assets	5.70%	7.70%
Compensation increase rate	N/A	N/A
Benefit obligations and funded status:		
Discount rate	3.14%	3.90%
Compensation increase rate	N/A	N/A

Note 13 - Net Assets with Donor Restrictions

Net assets with donor restrictions at December 31 are available for the following purposes (in thousands):

	2018	2017
Patient care	\$ 71,210	\$ 77,679
Construction	14,236	1,674
Research	80,629	81,540
Education	6,195	6,605
Equipment	2,356	2,277
Time-restricted	2,232	16,547
Plano campus	4,378	10,714
General operations and other	56,501	26,925
	<u>\$ 237,737</u>	<u>\$ 223,961</u>

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 on December 31, 2008, which provides guidance for the proper net asset classification of donor-restricted endowment funds for not-for-profits in states which have adopted an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006.

All donor-restricted endowment funds are established primarily to fund specific activities at Children's Health. 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 management, investment, and expenditure of endowment funds held by charitable organizations, which apply in the absence of explicit donor stipulations.

The Foundation classifies the historic value of donor-restricted gifts to be held in perpetuity as donor-restricted endowments. The intent of the Foundation is to preserve the historic value of donor restricted gifts. The endowment distribution policy allows 0% - 5% distribution of the endowment asset which is defined as the simple average of the previous 12 fiscal quarters' ending value. At December 31, 2018, net assets with donor restrictions representing donor-restricted perpetual endowment funds were \$148.9 million compared to \$140.8 million at December 31, 2017.



Note 14 - Accrued Liabilities

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

	<u>2018</u>	<u>2017</u>
Accrued salaries and benefits	\$ 37,742	\$ 35,798
Accrued paid time-off	43,797	42,216
Accrued medical claims payable, including premium deficiency reserve	49,062	30,515
Third-party settlement payable	7,551	6,137
Other	993	3,881
	<u>\$ 139,145</u>	<u>\$ 118,547</u>

Note 15 – 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 \$2.8 million, as of December 31, 2018. The current portion of the guarantees is included in current liabilities and the noncurrent portion of the guarantees is included in other noncurrent liabilities on the consolidated balance sheets. Total guarantees were \$11.5 million as of December 31, 2018 and \$10.4 million as of December 31, 2017.

Note 16 - 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 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 health care 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 health care 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 health care providers. Violations of these laws and regulations could result in expulsion from government health care 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, 2018, outstanding commitments for



construction are approximately \$44.6 million, outstanding commitments for equipment are approximately \$0.9 million, and outstanding commitments for IT-related projects are approximately \$0.5 million.

At December 31, 2018, Children's Health had unfunded commitments to fund private equity investments totaling \$165.1 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. The tax effects of the Act did not have a significant impact on Children's Health.

Note 17 – Professional Liability

The net amount of Children's Health's professional liability was \$24.1 million as of December 31, 2018 and \$8.0 million as of December 31, 2017. ASU 2010-24, *Healthcare Entities Presentation of Insurance Claims and Related Insurance Recoveries*, requires professional liabilities to be reported at gross, without the consideration of insurance recoveries. Accordingly, Children's Health has recorded professional liabilities of \$33.2 million, in other noncurrent liabilities in the consolidated balance sheets and an asset representing insurance recoveries of \$9.1 million in other assets in the consolidated balance sheets at December 31, 2018 and \$10.1 million, in the other noncurrent liabilities portion of the consolidated balance sheet and an asset representing insurance recoveries of \$2.1 million in other assets in the consolidated balance sheet at December 31, 2017.

Note 18- 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 ("UC"), 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, the Centers for



Medicare and Medicaid Services (“CMS”) stated that no further extension of the state’s UC 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 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 UC 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 UC 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 continues to evaluate the potential financial impact of the new 1115 Waiver over the five-year period.

The 1115 Waiver funds the UC and DSRIP pools from which modified supplemental payments are made to providers.

The UC 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 CHCO’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 UC and DSRIP programs has shifted dollars from the UC program to the DSRIP program over the five-year term of the 1115 Waiver. Consequently, CHCO’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 Texas HHSC has approval from CMS to implement the Uniform Hospital Rate Increase Program (“UHRIP”) for hospital services provided to patient enrolled in Medicaid Managed Care program. At this time, only STAR and STAR+PLUS Medicaid Managed Care Programs participate in UHRIP. A rollout of UHRIP across Service Delivery Areas (“SDAs”) was implemented March 1, 2018. State-wide rate increase ranges are set for each hospital class by HHSC with approval from CMS, and the final rate increase for each hospital class in an SDA is determined through negotiations between hospitals within that SDA. Final rates must stay within the initial state-wide rate increase ranges and are re-evaluated annually. During 2018, the state-wide children’s hospital class was set at a 2% increase to hospital payments.

The CHGME program provides federally funded 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, 2018 and 2017, (in thousands):

	<u>2018</u>	<u>2017</u>
DSH	\$ 19,520	\$ 24,628
UC	33,642	20,161
DSRIP	42,447	52,611
CHGME	7,177	6,197

Children’s Health reflects DSH, UC, and DSRIP in net patient services revenue and CHGME in other revenues in the accompanying consolidated statement of operations.



Note 19 - Functional Expenses

Functional Expenses for the year ended December 31, 2018 (in thousands) were as follows:

	Healthcare Services			Support Services		Total
	Hospital	Physician Services	Health Plan	MG&A	Fundraising	
Salaries and benefits	\$ 528,434	\$ 58,474	\$ 19,612	\$ 158,821	\$ 5,700	\$ 771,041
Physician and provider costs	126,344	21,751	-	-	-	148,095
Medical supplies	165,104	2,754	-	1,006	2	168,866
Medical plan expenses	-	-	217,464	-	-	217,464
General support	106,924	16,232	12,964	132,123	2,920	271,163
Depreciation and amortization	53,521	2,725	362	15,948	-	72,556
Interest	14,686	37	-	-	-	14,723
	<u>\$ 995,013</u>	<u>\$ 101,973</u>	<u>\$ 250,402</u>	<u>\$ 307,898</u>	<u>\$ 8,622</u>	<u>\$ 1,663,908</u>

Management, general and administrative (“MG&A”) expenses include overhead areas such as accounting, human resources, marketing, information services and other corporate related expenses. These expenses were not allocated to the health care service lines.

Note 20 – Charity Care

The value of charity care provided by Children’s Health, based upon its established rates was \$37.5 million for the year ended December 31, 2018 and \$18.2 million for the year ended December 31, 2017. Children’s Health utilizes the cost to charge ratios, as calculated based on its most recent cost reports filed with the CMS, to determine the total cost. Children’s Health’s cost of providing charity care was \$13.4 million and \$6.6 million for the year ended December 31, 2018 and 2017, 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.

Note 22 – Significant Transactions

On June 4, 2018, Children’s Health partnered with MD Medical Group to expand the Children’s Health’s ability to provide high-quality primary care across North Texas. This strategic decision will also facilitate the continuance and furthering of CHPG’s efforts to promote availability and accessibility of quality pediatric health care services. As part of this partnership, Children’s Health transferred ownership of 13 CHPG clinics to MD Medical Group and retained an 8% ownership in MD Medical Group.

In 2018, the remaining parcels of land located in Sachse, TX were sold. In October 2018, a purchase and sale agreement was executed between the Foundation and a buyer for the purchase of 108.541 acres for \$17.1 million. The sale was finalized on October 4, 2018, which resulted in a gain of \$14.9 million.

The resulting gains from these sales affected donor restricted net assets, as the donor’s intent was to establish an endowment fund from the proceeds. In consideration for the gift of the property in 1975, the Foundation agreed to distribute 10% of the net proceeds to Trinity Valley School which was chosen by the donor. This restriction resulted in \$1.7 million due to the school which was offset against the gain.

Supplementary Information



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Report of Independent Auditors on Supplementary Information

The Board of Directors
Children's Health System of Texas

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements of Children's Health System of Texas and Affiliates as a whole. The accompanying combining balance sheet and statement of operations of Children's Health Obligated Group and the financial and operating information including the utilization statistics, coverage of debt service requirements, summary of cash and investment liquidity and capitalization ratios and payor mix analysis are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information, except for that portion marked "unaudited," has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information, except for that portion marked "unaudited" on which we express no opinion, is fairly stated, in all material respects, in relation to the financial statements as a whole.

Ernst & Young LLP

May 3, 2019



OBLIGATED GROUP
Combining Balance Sheet
As of December 31, 2018
(in thousands)

	CHST	CHCO	Foundation	Eliminations	Combined
ASSETS					
CURRENT ASSETS					
Cash and cash equivalents	204,966	103,264	13,841	-	322,071
Short-term investments	-	-	-	-	-
Patient accounts receivable, net of allowances	(467)	128,344	-	-	127,877
Pledges receivable, net of allowances	-	-	14,819	-	14,819
Inventories	2,627	16,390	-	-	19,017
Other current assets	54,213	11,930	678	-	66,821
TOTAL CURRENT ASSETS	261,339	259,928	29,338	-	550,605
Pledges receivable, net of allowances	-	-	12,854	-	12,854
Receivables from remainder trusts	-	-	4,456	-	4,456
Property and equipment, net	106,746	842,447	-	(94)	949,099
Assets limited as to use	-	14,475	1,306,088	-	1,320,563
Net assets of the Foundation	-	1,346,458	-	(1,346,458)	-
Other assets	240,898	50,204	13,231	-	304,333
TOTAL ASSETS	608,983	2,513,512	1,365,967	(1,346,552)	3,141,910
LIABILITIES AND NET ASSETS					
CURRENT LIABILITIES					
Accounts payable	56,849	65,704	845	-	123,398
Accrued liabilities	23,413	61,628	977	-	86,018
Accrued interest	-	6,721	-	-	6,721
Current portion of long-term debt and capital lease obligations	-	8,745	-	-	8,745
Other current liabilities	36,193	-	-	-	36,193
TOTAL CURRENT LIABILITIES	116,455	142,798	1,822	-	261,075
Long-term debt and capital lease obligations, net of current portion	-	439,213	-	-	439,213
Other non-current liabilities	1,761	34,102	1,958	-	37,821
Intercompany	1,179,858	(1,429,344)	9,846	159,069	(80,571)
NET ASSETS					
Without donor restrictions	(689,091)	1,961,120	1,212,186	(159,163)	2,325,052
With donor restrictions	-	1,365,623	140,155	(1,346,458)	159,320
TOTAL NET ASSETS	(689,091)	3,326,743	1,352,341	(1,505,621)	2,484,372
TOTAL LIABILITIES AND NET ASSETS	608,983	2,513,512	1,365,967	(1,346,552)	3,141,910



OBLIGATED GROUP
Combining Statement of Operations
For the Year Ended December 31, 2018
(in thousands)

	CHST	CHCO	Foundation	Eliminations	Combined
OPERATING REVENUE					
PATIENT SERVICES REVENUE	109,922	1,292,108	-	-	1,402,030
Provision for doubtful accounts	-	-	-	-	-
NET PATIENT SERVICES REVENUE	109,922	1,292,108	-	-	1,402,030
Other revenue	3,477	66,979	5,265	(2)	75,719
TOTAL OPERATING REVENUE	113,399	1,359,087	5,265	(2)	1,477,749
OPERATING EXPENSES					
Salaries and benefits	178,992	485,005	5,701	-	669,698
Physician and provider costs	31,355	112,351	-	-	143,706
Medical supplies	1,025	163,922	2	-	164,949
Medical plan expenses	-	-	-	-	-
General support	184,215	53,328	3,839	(2)	241,380
Depreciation and amortization	16,082	53,003	-	(10)	69,075
Interest	-	14,685	-	-	14,685
Shared services	(361,137)	336,655	-	-	(24,482)
TOTAL OPERATING EXPENSES	50,532	1,218,949	9,542	(12)	1,279,011
INCOME FROM OPERATIONS	62,867	140,138	(4,277)	10	198,738
NON-OPERATING INCOME LOSS					
Realized investment (losses) gains	(4,819)	1,918	41,224	-	38,323
Unrealized investment gains (losses)	-	26	(113,665)	-	(113,639)
Other	-	-	-	-	-
TOTAL NON-OPERATING INCOME (LOSS)	(4,819)	1,944	(72,441)	-	(75,316)
NET INCOME (LOSS)	58,048	142,082	(76,718)	10	123,422
Operating margin ¹					13.4%
Operating cash flow margin ²					19.1%

¹ Operating margin is calculated as income from operations divided by total operating revenue.

² Operating cash flow margin is calculated as the sum of income from operations, interest expense, depreciation and amortization divided by total operating revenue.

Children's Health Obligated Group
Note to Combining Obligated Group
For the Years Ended December 31, 2018 and 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 Indentures through Number 20, dated December 1, 2017, is comprised of Children's Health System of Texas ("CHST"), Children's Health Clinical Operations ("CHCO") 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
(Unaudited)

	Year Ended December 31,	
	2018	2017
Weighted Average Beds in Service ¹	499	505
Discharges (including observations)	37,850	36,696
Average Length of Stay (days)	3.40	3.45
Patient Days (including observations)	128,765	126,645
Average Daily Census	353	347
Percentage Occupancy	71%	69%
Clinic Visits ²	666,577	845,139
Surgeries	27,523	29,344

¹ Average number of beds in service year-to-date; 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)

	Years Ended December 31,	
	2018	2017
Income from operations	\$85,139	\$75,850
Depreciation and amortization expense	72,556	67,992
Interest expense	14,723	17,488
Realized investment gains	42,367	27,665
Consolidated revenues available for debt service ¹	\$214,785	\$188,995
Historical maximum annual debt service ²	29,813	29,813
Historical coverage of maximum annual debt service ³	7.2x	6.3x

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)

	As of December 31,	
	2018	2017
Cash and cash equivalents	\$ 430,405	\$ 252,497
Short-term investments	-	109,173
Board designated investments	1,150,744	1,216,648
Total available cash and investments	\$ 1,581,149	\$ 1,578,318
Total debt ¹	\$ 452,817	\$ 460,180
Total operating expenses	\$ 1,663,908	\$ 1,593,155
Less: depreciation and amortization	72,556	67,992
Adjusted total operating expenses	\$ 1,591,352	\$ 1,525,163
Average daily operating expense ²	\$ 4,360	\$ 4,179
Days cash on hand ³	363	378
Debt-to-capitalization ⁴	17.9%	18.0%
Cash-to-debt ⁵	349.2%	343.0%

¹ Total debt includes unamortized bond premium/discount and other deferred financing costs of \$29.6 million and \$33.3 million as of December 31, 2018 and 2017, 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, 2018 and 2017.

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, 2018 and 2017, 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,	
	2018	2017
Medicare	1%	1%
Medicaid (Traditional)	9	10
Medicaid (Managed Care)	55	54
Commercial	32	33
Self-Pay	1	1
All Other	2	1

**Payor Mix
Dallas Campus**

	Years Ended December 31,	
	2018	2017
Medicare	1%	1%
Medicaid (Traditional)	10	10
Medicaid (Managed Care)	57	57
Commercial	29	30
Self-Pay	1	1
All Other	2	1

**Payor Mix
Plano Campus**

	Years Ended December 31,	
	2018	2017
Medicare	0%	0%
Medicaid (Traditional)	5	5
Medicaid (Managed Care)	46	44
Commercial	45	48
Self-Pay	2	2
All Other	2	1

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

Summary of Utilization

Quarters and Years Ended December 31, 2018 and 2017

	Fourth Quarter		Year Ended	
	2018	2017	2018	2017
Inpatient discharges	3,889	4,254	14,615	15,723
Patient days	27,331	27,215	105,530	105,672
- ICU days	8,979	9,278	33,291	34,847
ED visits	45,807	49,660	166,921	174,838
Ambulatory visits	80,405	111,335	374,970	426,644
Professional services visits	33,081	92,522	221,201	343,084
- CHPG visits	10,523	70,133	132,990	253,648
Surgeries	6,017	7,087	27,523	29,344
Case mix index	2.56	2.36	2.56	2.38
- Medicaid case mix index	2.74	2.58	2.74	2.66
Payor mix:				
Commercial	32%	32%	32%	33%
Medicaid (Traditional)	10%	9%	9%	10%
Medicaid (Managed Care)	54%	56%	55%	54%
Other	4%	3%	4%	3%

Volumes

Inpatient discharges decreased by 365 (9%) and 1,108 days (7%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year.

Patient days increased by 116 days (<1%) and decreased 142 days (<1%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year.

ICU days decreased by 299 days (3%) and 1,556 days (4%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year.

ED visits decreased by 3,853 (8%) and 7,917 (5%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year.

Ambulatory visits decreased by 30,930 (28%) and 51,674 (12%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year.

Professional services decreased by 59,441 (64%) and 121,883 (36%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year. CHPG clinic visits decreased by 59,610 (85%) and 120,658 (48%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year. As of June 4, 2018, CHPG operates one clinic in Dallas County due to the sale of 16 clinics to Familia Care, Inc. d/b/a MD Medical Group ("MDMG"), compared to 18 clinics for the fourth quarter of 2017.

Surgeries decreased by 1,070 (15%) and 1,821 (6%) for the quarter and year ended December 31, 2018, respectively, compared to the same periods in the prior year.



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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 payors 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 payors 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's charity guidelines, are recorded as charity care and excluded from net patient service revenue.

Accounts receivable on Children's Health's balance sheets is recorded net of allowances for contractual adjustments, Implicit Price Concessions, 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, 2018 and 2017, salaries and benefits were 46% and 44% of Children's Health operating expenses, respectively. For the years ended December 31, 2018 and 2017, salaries and benefits were 48% of Children's Health operating expenses. 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. For the quarters ended December 31, 2018 and 2017, professional services were 9% of the operating expenses. For the years ended December 31, 2018 and 2017, 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 11% and 10% of the operating expenses for the quarters ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, supplies and other were 10% of operating expenses.

Plan medical expenses, which represent claims paid under the STAR Kids program, were 13% and 18% of the operating expenses for the quarters ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, plan medical expenses were 13% and 14% of the 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. General support expenses were 18% and 16% of the operating expenses for the quarters ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, general support expenses were 16% of the operating expenses.



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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 was 5% and 4% of the operating expenses for the quarters ended December 31, 2018 and 2017. For the years ended December 31, 2018 and 2017 depreciation expense was 4% of the operating expenses. 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 the operating expenses for the quarters and years ended December 31, 2018 and 2017. For the years ended December 31, 2018 and 2017 no interest was capitalized.

Results of Operations

Operating income of \$45.1 million for the quarter ended December 31, 2018, represents a \$19.1 million (73%) increase over the same period in 2017. Operating income for the year ended December 31, 2018, increased \$9.3 million to \$85.1 million (12%) over the same period in 2017.

Net patient service revenue increased \$20.6 million (6%) for the quarter ended December 31, 2018, compared to the same period in 2017. For the year ended December 31, 2018, net patient service revenue increased \$50.2 million (4%) compared to the same period in 2017.

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 under Children's Health charity). These amounts include account balances from uninsured patients and unpaid deductible and co-pay amounts from insured patients. Children's Health adopted ASC-606 – "Revenue from Contracts with Customers" effective January 1, 2018, and therefore has no provision for doubtful accounts for 2018, as these are now treated as Implicit Price Concessions.

Children's Health portion of the DSH program administered by the Texas Department of Human Services decreased by \$5.1 million (21%) for the year ended December 31, 2018, compared to the same period in 2017. 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 portion of the UC program administered by the Texas Department of Human Services increased by \$13.5 million (67%) for the year ended December 31, 2018, compared to the same period in 2017.

Children's Health provided charity care of \$10.0 million and \$37.5 million, based on charges, in the quarter and year ended December 31, 2018, compared to \$5.1 million and \$18.2 million in the quarter and year ended December 31, 2017.

The Children's Hospital Graduate Medical Education (CHGME) program receipts increased \$0.8 million to \$2.0 million for the quarter ended December 31, 2018, compared to the same period in 2017. Program receipts increased \$1.0 million to \$7.2 million for the year ended December 31, 2018, compared to the same period in 2017.

Premium revenue from the Medicaid STAR Kids program of \$68.6 million increased by \$1.0 million (2%) for the quarter ended December 31, 2018, compared to the same time period in 2017. Premium revenue increased by \$21.0 million (9%) to \$266.1 million for year ended December 31, 2018, compared to the same period in 2017.

Other operating revenue decreased by \$0.3 million (2%) for the quarter ended December 31, 2018, compared to the same time period in 2017. Other operating revenue decreased by \$2.8 million (5%) for the year ended December 31, 2018, compared to the same time period in 2017.



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Salaries and benefits increased \$10.8 million (6%) for the quarter ended December 31, 2018, compared to the same period in 2017. Salaries and benefits as a percentage of net patient service revenue were 52% for the quarters ended December 31, 2018 and 2017. Salaries and benefits increased \$31.3 million (4%) for the year ended December 31, 2018, compared to the same period in 2017. Salaries and benefits as a percentage of net patient service revenue were 57% and 56% for the year ended December 31, 2018 and 2017, respectively.

Professional services decreased \$1.5 million (4%) for the quarter ended December 31, 2018 and increased \$0.1 million (<1%) for the year ended December 31, 2018, compared to the same periods in 2017. Professional services as a percentage of net patient service revenue were 10% and 11% for the quarter ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, professional services were 11% of net patient service revenue.

Supply costs increased \$6.0 million (15%) for the quarter ended December 31, 2018 and increased \$13.8 million (9%) for the year ended December 31, 2018, over the same periods in 2017. Supply costs as a percentage of net patient service revenue were 12% and 11% for the quarters ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, supply costs were 12%.

Plan medical expenses decreased \$21.1 million (28%) for the quarter ended December 31, 2018, over the same period in 2017. 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 15% and 22% for the quarters ended December 31, 2018 and 2017, respectively. Plan medical expenses increased \$1.0 million (<1%) for the year ended December 31, 2018, over the same period in 2017. Plan medical expenses as a percentage of net patient service revenue were 16% and 17% for the years ended December 31, 2018 and 2017, respectively.

General support increased \$10.4 million (15%) for the quarter ended December 31, 2018, and increased \$22.8 million (9%) for the year ended December 31, 2018, over the same periods in 2017. General support costs were 21% and 19% of net patient service revenue for the quarters ended December 31, 2018 and 2017, respectively. For the years ended December 31, 2018 and 2017, general support costs were 19% and 18% of net patient service revenue, respectively.

Depreciation and amortization expense increased \$1.3 million (7%) for the quarter ended December 31, 2018, and \$4.6 million (7%) for the year ended December 31, 2018, over the same periods in 2017. As a percentage of net patient service revenue, depreciation and amortization expense was 5% for the quarters and years ended December 31, 2018 and 2017.

Interest expense decreased \$0.7 million (16%) for the quarter ended December 31, 2018, compared to the same period in 2017. Interest expense decreased \$2.8 million (16%) for the year ended December 31, 2018, compared to the same period in 2017. As a percentage of net patient service revenue, interest expense was 1% for the quarters and years ended December 31, 2018 and 2017.

Investment income (realized and unrealized investment gains and losses) was a loss of \$96.8 million for the quarter ended December 31, 2018, compared to a gain of \$18.9 million for the quarter ended December 31, 2017. For the year ended December 31, 2018 there was a loss of \$75.0 million compared to a gain of \$127.3 million for the year ended December 31, 2017.

Liquidity and Capital Resources

Children's Health continues to enjoy strong financial liquidity, with unrestricted cash and investments of \$1.6 billion or 363 days of cash expenses.

Net cash provided by operating and nonoperating activities was \$224.1 million for the year ended December 31, 2018, compared to net cash provided by operating and nonoperating activities of \$110.1 million for the same period in 2017.



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Net cash used by investing activities was \$79.5 million for the year ended December 31, 2018, compared to \$130.8 million for the year ended December 31, 2017.

Net cash used by financing activities was \$33.2 million for the year ended December 31, 2018, compared to net cash provided by financing activities of \$95.3 million for the same period in 2017.

Off-Balance Sheet Financing

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