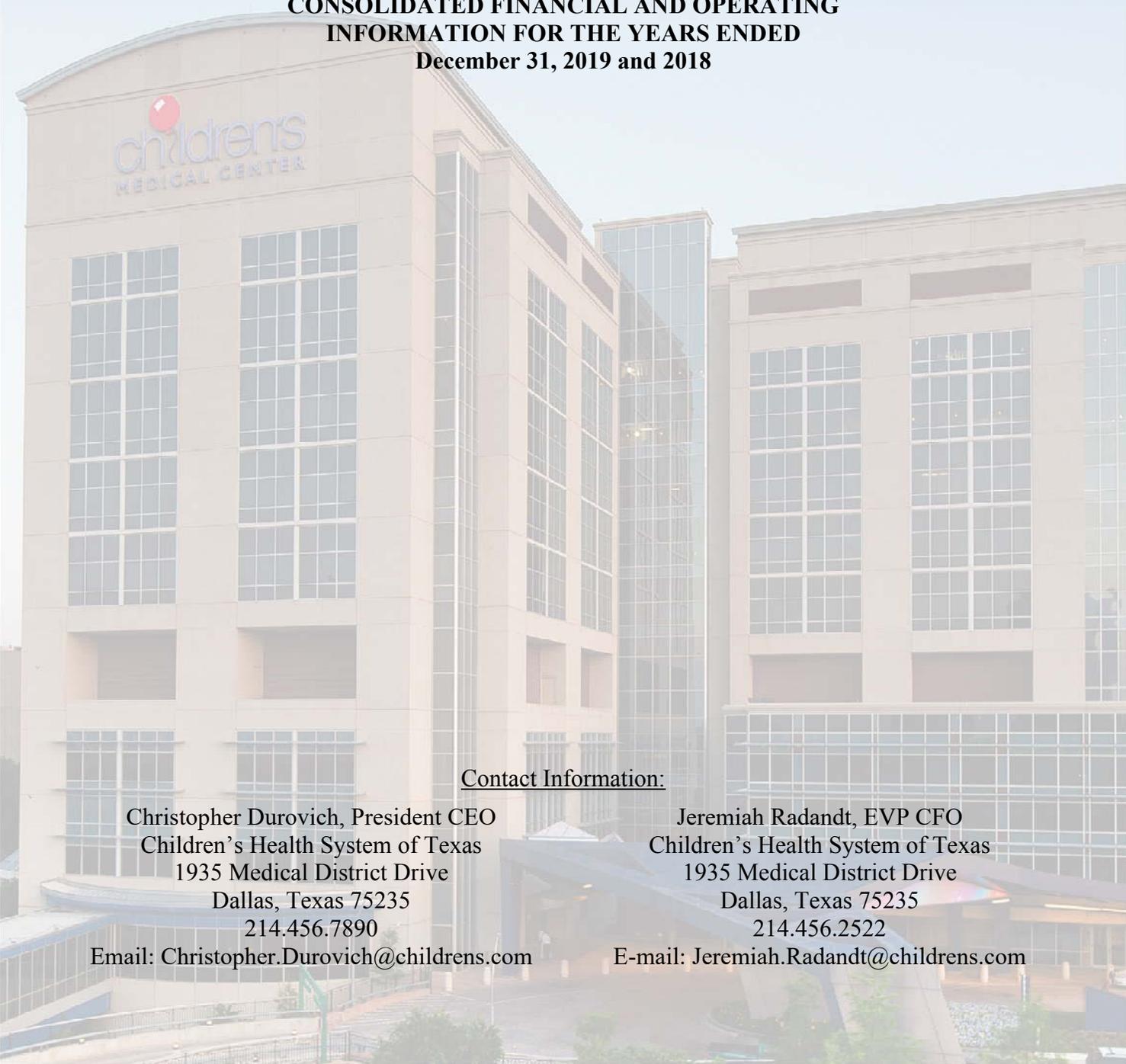




**CHILDREN'S HEALTH SYSTEM OF TEXAS AND AFFILIATES
CONSOLIDATED FINANCIAL AND OPERATING
INFORMATION FOR THE YEARS ENDED
December 31, 2019 and 2018**

A large, multi-story medical center building with a light-colored facade and numerous windows. The building has a curved top section on the left side. The "children's MEDICAL CENTER" logo is visible on the upper part of the building's facade.

children's
MEDICAL CENTER

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Report of Independent Auditors

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Report of Independent Auditors

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, 2019 and 2018, 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, 2019 and 2018 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.



Adoption of ASU No. 2016-02, *Leases (Topic 842)*

As discussed in Note 1 to the consolidated financial statements, Children’s Health System of Texas and Affiliates changed their method of accounting for leases as a result of the adoption of Accounting Standards Update 2016-02, *Leases (Topic 842)*, effective January 1, 2019. Our opinion is not modified with respect to this matter.

Ernst & Young LLP

May 19, 2020



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

	December 31, 2019	December 31, 2018
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 566,163	\$ 430,405
Patient accounts receivable, net	174,151	137,837
Pledges receivable, net	8,261	14,819
Inventories	23,485	19,266
Other current assets	76,753	70,943
TOTAL CURRENT ASSETS	848,813	673,270
Pledges receivable, net	8,758	12,854
Receivables from remainder trusts	61	4,456
Property and equipment, net	987,304	977,394
Assets limited as to use	1,601,773	1,387,092
Right-to-use asset	88,542	-
Other assets	105,472	79,596
TOTAL ASSETS	\$ 3,640,723	\$ 3,134,662
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	\$ 152,234	\$ 133,058
Accrued liabilities	152,035	139,145
Accrued interest	6,557	6,721
Current portion of long-term debt	10,614	9,639
Current portion of lease obligations	15,820	-
Other current liabilities	55,215	45,042
TOTAL CURRENT LIABILITIES	392,475	333,605
Long-term debt, net of current portion	429,444	443,178
Lease obligations, net of current portion	73,207	-
Other noncurrent liabilities	48,336	37,322
NET ASSETS		
Without donor restrictions	2,436,049	2,082,820
With donor restrictions	261,212	237,737
TOTAL NET ASSETS	2,697,261	2,320,557
TOTAL LIABILITIES AND NET ASSETS	\$ 3,640,723	\$ 3,134,662



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidated Statements of Operations
For the Years Ended December 31, 2019 and 2018
(in thousands)

	2019	2018
OPERATING REVENUE		
Net patient services revenue	\$ 1,537,607	\$ 1,399,765
Premium and capitation revenue	272,136	266,100
Other revenue	96,521	83,182
TOTAL OPERATING REVENUE	1,906,264	1,749,047
OPERATING EXPENSES		
Salaries and benefits	806,740	771,041
Physician and provider costs	140,217	148,095
Medical supplies	188,016	168,866
Medical plan expenses	191,018	217,464
General support	302,357	271,163
Depreciation and amortization	97,917	72,556
Interest	14,623	14,723
TOTAL OPERATING EXPENSES	1,740,888	1,663,908
INCOME FROM OPERATIONS	165,376	85,139
NONOPERATING INCOME (LOSS)		
Realized investment gains, net	50,830	42,367
Unrealized investment gains (losses), net	141,527	(113,640)
Net periodic pension costs	(78,354)	(4,044)
Other	(23,305)	274
TOTAL NONOPERATING INCOME (LOSS)	90,698	(75,043)
NET INCOME	\$ 256,074	\$ 10,096



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidated Statements of Changes in Net Assets
For the Years Ended December 31, 2019 and 2018
(in thousands)

	2019	2018
CHANGES IN NET ASSETS WITHOUT DONOR RESTRICTIONS		
Net income	\$ 256,074	\$ 10,096
Net assets released from restrictions	2,115	7,416
Change in pension plan net actuarial loss	89,368	(31,019)
Change in donor designation and other	5,672	(982)
INCREASE (DECREASE) IN NET ASSETS WITHOUT DONOR RESTRICTIONS	353,229	(14,489)
CHANGES IN NET ASSETS WITH DONOR RESTRICTIONS		
Contributions	21,023	34,364
Change in split-interest agreements	(1,651)	(308)
Gain on sale of assets	-	14,848
Realized investment gains, net	5,782	4,843
Unrealized investment gains (losses), net	18,774	(13,682)
Net assets released from restrictions for operations	(18,613)	(18,496)
Net assets released from restrictions for capital	(2,115)	(7,416)
Change in donor designation and other	275	(377)
INCREASE IN NET ASSETS WITH DONOR RESTRICTIONS	23,475	13,776
INCREASE (DECREASE) IN NET ASSETS	376,704	(713)
NET ASSETS BEGINNING OF PERIOD	2,320,557	2,321,270
NET ASSETS END OF THE PERIOD	\$ 2,697,261	\$ 2,320,557



CHILDREN'S HEALTH SYSTEM OF TEXAS
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2019 and 2018
(in thousands)

	2019	2018
CASH FLOW FROM OPERATING AND NONOPERATING ACTIVITIES		
Increase (decrease) in net assets	\$ 376,704	\$ (713)
Adjustment to reconcile increase in net assets to net cash provided by operating and nonoperating activities:		
Depreciation and amortization	97,917	72,556
Amortization of financing cost and bond discounts	268	289
Amortization of bond premium	(3,723)	(3,926)
Unrealized (gains) losses on investments	(141,527)	113,640
Loss on disposal/impairment of property and equipment	11,381	106
Change in right-to-use asset	12,324	-
Receipt of restricted contributions	(31,370)	(36,888)
Change in pension liability	(32,341)	8,430
Changes in operating assets and liabilities:		
Patient and other receivables	(19,100)	19,914
Pledges receivable, net	10,654	(4,168)
Inventory and other current assets	(27,243)	2,594
Other assets	(9,999)	(41,382)
Receivables from remainder trusts	4,395	14,687
Assets limited as to use	(84,733)	46,295
Accounts payable and accrued liabilities	31,902	26,679
Lease liability	(11,839)	-
Other current liabilities	10,173	34,869
Other noncurrent liabilities	39,014	(12,185)
NET CASH PROVIDED BY OPERATING AND NONOPERATING ACTIVITIES	232,857	240,797
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase and construction of property and equipment	(116,966)	(79,455)
Acquisitions, primarily goodwill	(18,119)	-
NET CASH USED BY INVESTING ACTIVITIES	(135,085)	(79,455)
CASH FLOWS FROM FINANCING ACTIVITIES		
Change in annuities and trust obligations, net	4,341	69
Receipt of restricted contributions	31,370	36,888
Issuance of long-term debt	-	4,859
Payments of long-term debt	(9,304)	(8,585)
NET CASH PROVIDED BY FINANCING ACTIVITIES	26,407	33,231
INCREASE IN CASH AND CASH EQUIVALENTS	124,179	194,573
CASH, CASH EQUIVALENTS AND RESTRICTED CASH, beginning of period	544,207	349,634
CASH, CASH EQUIVALENTS AND RESTRICTED CASH, end of period	\$ 668,386	\$ 544,207
Supplemental cash flow disclosures:		
Interest paid	\$ 18,234	\$ 12,708



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”). 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 oversees and coordinates 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 has a license to sell commercial HMO and Medicare Advantage products to a large group of 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.
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. PQA's voting board is comprised solely of practicing physicians appointed to the board by CHST.



<u>Entity</u>	<u>Business Purpose/Activities</u>
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 Care Network (“CHCN”)	The Children’s Health Care Network is a collaborative network of health care providers, including employed and community physicians, telehealth and telebehavioral health school sites, integrated behavioral health programs, pediatric specialists, primary care practices, wellness programs, urgent cares and more. The network offers a diverse set of health care resources that are affiliated with and endorsed by Children’s Health in communities across North Texas, meeting children where they are and ensuring their full range of health needs are met.

Children’s Health, with nearly 8,000 employees, is the leading pediatric health care system in North Texas and one of the largest pediatric health care providers in the nation. 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 and 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, assumptions and judgements that affect the reported in the consolidated financial statements, including the notes and related disclosures of commitments and contingencies, if any. Children’s Health considers critical accounting policies to be those that require significant judgements and estimates in the preparation of its consolidated financial statements, including the following: recognition of net patient service revenues, which include contractual allowances and the implicit price concessions; receivables from donor pledges and the related allowance for uncollectible pledges; estimates for reimbursement under the Supplemental Payment Programs which include Disproportionate Share (“DSH”), Uncompensated Care (“UC”), Delivery System Reform Incentive Payment (“DSRIP”); reserves for losses and expenses related to health care professional and general liabilities; accruals for claims incurred but not yet reported and for risk sharing liabilities related to Children’s Health’s health plan; determination of fair values of certain financial instruments; determination of fair value of certain goodwill and long-lived assets and management relies on historical experience and on other assumptions believed to be reasonable under the circumstances in making its judgements and estimates. Actual results could differ materially from these 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. See Note 9 for a further discussion.

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, 2019 and 2018 is as follows:

	<u>2019</u>	<u>2018</u>
Commercial	49 %	49 %
Managed Medicaid	39	35
Medicaid	6	10
Other	6	6
	<u>100 %</u>	<u>100 %</u>

Net patient accounts receivable arising from all government programs were approximately \$78.0 million and \$62.0 million at December 31, 2019 and 2018, respectively.

Net Patient Accounts Receivable and Net Patient Service Revenue

Net patient accounts receivable and net patient service revenue 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 care 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, Children with Special Health Care Needs ("CSHCN"), and Children's Health Insurance Program ("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.

Health Plan

CMCHP earns premium revenue from the Medicaid State of Texas Access Reform ("STAR") program. For the year ended December 31, 2019, 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 years ended December 31, 2019 and 2018, respectively, CMCHP recognized \$272.1 million and \$266.1 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, 2019 and 2018, CMCHP had no estimated experience rebate liability.

A liability was recorded on CMCHP's financial statements for incurred but not reported ("IBNR") medical claims for the years ended December 31, 2019 and 2018 of \$13.7 million and \$17.8 million, respectively. In addition, for the years ended December 31, 2019 and 2018, CMCHP recorded a premium deficiency reserve of \$21.2 million and \$31.3 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.

CMCHP notified HHSC and the Texas Department of Insurance ("TDI") that Children's Health will exit the STAR Kids program as of September 30, 2020 due to historical losses in the product. HHSC has agreed with this date, and CMCHP does not foresee any factors to prevent the entity from fulfilling its contractual obligations with HHSC.

Pledge Discounts and Allowances

The Foundation receives pledges on behalf of Children's Health and records unconditional 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 a 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.



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.

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". 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 judgement. Generally, the net asset value of Children's Health's 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, assets held for sale and oil and gas investments.

Children's Health has investments in unconsolidated organizations of \$52.5 million and \$38.4 million as of December 31, 2019 and 2018, respectively. Children's Health's investment in Pieces Technology, Inc. ("Pieces") was 39.9% at December 31, 2019 and is accounted for under the equity method of accounting. Pieces was formed on July 30, 2015 and is a health information technology company that provides end-to-end integrated monitoring, prediction, workflow optimization and organizational learning tools. Children's Health's investment in Rank One, LLC "Rank One" was 49.9% at December 31, 2019 and is also accounted for under the equity method of accounting. Rank One was formed in June 2018, it is a health care technology company which offers a health care app focused on standardization of student athletic injury documentation and provide a means of communication between K-12 school athletic staff and administrators and health care providers. Additionally, Children's Health's investment in GoNoodle® was 5.36% at December 31, 2019 and is accounted for under the cost-basis method of accounting. GoNoodle® was founded in 2010 and is involved in the development and marketing of software and online video products and apps for educating children about healthy living, exercise and nutrition. Children's Health's investment in MDMG was 8% at December 31, 2019. MDMG was formed as a result of Children's Health's divestiture of CHPG clinics in 2018. The investment in MDMG was accounted for using the cost-basis method of accounting. For the years ended December 31, 2019 and 2018, Children's Health recognized net losses from these investments of \$9.2



million and \$0, respectively, reflected in other nonoperating losses in the consolidated statements of operations.

Physician guarantees were \$4.2 million and \$2.8 million at December 31, 2019 and 2018, respectively. The physician guarantees are amortized on a straight-line basis over the guarantee period (see Note 16).

Intangibles include goodwill of \$22.4 million as of December 31, 2019 and \$4.3 million as of December 31, 2018. The increase resulted from the acquisition on January 10, 2019 of Pediatric Health Specialists Clinic and Pediatric Cardiology Associates of Houston.

At December 31, 2019, other assets included \$5.9 million related to the Southlake Specialty Center, a 34,000 square foot facility which ceased operations in November 2015, as assets available for sale. During 2019, Children's Health recorded an \$11.1 million impairment charge which is reflected in other nonoperating losses in the consolidated statements of operations.

Self-Insurance

Children's Health self-insures professional and general liability risk through TTRAC. 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 \$5.0 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.

Excess coverage (Medical Stop Loss) for Children's Health employee health benefits is 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 \$9.2 million and \$8.6 million, is included in accrued liabilities in the accompanying consolidated balance sheets as of December 31, 2019 and 2018, respectively.

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 consolidated statements of operations and the consolidated statements of 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. Reclassifications 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.

Income Taxes

The authoritative guidance in ASC 740 *Income Taxes*, creates a single model to address uncertainty in tax positions and clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. Management annually reviews its tax positions and has determined that there are no material uncertain tax positions that require



recognition in the accompanying consolidated balance sheets. The statute of limitations remains open for tax years 2016 through 2019 in Children's Health main taxing jurisdictions.

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, 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 2019

In May 2019, the FASB issued Accounting Standards Update ("ASU") 2019-06, *Intangibles – Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities*. The objective of ASU 2019-06 is to extend the scope of the accounting alternatives provided in ASU 2014-02, *Intangibles – Goodwill and Other (Topic 350): Accounting for Goodwill (A Consensus of the Private Company Council)* and ASU 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Assets in a Business Combination (A Consensus of the Private Company Council)* to not-for-profit ("NFP") entities.

CHST has determined that the goodwill currently recorded relating to the 2019 acquisitions of Pediatric Heart Specialist ("PHS") and Pediatric Cardiology Associates of Houston ("PCAH") and OCH qualifies for the policy election to apply the accounting alternative discussed in ASU 2019-06 because that goodwill was recognized due to an acquisition by a NFP entity as defined. Therefore, CHST has elected to apply the accounting alternatives described in ASU 2019-06 in 2019.

In considering the guidance above, CHST has made the following policy elections:

- 1) All goodwill balances in existence at January 1, 2019 will be amortized over a period of 10 years. This period was selected as it is the maximum period allowed per the guidance above. CHST expects to benefit from the acquisitions of the aforementioned clinics and OCH for at least 10 years.
- 2) CHST will evaluate goodwill for impairment at the entity level rather than the reporting unit level.

PHS and PCAH were both acquired on January 10, 2019 and the amount of goodwill assigned as a result of these acquisitions was \$9.4 million and \$8.7 million, respectively. A full year of amortization expense was recognized in the financial statements of \$1.8 million for these clinics. The goodwill associated with the acquisition of OCH has been recorded since 2015 and, as a result of this election, CHST has recorded a full year of amortization expense in 2019 of \$0.4 million for the goodwill of \$4.3 million.

In January 2017, FASB issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, which eliminated the calculation of implied goodwill fair value. Under the simplified model, goodwill impairment is calculated as the difference between the carrying amount of the reporting unit and its fair value, but not to exceed the carrying amount of goodwill allocated to that reporting unit. The guidance is effective for annual or any interim goodwill impairment tests for fiscal years beginning after December 15, 2021 for all other non-public entities. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. This standard was evaluated in conjunction with the adoption of ASU 2019-06 and determined this guidance would be applied.

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 of 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.

Children's Health leases office space and certain equipment under operating leases that extend through 2031. Leased office space includes annual escalations per the contract. Children's Health adopted ASU 2016-02, effective January 1, 2019 using the modified retrospective approach for leases that exist or are executed after the beginning of the earliest comparative period in the financial statements. ASU 2016-02 requires operating leases be recorded on the balance sheet through recognition of a liability for the discounted present value of future fixed lease payments and a corresponding right-of-use ("ROU") asset. The ROU asset recorded at the commencement of the lease represents the right to use the underlying asset over the lease term in exchange for the lease payments.

Children's Health elected the following three practical expedients under ASC 842-10-65-1, which are elected as a package and are to be applied consistently to all leases. As of the date of adoption, January 1, 2019, Children's Health does not need to reassess:

- 1) whether any expired or existing contracts are or contain leases,
- 2) the lease classification for any expired or existing leases as operating or finance leases and
- 3) initial direct costs for any existing leases.

Additionally, Children's Health has utilized a practical expedient which does not require separation of non-lease and associated lease components. Children's Health also elected a practical expedient for short-term lease exemption. Under this election, leases with an initial term of 12 months or less that do not have an option to purchase the underlying asset that are deemed reasonably certain to exercise and are not recorded on the balance sheet; rather, rent expense for these leases is recognized on a straight-line basis over the lease term. The lease term includes any options to renew that are reasonably certain of being exercised. Finally, Children's Health recognizes the total value of lease payments over the lease term as expense on a straight-line basis.

When readily determinable, Children's Health uses the interest rate implicit in a lease to determine the present value of future lease payments. For leases where the implicit rate is not readily determinable, Children's Health utilizes the Bloomberg Valuation of US Corporate AA+ mid yield curve. Children's Health calculates its incremental borrowing rate from the US Corporate AA+ rate during the initial year of the lease which estimates the rate of interest Children's Health would have to pay to borrow an amount equal to the total lease payments on a collateralized basis over a term similar to the lease. Each lease was analyzed independently, and the appropriate rate was applied to future payments to determine the net present value of those payments. The impact of adoption of ASU 2016-02 was to record ROU asset and lease obligations of \$99.0 million as of January 1, 2019 and did not have a material impact on Children's Health's consolidated statement of operations for the year ended December 31, 2019.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* ("ASU 2016-18"), which applies to all entities that have restricted cash and are required to present a statement of cash flows under Topic 230. ASU 2016-18 requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Children's Health adopted ASU 2016-18 for the year ended December 31, 2019, using a modified retrospective approach. The effect of the new standard was to increase the amounts included in cash, cash equivalents, and restricted cash on the consolidated statements of cash flows by \$102,223, \$113,802, and \$97,137 as of December 31, 2019, December 31, 2018, and January 1, 2018, respectively.

Pending 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.

In December 2019, the FASB issued ASU 2019-12, *Income Taxes (Topic 740) Simplifying the Accounting for Income Taxes* ("ASU 2019-12"). The amendments in ASU 2019-12 simplify the accounting for income taxes by removing certain exceptions to the general principles in Topic 740. ASU 2019-12 is effective for public business entities for fiscal years beginning after December 15, 2020. Management is currently assessing the impact ASU 2019-12 will have on the Company, but it is not expected to have a material impact on the Company's consolidated financial statement disclosures.

Subsequent Events

Children's Health has evaluated events and transactions occurring subsequent to December 31, 2019, through May 19, 2020, the date the accompanying consolidated financial statements were issued.

Beginning around mid-March 2020, the COVID-19 outbreak in the United States has caused business disruption through mandated and voluntary closings, social distancing efforts and shelter in place orders. While the disruption is currently expected to be temporary, there is considerable uncertainty around the duration of the effects. Management is evaluating the impact of the COVID-19 pandemic on the industry and has concluded that while it is reasonably possible that the virus could have a temporary negative impact on the Company's consolidated financial position, the specific financial impact is not readily determinable as of the date of these consolidated financial statements. The accompanying consolidated financial statements as of and for the year ended December 31, 2019 do not reflect the effects of these subsequent events.

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, 2019 was as follows (in thousands):

Revenue Source	Payor			Total
	Government	Commercial	Other	Consolidated
Patient Revenue	\$ 706,905	\$ 766,380	\$ 64,322	\$ 1,537,607
Premium Revenue	272,136	-	-	272,136
Graduate Medical Education	8,165	-	-	8,165
Other	-	-	88,356	88,356
Total	\$ 987,206	\$ 766,380	\$ 152,678	\$ 1,906,264

Children's Health revenue by payor type and major service line for the year ended December 31, 2018 was as follows (in thousands):

Revenue Source	Payor			Total
	Government	Commercial	Other	Consolidated
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 its 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 consolidated balance sheet amounts recorded are adequate to cover any such adjustments. At December 31, 2019 and 2018, Children's Health had a liability of \$19.3 million and \$7.6 million, respectively, recorded in accrued liabilities in the accompanying consolidated balance sheets. For fiscal years 2019 and 2018, revenue increased \$2.8 million and \$1.4 million, respectively, related to changes in estimates for cost report reopenings, appeals, and tentative and final cost report settlements on filed cost reports, of which some are still subject to audit, additional reopening, and/or appeal.

Note 3 - Unconditional Pledges Receivable

Unconditional pledges receivable at December 31, 2019 are as follows (in thousands):

	Less Than 1 Year	1-5 Years	More Than 5 Years	Total
Pledges receivable	\$ 9,216	\$ 8,832	\$ 195	\$ 18,243
Discounts on long-term pledges receivable	(849)	(152)	(5)	(1,006)
Allowance for uncollectible pledges	(106)	(110)	(2)	(218)
Net pledges receivable	<u>\$ 8,261</u>	<u>\$ 8,570</u>	<u>\$ 188</u>	<u>\$ 17,019</u>



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

	Less Than 1 Year	1-5 Years	More Than 5 Years	Total
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	\$ 14,819	\$ 12,568	\$ 286	\$ 27,673

Note 4 - Conditional Pledges Receivable

The Foundation had pledges that contained donor conditions of \$2.0 million and \$13.9 million at December 31, 2019 and 2018, respectively. \$2.0 million and \$5.6 million was contingent upon Children's Health developing and expanding services for underserved teens in the areas of behavioral health, depression, suicide prevention and substance use at December 31, 2019 and 2018, respectively. \$0.03 million and \$1.0 million was contingent upon the donor's successful fundraising campaign at December 31, 2019 and 2018, respectively. 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, and commodities. As of December 31, 2019 and 2018, the fair value of the receivables from remainder trusts are \$0.06 million and \$4.5 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 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, 2019, the Internal Revenue Service discount rate, which is used to determine the charitable deduction for planned gifts, was 2.0%.



Note 6 - Property and Equipment

Property and equipment consist of the following as of December 31, 2019 and 2018 (in thousands):

	<u>2019</u>	<u>2018</u>
Land and improvements	\$ 113,568	\$ 67,153
Buildings and improvements	1,036,642	998,439
Leasehold improvements	36,822	28,354
Fixed equipment	37,015	33,248
Moveable equipment	480,520	452,429
	<u>1,704,567</u>	<u>1,579,623</u>
Accumulated depreciation and amortization	(795,236)	(709,595)
Construction in progress	77,973	107,366
Property and equipment, net	<u>\$ 987,304</u>	<u>\$ 977,394</u>

Note 7 - Assets Limited as to Use

Assets limited as to use consist of the following as of December 31, 2019 and 2018 (in thousands):

	<u>2019</u>	<u>2018</u>
Investments designated by the Board for the consolidated group	\$ 1,351,722	\$ 1,150,744
Project fund escrow	21,563	50,179
Investments of donor restricted funds	211,023	169,819
Other restricted investments	17,465	16,350
	<u>\$ 1,601,773</u>	<u>\$ 1,387,092</u>

Project fund escrow 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

Financial assets available for general expenditure within one year of the consolidated balance sheet date consist of the following as of December 31, 2019 and 2018 (in thousands):

	<u>2019</u>	<u>2018</u>
Cash and cash equivalents	\$ 561,755	\$ 429,805
Patient accounts receivable, net of allowances	174,151	137,837
Assets limited as to use	773,986	703,095
	<u>\$ 1,509,892</u>	<u>\$ 1,270,737</u>

Children's Health's days cash on hand was 426 days and 363 days as of December 31, 2019 and 2018, respectively.

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 - Restricted Cash

Cash, cash equivalents, and restricted cash as reported in the consolidated statements of cash flows are presented separately within the consolidated balance sheet in the following asset classes as of December 31, 2019 and 2018 (in thousands):

	<u>2019</u>	<u>2018</u>
Cash and cash equivalents	\$ 566,163	\$ 430,405
Assets limited as to use or restricted	102,223	113,802
Total cash, cash equivalents and restricted cash	<u>\$ 668,386</u>	<u>\$ 544,207</u>

Note 10 - 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 assets 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 assumptions 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 of input that is significant to the fair value measurement 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 and private equity 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 Measurement*. The tables also do not include alternative investments held at the Foundation 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, 2019 (in thousands):

	<u>Total</u>	<u>Assets at Fair Value</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment portfolio:				
Cash and cash equivalents	\$ 102,223	\$ 102,223	\$ -	\$ -
U.S. government securities	84,552	84,552	-	-
Common stocks	85,611	85,611	-	-
Debt securities:				
Corporate bonds	112,712	3,151	109,561	-
Mortgage-backed securities	3,540	-	3,540	-
Mutual funds:				
Registered:				
Domestic equity	4,827	4,827	-	-
International equity	34,550	34,550	-	-
Total investments at fair value	\$ 428,015	\$ 314,914	\$ 113,101	\$ -
Investments recognized at net asset value:				
Common/collective trusts:				
Domestic equity	165,840			
International equity	226,439			
Fixed income	39,145			
Hedge funds	569,967			
Private equity	168,135			
Total investment portfolio	1,597,541			
Included in short-term investments	-			
Total assets limited to use	\$ 1,597,541			
Receivable from remainder trusts	\$ 61			



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			

The tables above include equity investments in managed funds held at the Foundation. Remaining alternative investments in managed funds held by Children's Health of \$4,231,723 and \$0 at December 31, 2019 and 2018, respectively, are not included in this table since they are accounted for using the equity method of accounting.

Long-Term Debt

ASC Topic 825, *Financial Instruments*, requires disclosure of fair value information, whether or not recognized on the consolidated balance sheets, 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 \$492.2 million at December 31, 2019, compared to \$481.6 million at December 31, 2018. The carrying value of long-term debt was \$440.1 million at December 31, 2019, compared to \$452.8 million at December 31, 2018. Estimates are based on available market quotes, for comparably rated debt instruments, which constitute a Level 2 estimate.



Note 11 - Operating Leases

Children's Health leases office space and certain equipment under operating lease agreements that extend through 2031. Operating lease and rental expenses were approximately \$17.9 million and \$18.5 million as of December 31, 2019 and 2018, respectively, and is included in general support in the accompanying consolidated statements of operations. Lease liabilities arising from the initial recognition of new lease ROU assets during 2019 were approximately \$1.9 million. As of December 31, 2019, the weighted average discount rate was 3.0% and the weighted average remaining lease terms was 3.3 years for operating leases.

The minimum future obligations under these agreements are as follows (in thousands):

	As of
	<u>December 31, 2019</u>
2020	\$ 16,102
2021	14,779
2022	14,090
2023	13,822
2024	12,568
Thereafter	29,317
Total minimum lease payments	<u>100,678</u>
Less: amount of lease payments representing interest	<u>(11,651)</u>
Present value of future minimum lease payments	89,027
Less: current obligations under leases	<u>(15,820)</u>
Long-term lease obligations	<u><u>\$ 73,207</u></u>



Note 12 - Long-Term Obligations

Long-term obligations consist of the following as of December 31, 2019 and 2018 (in thousands):

	<u>2019</u>	<u>2018</u>
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
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%	23,575	30,720
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 \$4.3 million note, 4.17% interest	14,485	15,044
	<u>413,870</u>	<u>423,174</u>
Unamortized bond premium/issue costs, net	26,188	29,643
Less current portion	<u>(10,614)</u>	<u>(9,639)</u>
	<u>\$ 429,444</u>	<u>\$ 443,178</u>

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.

Unamortized bond premium/discount, net of issue costs of \$26.2 million and \$29.6 million at December 31, 2019 and 2018, 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>
2020	\$ 9,980	\$ 634	\$ 10,614
2021	10,480	661	11,141
2022	10,940	689	11,629
2023	11,300	719	12,019
2024	11,865	749	12,614
Thereafter	344,820	11,033	355,853
	<u>\$ 399,385</u>	<u>\$ 14,485</u>	<u>\$ 413,870</u>

Note 13 - 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 2020.

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 2019 and 2018, Children’s Health made contributions to the Savings Plan of \$28.5 million and \$25.9 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, 2019 and 2018 (in thousands):

	2019	2018
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year	\$ 258,465	\$ 245,226
Interest costs	3,045	9,367
Actuarial loss	6,711	17,931
Benefits paid	(151,294)	(14,059)
Annuity purchase	(115,158)	-
Projected benefit obligation, end of year	<u>\$ 1,769</u>	<u>\$ 258,465</u>
Change in plan assets:		
Fair value of plan assets, beginning of year	224,787	219,978
Actual return on plan assets	20,812	(7,732)
Employer contributions	21,285	26,600
Benefits paid	(151,294)	(14,059)
Annuity purchase	(115,158)	-
Fair value of plan assets, end of year	<u>\$ 432</u>	<u>\$ 224,787</u>
Funded status, end of year	<u>\$ (1,337)</u>	<u>\$ (33,678)</u>

Amounts recognized in the consolidated balance sheets as of December 31, 2019 and 2018 consist of the following (in thousands):

	2019	2018
Other current liabilities	\$ 1,337	\$ 33,678

The net periodic pension cost as of December 31, 2019 and 2018 includes the following components (in thousands):

	2019	2018
Net periodic benefit expense:		
Interest costs	\$ 3,045	\$ 9,367
Expected return on plan assets	(2,763)	(12,252)
Amortization of net actuarial loss	6,440	3,650
Net periodic benefit expense:	<u>6,722</u>	<u>765</u>
Recognized settlement loss ¹	71,590	3,245
Total cost	<u>\$ 78,312</u>	<u>\$ 4,010</u>

¹ Settlement expense was recognized in 2019 and 2018 as lump-sum retirement elections exceeded the total service and interest cost for the period.



At December 31, 2019, the Plan's target allocation is 100% cash and cash equivalents.

	Target Asset Allocation	Plan Assets at December 31,			
		2019		2018	
Cash and cash equivalents	100.0 %	\$ 430	99.5 %	\$ 5,468	2.4 %
Common stocks	-	2	0.5	2	0.0
US government securities ¹	-	-	-	20,323	9.0
Debt securities ¹	-	-	-	105,144	46.8
Common / collective trusts ¹	-	-	-	86,921	38.7
Hedge funds	-	-	-	6,929	3.1
	<u>100.0 %</u>	<u>\$ 432</u>	<u>100.0 %</u>	<u>\$ 224,787</u>	<u>100.0 %</u>

¹ U.S. government securities and common / collective trusts target allocation is included with debt securities
All plan assets at December 31, 2019 are categorized as Level 1 investments.

At December 31, 2019 and 2018, the Plan's investment in alternative investments of zero and \$6.9 million, respectively, were included in hedge funds. As described in Note 10, 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	86,921	86,921	-	-
Subtotal	217,858	\$ 112,714	\$ 105,144	\$ -
Investments recognized at net asset value:				
Hedge funds	6,929			
Total	\$ 224,787			

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, \$1.8 million, are expected to be paid in 2020.



Other changes in plan assets and benefit obligations recognized in changes in unrestricted net assets for the years ended December 31, 2019 and 2018 are as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Net (gain) loss	\$ (11,338)	\$ 37,914
Amortization of net actuarial loss	(6,440)	(3,650)
Recognized settlement loss	(71,590)	(3,245)
Total recognized changes in net assets without donor restrictions	<u>\$ (89,368)</u>	<u>\$ 31,019</u>

Amounts in net assets without donor restrictions that have not been recognized in net periodic benefit cost, as of December 31, 2019 and 2018 consist of the following (in thousands):

	<u>2019</u>	<u>2018</u>
Net actuarial (gain)/loss	\$ (466)	\$ 88,902

The net gain 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 \$0.5 million.

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

	<u>2019</u>	<u>2018</u>
Net periodic benefit costs:		
Discount rate ¹	3.14% / 2.14%	3.90%
Expected long-term rate of return on plan assets ²	3.30% / 0.00%	5.70%
Compensation increase rate	N/A	N/A

¹ The discount rate assumption for determining net periodic pension cost for 2019 was 3.14% from January 1, 2019 to September 30, 2019 and 2.14% from October 1, 2019 to December 31, 2019.

² The expected return on asset assumption for determining net periodic pension cost for 2019 was 3.30% from January 1, 2019 to September 30, 2019 and 0.00% from October 1, 2019 to December 31, 2019.

	<u>2019</u>	<u>2018</u>
Benefit obligations and funded status:		
Discount rate	N/A	3.14%
Compensation increase rate	N/A	N/A



Note 14 - Net Assets with Donor Restrictions

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

	<u>2019</u>	<u>2018</u>
Patient care	\$ 83,184	\$ 71,210
Construction	15,039	14,236
Research	87,285	80,629
Education	7,071	6,195
Equipment	1,132	2,356
Time-restricted	612	2,232
Plano campus	2,561	4,378
General operations and other	64,328	56,501
	<u>\$ 261,212</u>	<u>\$ 237,737</u>

Note 15 - Accrued Liabilities

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

	<u>2019</u>	<u>2018</u>
Accrued salaries and benefits	\$ 51,317	\$ 37,742
Accrued paid time-off	45,792	43,797
Accrued medical claims payable, including premium deficiency reserve	34,868	49,062
Third-party settlement payable	19,260	7,551
Other	798	993
	<u>\$ 152,035</u>	<u>\$ 139,145</u>

Note 16 - 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 \$4.2 million and \$2.8 million, as of December 31, 2019 and 2018, respectively. 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 \$12.0 million and \$11.5 million as of December 31, 2019 and 2018, respectively.

Note 17 - Commitments and Contingencies

Under terms of an agreement, as amended, originally dated October 29, 1964, and most recently renewed on October 1, 2019, 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. As discussed in Note 19, Children's Health participated in the 1115 Waiver program which funds the UC and DSRIP pools and other programs from which modified supplemental payments are made to providers. In order to qualify for these funds, an application is filed annually and amounts received are subject to audit and review. Management estimates amounts subject to adjustment and potential recoupment under these programs.

Children's Health continues to upgrade and improve its facilities, as well as its information technology ("IT") capabilities and infrastructure. For the year ended December 31, 2019, outstanding commitments for construction are approximately \$38.2 million, outstanding commitments for equipment are approximately \$2.6 million, and outstanding commitments for IT-related projects are approximately \$7.5 million.

At December 31, 2019, Children's Health had unfunded commitments to fund private equity investments totaling \$179.3 million.

Note 18 - Professional Liability

The net amount of Children's Health's professional liability was \$24.6 million as of December 31, 2019 and \$24.1 million as of December 31, 2018. 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 \$31.1 million, in other noncurrent liabilities in the consolidated balance sheets and an asset representing insurance recoveries of \$6.5 million in other assets in the consolidated balance sheets at December 31, 2019 and \$33.2 million, in the other noncurrent liabilities portion of the consolidated balance sheet and an asset representing insurance recoveries of \$9.1 million in other assets in the consolidated balance sheet at December 31, 2018.

Note 19 - 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), the STAR+PLUS program (the managed care program for disabled and chronically ill patients) and the STAR Kids program (managed care program, that began on November 1, 2016, to provide Medicaid benefits to children and adults ages 20 years and younger who have disabilities). Under these programs, the state pays capitated health insurance premiums to Medicaid Managed Care Organizations (MCOs) for Medicaid-eligible insureds who elect to obtain coverage, and the MCOs negotiate payment rates with hospitals and other providers for care provided to their enrollees.



Children's Health also receives funding from 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 DSH, UC, DSRIP, the Children's Hospital Graduate Medical Education ("CHGME") program, and the Uniform Hospital Rate Increase Program ("UHRIP").

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

In 2011, the State of Texas secured a Section 1115 Medicaid waiver, which exempted the state from certain federal Medicaid requirements for the five-year period ending September 1, 2016. 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 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 Children's Health 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 the federal government.

The State of Texas subsequently secured an amendment to the waiver to extend the waiver for another 15 months to December 31, 2017. In December 2017, The State of Texas and the federal Centers for Medicare and Medicaid Services ("CMS") agreed to an 1115 Waiver extension effective January 1, 2018 through September 30, 2022. Under the terms of the agreement, CMS will provide Texas five additional years of UC funding. Due to a change in federal policy, beginning in September 2019, hospitals are required to report uncompensated care in a way that limits UC to charity care and eliminates Medicaid shortfall from the calculation. Children's hospitals were adversely impacted, because Medicaid shortfall makes up a large portion of their uncompensated care. Under the waiver extension, the DSRIP program is phasing out, with decreases beginning in October 2019, and funding completely eliminated by October 2021.

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

The State of Texas has approval from CMS to implement UHRIP for hospital services provided to patients enrolled in the STAR and STAR+PLUS Medicaid Managed Care programs. A rollout of UHRIP across Service Delivery Areas ("SDAs") was initiated in 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 for hospital payments and was subsequently increased to 21% beginning September 2019.

Revenue received through the waiver program is recorded as components of net patient service revenue over the applicable demonstration year. Determination of payments due from these programs are based on estimates made by management with the assistance of various consultants and advisors. These applications are periodically examined by government agencies which could result in significant recoupment for amounts previously received. Given the complexity and variability of the ultimate determination of payments made to CHST under the waiver Program, management records reserves and allowances until ultimate review, audit or settlement of these amounts.



Revenue for the DSH, DSRIP and UC programs was \$35.3 and \$95.6 million for the year ending December 31, 2019 and 2018, respectively, and are included net patient service revenue. The revenue for CHGME was \$8.2 and \$7.2 million for the year ending December 31, 2019 and 2018, respectively, and is included in other revenue.

Note 20 - Functional Expenses

Functional expenses for the year ended December 31, 2019 were as follows (in thousands):

	Health Care Services			Support Services		Total
	Hospital	Physician Services	Health Plan	MG&A	Fundraising	
Salaries and benefits	\$ 488,869	\$ 107,403	\$ 30,523	\$ 172,179	\$ 7,766	\$ 806,740
Physician and provider costs	117,240	22,977	-	-	-	140,217
Medical supplies	185,347	2,917	-	(248)	-	188,016
Medical plan expenses	-	-	191,018	-	-	191,018
General support	129,221	16,829	13,456	139,630	3,221	302,357
Depreciation and amortization	65,344	4,044	362	27,802	365	97,917
Interest	14,429	194	-	-	-	14,623
	<u>\$ 1,000,450</u>	<u>\$ 154,364</u>	<u>\$ 235,359</u>	<u>\$ 339,363</u>	<u>\$ 11,352</u>	<u>\$ 1,740,888</u>

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

	Health Care 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 21 - Charity Care

The value of charity care provided by Children’s Health, based upon its established rates was \$45.1 million and \$37.5 million for the year ended December 31, 2019 and 2018, respectively. 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 \$15.6 million and \$13.4 million for the years ended December 31, 2019 and 2018, respectively.

Note 22 - 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 23 - Significant Transactions

On January 10, 2019, Children's Health purchased two physician practices dedicated to Pediatric Cardiology: Pediatric Heart Specialists in Dallas and Pediatric Cardiology Associates of Houston for \$18.9 million, resulting in the recognition of goodwill of \$18.1 million. The goodwill resulting from these purchases is being amortized in accordance with ASU 2019-06.

Children's Health purchased 72.24 acres of land located in Prosper, Texas on April 16, 2019 as a future development site for \$50.9 million. Children's Health is committed to investing in the North Texas community, and is expanding its high-quality health care to the town of Prosper and the surrounding areas of Collin and Denton counties. Future plans for the site include offering pediatric health care services to create a community medical campus.

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 19, 2020



OBLIGATED GROUP
Combining Balance Sheet
As of December 31, 2019
(in thousands)

	CHST	CHCO	Foundation	Eliminations	Combined
ASSETS					
CURRENT ASSETS					
Cash and cash equivalents	\$ 448,561	\$ (3,671)	\$ 24,362	\$ -	\$ 469,252
Patient accounts receivable, net of allowances	(1)	150,836	-	-	150,835
Pledges receivable, net of allowances	-	-	8,261	-	8,261
Inventories	5,982	17,129	-	-	23,111
Other current assets	68,475	11,107	405	-	79,987
TOTAL CURRENT ASSETS	523,017	175,401	33,028	-	731,446
Pledges receivable, net of allowances	-	-	8,758	-	8,758
Receivables from remainder trusts	-	-	61	-	61
Property and equipment, net	86,785	874,941	1,691	(85)	963,332
Assets limited as to use	-	40,060	1,544,248	-	1,584,308
Net assets of the Foundation	-	1,576,114	-	(1,576,114)	-
Right-to-use asset	87,439	-	1,103	-	88,542
Other assets	251,648	30,528	8,791	(8,850)	282,117
TOTAL ASSETS	\$ 948,889	\$ 2,697,044	\$ 1,597,680	\$ (1,585,049)	\$ 3,658,564
LIABILITIES AND NET ASSETS					
CURRENT LIABILITIES					
Accounts payable	\$ 22,934	\$ 114,911	\$ 508	\$ -	\$ 138,353
Accrued liabilities	27,972	69,139	794	-	97,905
Accrued interest	-	6,557	-	-	6,557
Current portion of long-term debt	-	9,980	-	-	9,980
Current portion of lease obligations	15,678	-	141	-	15,819
Other current liabilities	63,226	1,337	-	(8,850)	55,713
TOTAL CURRENT LIABILITIES	129,810	201,924	1,443	(8,850)	324,327
Long-term debt, net of current portion	-	425,778	-	-	425,778
Lease obligations, net of current portion	72,212	-	996	-	73,208
Other noncurrent liabilities	36,455	457	6,298	-	43,210
Intercompany	1,485,572	(1,794,431)	12,829	199,133	(96,897)
NET ASSETS					
Without donor restrictions	(775,160)	2,267,745	1,334,359	(199,218)	2,627,726
With donor restrictions	-	1,595,571	241,755	(1,576,114)	261,212
TOTAL NET ASSETS	(775,160)	3,863,316	1,576,114	(1,775,332)	2,888,938
TOTAL LIABILITIES AND NET ASSETS	\$ 948,889	\$ 2,697,044	\$ 1,597,680	\$ (1,585,049)	\$ 3,658,564



OBLIGATED GROUP
Combining Statement of Operations
For the Year Ended December 31, 2019
(in thousands)

	CHST	CHCO	Foundation	Eliminations	Combined
OPERATING REVENUE					
Net patient services revenue	\$ 35,314	\$ 1,474,331	\$ -	\$ -	\$ 1,509,645
Other revenue	3,847	83,800	4,359	(1,030)	90,976
TOTAL OPERATING REVENUE	39,161	1,558,131	4,359	(1,030)	1,600,621
OPERATING EXPENSES					
Salaries and benefits	172,179	472,531	7,766	-	652,476
Physician and provider costs	10,150	172,717	-	-	182,867
Medical supplies	(249)	183,908	3	-	183,662
General support	209,660	55,887	4,249	(1,030)	268,766
Depreciation and amortization	27,811	64,600	365	(10)	92,766
Interest	-	14,429	-	-	14,429
Shared services	(374,949)	346,860	-	-	(28,089)
TOTAL OPERATING EXPENSES	44,602	1,310,932	12,383	(1,040)	1,366,877
INCOME (LOSS) FROM OPERATIONS	(5,441)	247,199	(8,024)	10	233,744
NON-OPERATING INCOME LOSS					
Realized investment (losses) gains	(773)	6,184	41,894	-	47,305
Unrealized investment gains (losses)	-	(3)	141,529	-	141,526
Net periodic pension costs	(78,354)	-	-	-	(78,354)
Other	(1,500)	(11,087)	-	-	(12,587)
TOTAL NON-OPERATING INCOME (LOSS)	(80,627)	(4,906)	183,423	-	97,890
NET INCOME (LOSS)	\$ (86,068)	\$ 242,293	\$ 175,399	\$ 10	\$ 331,634
Operating margin ¹					14.6%
Operating cash flow margin ²					21.3%

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, 2019 and 2018

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,	
	2019	2018
Weighted Average Beds in Service ¹	492	499
Inpatient Discharges	15,187	14,615
Inpatient Days	109,892	105,530
Average Length of Stay (days)	7.24	7.22
Patient Days (including observations)	134,429	128,765
Average Daily Census	368	353
Percentage Occupancy	75%	71%
Clinic Visits ²	394,853	512,743
Surgeries	27,561	27,523

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. 2018 has been restated to exclude ancillary visits.

Coverage of Debt Service Requirements
(in thousands)

	Years Ended December 31,	
	2019	2018
Income from operations	\$165,376	\$85,139
Depreciation and amortization expense	97,917	72,556
Interest expense	14,623	14,723
Realized investment gains	50,830	42,367
Consolidated revenues available for debt service ¹	\$328,746	\$214,785
Historical maximum annual debt service ²	29,813	29,813
Historical coverage of maximum annual debt service ³	11.0x	7.2x

¹ Excludes unrealized gain (loss) on investments.

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

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



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

	As of December 31,	
	2019	2018
Cash and cash equivalents	\$ 566,163	\$ 430,405
Short-term investments	-	-
Board designated investments	1,351,722	1,150,744
Total available cash and investments	\$ 1,917,885	\$ 1,581,149
Total debt ¹	\$ 440,058	\$ 452,817
Total operating expenses	\$ 1,740,888	\$ 1,663,908
Less: depreciation and amortization	97,917	72,556
Adjusted total operating expenses	\$ 1,642,971	\$ 1,591,352
Average daily operating expense ²	\$ 4,501	\$ 4,360
Days cash on hand ³	426	363
Debt-to-capitalization ⁴	15.3%	17.9%
Cash-to-debt ⁵	435.8%	349.2%

¹ Total debt includes unamortized bond premium/discount and other deferred financing costs of \$26.2 million and \$29.6 million as of December 31, 2019 and 2018, 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, 2019 and 2018.

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, 2019 and 2018, divided by adjusted total operating expenses less depreciation and amortization for such months.



**Payor Mix
All Campus**

	Years Ended December 31,	
	2019	2018
Medicare	1%	1%
Medicaid (Traditional)	9	9
Medicaid (Managed Care)	55	55
Commercial	32	32
Self-Pay	1	1
All Other	2	2

**Payor Mix
Dallas Campus**

	Years Ended December 31,	
	2019	2018
Medicare	1%	1%
Medicaid (Traditional)	10	10
Medicaid (Managed Care)	57	57
Commercial	29	29
Self-Pay	1	1
All Other	2	2

**Payor Mix
Plano Campus**

	Years Ended December 31,	
	2019	2018
Medicare	0%	0%
Medicaid (Traditional)	4	5
Medicaid (Managed Care)	47	46
Commercial	45	45
Self-Pay	2	2
All Other	2	2

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



Children's Health System of Texas and Affiliates
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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

Years Ended December 31, 2019 and 2018

	2019	2018	Change from Prior	% of Change
Inpatient discharges	15,187	14,615	572	3.9%
Patient days	109,892	105,530	4,362	4.1%
- ICU days	38,136	33,291	4,845	14.6%
ED visits	172,690	166,921	5,769	3.5%
Ambulatory visits	355,631	374,970	(19,339)	-5.2%
Professional services visits ¹	39,222	135,252	(96,030)	-71.0%
- CHPG visits	37,251	132,990	(95,739)	-72.0%
Surgeries	27,561	27,523	38	0.1%
Case mix index	2.53	2.56	(0.03)	-1.2%
- Medicaid case mix index	2.65	2.74	(0.09)	-3.3%
Payor mix:				
Commercial	32%	32%	-	0%
Medicaid (Traditional)	55%	55%	-	0%
Medicaid (Managed Care)	9%	9%	-	0%
Other	4%	4%	-	0%

¹2018 has been restated to exclude ancillary.

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 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 consolidated 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.



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Expenses

Health care is a very labor-intensive industry. For the years ended December 31, 2019 and 2018, salaries and benefits were 46% 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 include the costs associated with residents and the cost of contract labor, including medical administrative and physician coverage fees. For the years ended December 31, 2019 and 2018, professional services were 8% and 9% 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 years ended December 31, 2019 and 2018, respectively.

Plan medical expenses, which represent claims paid under the STAR Kids program, were 11% and 13% of the operating expenses for the years ended December 31, 2019 and 2018, 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 17% and 16% of the operating expenses for the years ended December 31, 2019 and 2018, respectively.

The depreciation and amortization expense category represents the cost of property and equipment, recognized over the estimated useful lives of the assets, as well as goodwill. Depreciation and amortization expense was 6% and 4% of the operating expenses for the years ended December 31, 2019 and 2018. Depreciation and amortization are computed using the straight-line method over a period of 3 to 40 years, based on the asset classification, and goodwill is amortized over 10 years.

The interest expense category represents the cost of financing the outstanding bond issues. Interest expense was 1% of the operating expenses for the years ended December 31, 2019 and 2018. For the years ended December 31, 2019 and 2018, no interest was capitalized.

Results of Operations

Operating income of \$165.4 million for the year ended December 31, 2019 represents a \$80.2 million (94%) increase, compared to the same period in 2018.

Net patient service revenue increased \$137.8 million (10%) for the year ended December 31, 2019, compared to the same period in 2018.

Children's Health's portion of the DSH program administered by the Texas Department of Human Services decreased by \$35.0 million (179%) for the year ended December 31, 2019, compared to the same period in 2018. The decrease is primarily due to changes to programs. 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 decreased by \$2.0 million (6%) for the year ended December 31, 2019, compared to the same period in 2018.

Children's Health provided charity care of \$45.1 million and \$37.5 million based on charges for the years ended December 31, 2019 and 2018, respectively.

The CHGME program receipts of \$8.2 million increased by \$1.0 million (14%) for the year ended December 31, 2019, compared to the same period in 2018.



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Premium revenue from the Medicaid STAR Kids program of \$272.1 million increased by \$6.0 million (2%) for the year ended December 31, 2019, compared to the same time period in 2018.

Other operating revenue increased by \$12.1 million (21%) for the year ended December 31, 2019, compared to the same time period in 2018.

Salaries and benefits increased \$35.7 million (5%) for the year ended December 31, 2019, compared to the same period in 2018. Salaries and benefits as a percentage of net patient service revenue were 52% and 55% for the years ended December 31, 2019 and 2018, respectively.

Professional services decreased \$7.9 million (5%) for the year ended December 31, 2019, compared to the same period in 2018. Professional services as a percentage of net patient service revenue were 9% and 11% for the years ended December 31, 2019 and 2018, respectively.

Supply costs increased \$19.2 million (11%) for the year ended December 31, 2019, compared to the same period in 2018. Supply costs as a percentage of net patient service revenue were 12% for the years ended December 31, 2019 and 2018.

Plan medical expenses decreased \$26.4 million (12%) for the year ended December 31, 2019, compared to the same period in 2018. 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 12% and 16% for the years ended December 31, 2019 and 2018, respectively.

General support increased \$31.2 million (12%) for the year ended December 31, 2019, compared to the same period in 2018. General support costs were 20% and 19% of net patient service revenue for the years ended December 31, 2019 and 2018, respectively.

Depreciation and amortization expense increased \$25.4 million (35%) for the year ended December 31, 2019, compared to the same period in 2018. As a percentage of net patient service revenue, depreciation and amortization expense was 6% and 5% for the years ended December 31, 2019 and 2018, respectively.

Interest expense decreased \$0.1 million (1%) for the year ended December 31, 2019, compared to the same period in 2018. As a percentage of net patient service revenue, interest expense was 1% for the years ended December 31, 2019 and 2018.

Investment income (realized and unrealized investment gains and losses) was a gain of \$192.4 million for the year ended December 31, 2019, compared to a loss of \$71.3 million for the year ended December 31, 2018.

Liquidity and Capital Resources

Children's Health continues to enjoy strong financial liquidity, with unrestricted cash and investments of \$1.9 billion or 426 days of cash expenses.

Net cash provided by operating and nonoperating activities was \$232.9 million for the year ended December 31, 2019, compared to net cash provided by operating and nonoperating activities of \$240.8 million for the same period in 2018.

Net cash used by investing activities was \$135.1 million for the year ended December 31, 2019, compared to net cash used by investing activities of \$79.5 million for the year ended December 31, 2018.

Net cash provided by financing activities was \$26.4 million for the year ended December 31, 2019, compared to net cash provided by financing activities of \$33.2 million for the same period in 2018.



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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.