

CONSOLIDATED FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION

Phoenix Children's Hospital and Affiliates
Years Ended December 31, 2019 and 2018
With Reports of Independent Auditors

Ernst & Young LLP



Phoenix Children’s Hospital and Affiliates

Consolidated Financial Statements and
Supplementary Information

Years Ended December 31, 2019 and 2018

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Report of Independent Auditors

The Board of Directors
Phoenix Children's Hospital and Affiliates

We have audited the accompanying financial statements of Phoenix Children's Hospital and Affiliates, which comprise the consolidated balance sheets as of December 31, 2019 and 2018, and the related consolidated statements of operations and 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 U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

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



Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Phoenix Children's Hospital and Affiliates as of December 31, 2019 and 2018, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Change in Accounting Principle

As discussed within Note 8 to the consolidated financial statements, Phoenix Children's Hospital and Affiliates changed its method of accounting for leases as a result of the adoption of the Financial Accounting Standards Board Accounting Standards Update No. 2016-02, *Leases (Topic 842)*, effective January 1, 2019. Our opinion is not modified with respect to this matter.

Ernst + Young LLP

May 1, 2020

Phoenix Children's Hospital and Affiliates

Consolidated Balance Sheets

(Dollars in Thousands)

	December 31	
	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 48,895	\$ 45,328
Short-term investments	609,542	508,015
Accounts receivable, net	166,815	143,976
Contributions receivable, net	8,198	6,583
Inventory	17,132	14,868
Other current assets	28,536	25,813
Total current assets	879,118	744,583
Assets limited as to use	176,634	154,684
Long-term contributions receivable, net	5,271	3,740
Operating lease right-of-use assets	114,296	—
Property and equipment, net	530,960	538,727
Other long-term assets	42,105	40,035
Total assets	\$ 1,748,384	\$ 1,481,769
Liabilities and net assets		
Current liabilities:		
Accounts payable, accrued liabilities, and other	\$ 114,697	\$ 98,542
Current portion of operating lease liabilities	10,870	—
Current portion of long-term debt	11,606	11,341
Total current liabilities	137,173	109,883
Operating lease liabilities, less current portion	115,241	—
Interest rate swap obligations	79,667	59,406
Long-term debt, less current portion	524,230	540,338
Other liabilities	85,288	85,312
Total liabilities	941,599	794,939
Net assets:		
Without donor restrictions:		
Controlling interest	729,700	615,918
Noncontrolling interest	2,269	4,206
Total without donor restrictions	731,969	620,124
With donor restrictions	74,816	66,706
Total net assets	806,785	686,830
Total liabilities and net assets	\$ 1,748,384	\$ 1,481,769

See accompanying notes.

Phoenix Children's Hospital and Affiliates

Consolidated Statements of Operations and Changes in Net Assets
(Dollars in Thousands)

	Year Ended December 31	
	2019	2018
Revenues:		
Net patient service revenue	\$ 957,609	\$ 856,713
Other operating revenue	45,526	28,745
Donations, gifts, and contributions	18,171	14,592
Net assets released from restrictions used for operations	11,207	9,346
	<u>1,032,513</u>	<u>909,396</u>
Expenses:		
Employee compensation and benefits	545,671	480,834
Supplies, purchased services, and professional fees	287,663	255,457
Operating and other expenses	48,646	44,367
Depreciation and amortization	49,637	49,438
Interest	26,649	26,757
	<u>958,266</u>	<u>856,853</u>
Income from operations	74,247	52,543
Other income (loss):		
Net investment income (loss)	60,987	(30,727)
Change in fair value of interest rate swaps	(20,261)	10,497
Loss on debt extinguishment	(1,998)	-
Total other income (loss)	<u>38,728</u>	<u>(20,230)</u>
Excess of revenues over expenses	112,975	32,313
Less excess of revenues over expenses attributable to noncontrolling interest	<u>2,219</u>	<u>1,605</u>
Excess of revenues over expenses attributable to Phoenix Children's Hospital and Affiliates	<u>110,756</u>	<u>30,708</u>

Phoenix Children's Hospital and Affiliates

Consolidated Statements of Operations and Changes in Net Assets (continued)
(Dollars in Thousands)

	Year Ended December 31	
	2019	2018
Net assets without donor restrictions:		
Controlling interest:		
Excess of revenues over expenses	\$ 110,756	\$ 30,708
Net assets released from restriction for purchase of property and equipment	5,591	2,337
Cumulative effect of change in accounting principle	(2,565)	–
Other	–	500
Change in controlling interest	<u>113,782</u>	<u>33,545</u>
Noncontrolling interest:		
Excess of revenues over expenses attributable to noncontrolling interest	2,219	1,605
Capital distribution to noncontrolling interest	(4,156)	–
Change in noncontrolling interest	<u>(1,937)</u>	<u>1,605</u>
Net assets with donor restrictions:		
Donations, gifts, and contributions	23,138	22,488
Net assets released from restrictions used for operations and purchase of property and equipment	(16,798)	(11,683)
Investment income	1,770	397
Change in net assets with donor restrictions	<u>8,110</u>	<u>11,202</u>
Change in net assets	119,955	46,352
Net assets, beginning of year	686,830	640,478
Net assets, end of year	<u>\$ 806,785</u>	<u>\$ 686,830</u>

See accompanying notes.

Phoenix Children's Hospital and Affiliates

Consolidated Statements of Cash Flows

(Dollars in Thousands)

	Year Ended December 31	
	2019	2018
Operating activities		
Change in net assets	\$ 119,955	\$ 46,352
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Provision for contributions receivable	665	(27)
Loss on debt extinguishment	1,998	–
Amortization of bond premium	(1,079)	(1,254)
Change in net unrealized gains and losses	(41,071)	69,046
Change in fair value of interest rate swaps	20,261	(10,497)
Depreciation and amortization	49,637	49,438
Cumulative effect of change in accounting principle	1,384	–
Restricted contributions received	(23,138)	(22,488)
Change in:		
Accounts receivable	(22,839)	(23,690)
Short-term investments	(86,112)	(48,544)
Inventory and other current assets	(8,798)	(10,441)
Other long-term assets	(2,070)	(302)
Accounts payable, accrued liabilities, and other	12,150	(5,504)
Operating lease liabilities, net of right-of-use assets	10,431	–
Other liabilities	470	(5,289)
Net cash provided by operating activities	<u>31,844</u>	<u>36,800</u>
Investing activities		
Purchase of property and equipment	(37,916)	(43,333)
Proceeds from assets held by trustee	171,424	31,288
Purchase of assets held by trustee	(159,419)	(32,718)
Net cash used in investing activities	<u>(25,911)</u>	<u>(44,763)</u>
Financing activities		
Proceeds from restricted contributions	23,138	22,488
Proceeds from issuance of bonds	159,250	–
Payments of bonds	(10,510)	(9,995)
Extinguishment of bonds	(150,000)	–
Debt issuance costs	(1,731)	–
Payments of notes payable	(14,214)	–
Net cash provided by financing activities	<u>5,933</u>	<u>12,493</u>
Increase in cash and cash equivalents	11,866	4,530
Cash, restricted cash, and cash equivalents, beginning of year	126,269	121,739
Cash, restricted cash, and cash equivalents, end of year	<u>\$ 138,135</u>	<u>\$ 126,269</u>
Supplemental disclosure of cash flow information		
Cash paid for interest	<u>\$ 27,478</u>	<u>\$ 26,699</u>
Supplemental disclosures of noncash investing and financing activity		
Increase in acquisitions of property and equipment included in accounts payable and other liabilities	<u>\$ 3,511</u>	<u>\$ 1,950</u>

See accompanying notes.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (In Thousands)

December 31, 2019

1. Organization and Operations

As Arizona's only licensed, freestanding, nonprofit children's hospital, Phoenix Children's Hospital (the Hospital) operates with the mission to provide hope, healing and the best healthcare for children and their families, as well as the vision that the Hospital will earn national recognition for pediatric care, innovative research, and medical education. The Hospital provides care to the state's pediatric patients in more than 75 subspecialties and includes 6 Centers of Excellence offering interdisciplinary care: the Center for Cancer and Blood Disorders; the Phoenix Children's Heart Center; the Barrow Neurological Institute at Phoenix Children's Hospital; the Center for Pediatric Orthopedics, a Level One Pediatric Trauma Center; and the Newborn Intensive Care Unit. The Hospital is one of the country's largest and busiest children's hospitals, with 457 licensed beds and a medical staff of nearly 1,000 practitioners.

In addition to the Hospital's main campus near downtown Phoenix, Arizona, the Hospital operates freestanding pediatric clinics throughout Arizona, including in Mesa, Gilbert, Scottsdale, Glendale, Avondale, Yuma, and Flagstaff. These pediatric clinics offer specialty care and advanced urgent care. Affiliates of the Hospital include the Phoenix Children's Hospital Foundation (the Foundation), Arizona Children's Risk Solutions (formerly Cambridge Arizona Insurance Company) (the Captive); Phoenix Children's Care Network (PCCN); Phoenix Children's Property Development, LLC (PCPD); and Phoenix Children's Cardiology Diagnostics, LLC (PCCD), collectively referred to as the Company.

The Hospital is a member-based Arizona nonprofit corporation exempt from income taxes under Internal Revenue Code (Code) Section 501(c)(3). The Hospital's members are Children's Healthcare of Arizona Inc. (the Parent), which holds a membership interest of 80% and Dignity Community Care (Dignity), wholly owned by Dignity Health, which holds member interest of 20%. In accordance with the affiliation agreement between the Hospital, the Parent, and Dignity (the Affiliation Agreement), the Hospital agreed to make future distributions of its available free cash flow, if any, in proportion to the Parent's and Dignity's membership interests, to the extent such distributions would not result in a violation of any Hospital debt covenants, and subject further to the Hospital Board of Directors' (the Board) approval of all distributions. The Affiliation Agreement enables the Hospital to request capital contributions from its members and specifies certain actions of the Hospital that require approval of the members. No distributions or capital contributions were made or required to be made during 2019 or 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

1. Organization and Operations (continued)

Beginning in 2026, and at each five-year period thereafter, pursuant to the Affiliation Agreement, each member has the right to put/call to the other member its outstanding membership interest based on the then-fair market value of the Hospital, as defined in the Affiliation Agreement. The put/call rights can also be exercised in the event of adverse changes at either member. Such put/call rights are considered to be embedded financial instruments in the Hospital membership interests, but do not meet the definition of a derivative and, therefore, have not been accounted for separately.

In 2017, the Hospital entered into an agreement with Dignity for the construction of a new Women's and Children's Pavilion on the Dignity Health Mercy Gilbert Medical Center campus, which will include labor and delivery and post-partum rooms and will have the capability to care for high-risk births and emergent pediatric services. Dignity will fund the construction and the Hospital will lease its portion of the space. In return, Dignity has the rights to a 33.0% interest in the available free cash flow of the project. The facility is expected to open in 2021.

The Foundation is operated for charitable, scientific, and educational purposes and, in accomplishment of such purposes, is administered for the benefit of the Hospital, the sole statutory member of the Foundation. Funds raised by the Foundation are used for clinical programs, charitable care coverage, research initiatives, capital programs, facility upgrades, community outreach, and support services.

The Captive, a subsidiary of the Hospital, provides captive insurance coverage to Phoenix Children's Hospital and related affiliates. The Captive specifically provides professional and general liability insurance pursuant to the provisions of Arizona Revised Statutes 20-1098, and has been approved by the State of Arizona Department of Insurance.

PCCN is a wholly owned networking contracting company and the only physician-led clinically integrated organization in Arizona devoted exclusively to children. PCCN is a limited liability company and was created by the Hospital to facilitate future efforts to jointly contract with payors, along with other area providers, to improve the quality and managing the cost of care.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

1. Organization and Operations (continued)

In 2014, the Hospital and APC Holdings, LLC, a wholly owned subsidiary of Obstetrix Medical Group of Phoenix, P.C., formed PCCD as a limited liability company to consolidate and expand its cardiology service line. The Hospital owns 62.5% of PCCD, with APC Holdings, LLC, owning the remaining 37.5%.

The Hospital owns 90.0% of PCPD, with the Foundation owning the remaining 10.0%. PCPD was formed as a limited liability company in 2014 to develop and own the assets associated with the build-out of the ninth floor of the Hospital tower pursuant to a New Markets Tax Credit financing, which closed in December 2014.

Chan Soon-Shiong Children's Precision Medicine Institute at Phoenix Children's Hospital, LLC (CSSCMI) was formed by the Hospital and a third party, CSSPMI Holdings, LLC, to use state-of-the-art genomic and proteomic technology to create targeted diagnoses, treatments, and cures for pediatric patients facing serious illnesses, such as cancer and other genetic-based pediatric diseases. The Hospital owns 49.0% of the business venture and records its investment using the equity method.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Hospital and its affiliates, the Foundation, the Captive, PCCN, PCPD, and PCCD. These entities are collectively referred to as the Company. The Company records the unrelated investor's share of the controlled business venture as noncontrolling interest on the accompanying consolidated financial statements. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States (U.S.) requires management to make estimates and assumptions that affect the amounts reported in assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the amounts of revenues and expenses reported during the period. Actual results could differ from those estimates.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents include certain highly liquid investments with a maturity of three months or less at the date of purchase, except those subject to restrictions which are reported as assets limited as to use on the consolidated balance sheets. The Company invests a portion of its surplus operating funds in money market and mutual funds. These funds generally invest in highly liquid U.S. government and U.S. government agency obligations.

The Company's cash, restricted cash, and cash equivalents consisted of the following:

	December 31	
	2019	2018
Cash and cash equivalents	\$ 48,895	\$ 45,328
Short-term investments	1,331	10,117
Assets limited as to use	87,909	70,824
Total cash, restricted cash, and cash equivalents	<u>\$ 138,135</u>	<u>\$ 126,269</u>

Investments and Investment Income

Investments in equity securities with readily determinable fair values and all investments in debt securities are presented at fair value. Short-term investments in certificates of deposit are recorded at amortized cost, which approximates market value.

The Company designates its investment portfolio as trading. Accordingly, investment income or loss, including realized and unrealized gains and losses on investments, interest, and dividends, is included in the excess of revenues over expenses, unless their use is restricted by the donor or by law. Investment and dividend income is recognized when earned.

Donor restricted investment income is reported as a change in net assets with donor restrictions on the consolidated statements of operations. Restricted amounts are reflected as net assets released from restrictions on the consolidated statements of operations and changes in net assets to the extent they become available for use during the period. Realized gains and losses are calculated based upon the specific cost of the investment.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Fair Value Measurements

Fair value is defined as an exit price and represents the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Financial assets and liabilities recorded at fair value on the consolidated balance sheets are categorized by the level of objectivity associated with the inputs used to measure their fair value. Fair value accounting guidance includes a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value.

The three levels are defined as follows:

Level 1 – Pricing inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities at the measurement date.

Level 2 – Pricing inputs are quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities.

Valuation Techniques. Assets and liabilities measured at fair value are based on one or more of the following techniques:

- (a) *Market approach.* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- (b) *Cost approach.* Amount that would be required to replace the service capacity of an asset or liability (replacement cost).
- (c) *Income approach.* Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option pricing, and excess earnings models).

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Inventory

Inventory, consisting primarily of medical supplies and pharmaceuticals, is stated at the lower of cost or net realizable value, utilizing the first-in, first-out method of accounting.

Assets Limited as to Use

Assets limited as to use include assets held by trustee for payment of bond obligations, amounts held by a commercial bank as collateral against mark-to-market adjustments in accordance with the Company's swap agreements, donor restricted endowment investments and charitable remainder trust investments, and Company-held retirement funds.

Derivative Instruments

The Company has various interest rate swaps used to manage the overall cost of borrowing. These interest rate swaps do not qualify as hedges. Derivatives that do not qualify as hedges must be adjusted to fair value through the consolidated statements of operations. Therefore, the changes in their fair values are recognized on the consolidated statements of operations within the excess of revenues over expenses. The derivative instruments and related collateral are recorded at gross fair value on the consolidated balance sheets.

Retirement Plans

401(k) Plan

The Company sponsors a defined contribution 401(k) plan (the Plan). For employees meeting certain eligibility requirements, the Plan permits each participant to contribute up to 30.0% of eligible compensation on a pretax basis, subject to federally mandated dollar maximums. Under the terms of the Plan, the Company is required to provide a matching contribution for employees who meet service eligibility requirements equal to a portion of the employee's contribution each year, up to a maximum of 4.0% of the employee's eligible compensation. Contributions by the Company totaled approximately \$13,075 in 2019, compared with \$11,240 in 2018. All participants are fully vested in the Plan.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

SERP Plan

The Hospital provides a deferred compensation plan (the SERP Plan) for the exclusive benefit of certain employees who are among a select group of management or highly compensated employees and have been selected by the Board. The Hospital contributes an amount equal to a percentage of the compensation paid to each participant during the plan year to the SERP Plan as indicated in the SERP Plan documents.

457 Plan

The Hospital provides an additional deferred compensation plan for a select group of management or highly compensated employees (the 457 Plan). The Hospital contributes an amount equal to a percentage of the compensation paid to each participant during the plan year for the benefit of each participant under the 457 Plan, as identified in the 457 Plan document or as determined, as it may be from time to time, by action of the Board.

Hospital contributions to the 457 Plan during 2019 totaled approximately \$5,091, compared with \$4,646 in 2018. At December 31, 2019, the 457 Plan investments, included within assets limited as to use, and liabilities, included within other liabilities, totaled approximately \$44,984, compared with \$33,833 at December 31, 2018.

Property and Equipment

Property and equipment are recorded at cost. Depreciation of property and equipment is calculated using the straight-line method over the estimated useful life of each class of depreciable asset. Equipment under capital lease obligations and leasehold improvements are amortized over the shorter period of the lease term or the estimated useful life of the asset. Such amortization is included in depreciation and amortization on the consolidated statements of operations. Interest cost incurred on borrowed funds during the period of construction, less interest income on qualified borrowed funds of capital assets, is capitalized as a component of the cost of acquiring those assets.

Costs incurred in the development and installation of software for internal use are expensed or capitalized, depending on whether they are incurred in the preliminary project stage, application development stage or post-implementation stage. Amounts capitalized are amortized over the useful life of the developed asset following project completion.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) *(Dollars in Thousands)*

Gifts of long-lived assets, such as land, buildings, or equipment, are reported as net assets without donor restrictions at fair value on the date of donation and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how long the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as net assets with donor restrictions. Absent explicit donor stipulations as to how long the long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Income Taxes

The Hospital, Foundation, and Captive are not-for-profit corporations that have been recognized as tax-exempt entities pursuant to Section 501(c)(3) of the Code. PCCN is disregarded for federal income tax purposes and any activity is reported on the tax return of the Hospital. PCPD and PCCD are treated as partnerships for federal income tax purposes. Management is of the opinion that substantially all of the Company's activities are related to their exempt purposes.

No material uncertain tax positions have been identified or recorded in the consolidated financial statements at December 31, 2019 or 2018. The Hospital, Foundation, and Captive each currently file a Form 990 in the U.S. federal jurisdiction and comparable forms in the state of Arizona. The Company is not subject to income tax examinations prior to 2016 in major tax jurisdictions.

Net Assets

Net assets are classified based on the existence or absence of donor imposed restrictions. Revenue and gains that are not restricted are included in net assets without donor restrictions. Net assets with donor restrictions are those whose use by the Company has been limited by donors to a specific time period or purpose. Net assets with donor restrictions also consist of endowment fund donations that have been restricted by donors to be maintained by the Foundation in perpetuity.

Contributions Receivable and Donor Restricted Gifts

Unconditional promises to give that are expected to be collected within one year are recorded at net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. The discounts on these amounts are computed using risk-free interest rates applicable to the years in which the promises are received. Conditional promises to give are not included as revenue until the conditions are

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

substantially met. The promises to give are reported as net assets with donor restrictions if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, either through the passage of time or fulfillment of purpose, these net assets are reclassified as net assets without donor restriction and are reported as net assets released from restrictions on the consolidated statements of operations and changes in net assets. Donor restricted contributions whose restrictions are met within the same year as received are reflected as revenue on the consolidated statements of operations and changes in net assets.

Endowments

The Foundation's endowment consists of individual donor restricted funds established for a variety of purposes. Management has interpreted the Uniform Prudent Management of Institutional Funds Act as requiring the preservation of the fair value of the original gift as of the gift date of the donor restricted endowment funds, absent explicit donor stipulations to the contrary. In this regard, the Foundation classifies the following as net assets with donor restrictions: the original value of gifts donated to the endowment, the original value of subsequent gifts to the endowment, and accumulations to the endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor restricted endowment fund is classified as net assets with donor restrictions until those amounts are specifically considered and appropriated for expenditure by the Foundation.

The Foundation's investment and spending policy for endowment assets attempts to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. To satisfy its long-term rate-of-return objectives, the Foundation relies on a total return strategy in which investment returns are achieved through both capital appreciation and current yield, thereby targeting a diversified asset allocation strategy that places a greater emphasis on equity-based investments. Actual returns in any given year may vary from the Foundation's estimated rate of return.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Net Patient Service Revenue

The Hospital records revenue over the period performance obligations are satisfied. Inpatient services are performance obligations satisfied over time. Unsatisfied or partially unsatisfied performance obligations relate to inpatient services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, usually within days or weeks of the end of the reporting period. Outpatient services are performance obligations satisfied over time: typically less than one day.

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated transaction price to reflect the total consideration expected to be received from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. If uninsured patients are unable or unwilling to pay for services provided, the Hospital records an implicit price concession to the uninsured patients in the period the services are provided based on historical collection.

The Hospital uses a portfolio approach to estimate the transaction price for categories of patient contracts as a collective group rather than recognizing revenue on an individual contract basis. The portfolios consist of major payor classes for inpatient revenue and outpatient revenue. Based on historical collection trends and other analyses, the Hospital believes that revenue recognized by utilizing the portfolio approach approximates the revenue that would have been recognized if an individual contract approach were used.

The transaction price, which involves significant estimates, is determined based on the Hospital's established charges with a reduction recorded for price concessions. The Hospital estimates the transaction price associated with services provided to patients who have third-party payor coverage based on the reimbursement terms outlined in contractual agreements and historical experience, and includes estimated retroactive revenue adjustments under the agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and such amounts are adjusted in future periods as final settlements are determined. For uninsured and under-insured patients who do not qualify for charity care, the Hospital determines the transaction price associated with services on the basis of charges reduced by

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

implicit price concessions. Implicit price concessions included in the estimate of the transaction price are based on the Hospital's historical collection experience for applicable patient portfolios. Patients who meet the Hospital's criteria for charity care are provided care without charge or at amounts less than established rates. Such amounts determined to qualify as charity care are not reported as revenue.

Laws and regulations governing Medicare and the Arizona Health Care Cost Containment System (AHCCCS) programs are complex and subject to interpretation. As a result, there is a reasonable possibility that actual results could differ from recorded estimates by a material amount in the near term. Amounts received from third-party payors in excess of expected reimbursement are reflected as third-party liabilities and are included in accounts payable and accrued liabilities on the consolidated balance sheets. Accounts receivable consist principally of amounts due for patient services rendered.

Charity and Uncompensated Care

The Hospital provides care to patients who meet certain criteria under its charity care policy, either without charge or at amounts less than its established rates. Costs of providing charity care are determined using an estimated cost to charge ratio. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, these amounts are excluded from patient service revenue.

The Hospital also provides services to other indigent patients under AHCCCS, which reimburses at amounts less than the cost of the services provided to the recipients. The difference between the cost of services provided to these indigent persons and the expected reimbursement is included in the estimated cost of uncompensated care. The Hospital receives supplemental funding from AHCCCS through disproportionate share hospital and graduate medical education payments.

Performance Indicator

The consolidated statements of operations and changes in net assets include the performance indicator as excess of revenues over expenses, which includes all the changes in net assets without donor restrictions other than contributions of long-lived assets (including assets acquired using contributions that, by donor restriction, were to be used for the purposes of acquiring such assets).

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Recently Issued Accounting Pronouncements

Following is a discussion of new accounting standards.

Leases (Topic 842): Codification Improvements. In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. (ASU) 2019-01, which requires the rights and obligations arising from lease contracts, including existing and new arrangements, to be recognized as assets and liabilities on the balance sheet. This accounting standard also requires additional disclosures about the amount, timing, and uncertainty of cash flows arising from leases. The Company adopted this ASU effective January 1, 2019, using the modified retrospective approach. Refer to Note 8 for further discussion.

Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments. In August 2016, the FASB issued ASU 2016-15, which applies to all entities that are required to present a statement of cash flows under Topic 230. ASU 2016-15 addresses the presentation and classification of cash flows related to certain matters pertaining to debt, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, distributions received from equity method investees, and certain other separately identifiable cash flows. The Company adopted this ASU for the year ended December 31, 2019, which did not have a material impact on the statement of cash flows.

Statement of Cash Flows (Topic 230): Restricted Cash. In November 2016, the FASB issued 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. This ASU requires that a statement of cash flows include the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The new standard is effective for the Company 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, restricted cash, and cash equivalents on the statements of cash flows by \$89,240, \$80,941, and \$81,491 as of December 31, 2019, December 31, 2018, and January 1, 2018, respectively.

Not-for-Profit Entities (Topic 958): Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made. In June 2018, the FASB issued ASU 2018-08, which clarifies and improves current accounting guidance in determining whether a transaction should be accounted for as a contribution or as an exchange transaction, and provides additional

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

guidance in determining if a contribution is conditional. This accounting standard is effective for the Company for annual reporting periods beginning after June 15, 2018, for contributions received and after December 15, 2018, for contributions made. The Company adopted this ASU effective January 1, 2019, which did not have a material impact on its consolidated financial statements.

Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. In January 2017, the FASB issued ASU 2017-04 to simplify the test used to evaluate goodwill and other intangibles for impairment. This ASU requires a company to perform its annual goodwill impairment test by comparing the fair value of the reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the impairment loss recognized should not exceed the total goodwill allocated to that reporting unit. A company will still have the option to perform the qualitative assessment for a reporting unit. This accounting standard is effective for fiscal years beginning after December 15, 2020. Management does not expect the adoption of this standard to have a material impact on its consolidated financial statements, which will be effective for the year ending December 31, 2021.

3. Concentrations of Credit Risk

The Company's consolidated financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash and cash equivalents, short-term investments, assets held by trustee, charitable remainder trusts and endowment investments, and patient accounts receivable.

The Company's cash and cash equivalents and restricted cash are held by large financial institutions and the Company's investment policy limits its exposure to concentrations of credit risk. In the normal course of business, the Company maintains cash balances in excess of the Federal Deposit Insurance Corporation's insurance limit. The Company routinely reviews the credit ratings of the financial institutions in which it holds funds; management believes that this related credit risk is minimal.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

3. Concentrations of Credit Risk (continued)

The mix of net accounts receivable from patients and third-party payors follows:

	December 31	
	2019	2018
AHCCCS	45%	43%
Contracted health care agreements	46	49
Other commercial payors	4	5
Self-pay and other	5	3
Total	100%	100%

4. Liquidity and Availability

The Company structures its financial assets to be available as its general expenditures, liabilities and other obligations come due. The Company also maintains a margin account collateralized by investments. As of December 31, 2019 and 2018, no balance was drawn against the margin account.

The Company's financial assets available for general expenditure within one year of the balance sheet date follow:

	December 31	
	2019	2018
Cash and cash equivalents	\$ 48,895	\$ 45,328
Short-term investments	609,542	508,015
Accounts receivable	166,815	143,976
Contributions receivable, net	2,218	851
Other current assets	6,571	—
Total financial assets	\$ 834,041	\$ 698,170

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

5. Investments and Assets Limited as to Use

At both December 31, 2019 and 2018, investments and endowment investments were composed of money market funds, mutual funds, and certificates of deposit.

Net investment income (loss) included in other income follows:

	December 31	
	2019	2018
Interest and dividend income, net	\$ 21,889	\$ 18,412
Realized (loss) gain on sales of securities	(1,973)	19,907
Change in net unrealized gain (loss)	41,071	(69,046)
Total investment income (loss) included in other income	<u>\$ 60,987</u>	<u>\$ (30,727)</u>

Assets limited as to use consist of the following:

	December 31	
	2019	2018
Assets held by trustee	\$ 28,456	\$ 40,461
Swap collateral	53,071	36,469
Donor restricted	47,098	41,367
Deferred compensation	48,009	36,387
Total assets limited as to use	<u>\$ 176,634</u>	<u>\$ 154,684</u>

The Foundation held approximately \$17,558 at December 31, 2019, in endowments classified as restricted, compared with \$12,609 at December 31, 2018. The endowment portfolio incurred net unrealized gains of approximately \$1,290 in 2019, and net unrealized losses of approximately \$2,044 in 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

5. Investments and Assets Limited as to Use (continued)

Assets held in trust by the third-party trustee were designated as follows:

	December 31	
	2019	2018
2012A Debt Service Reserve Fund	\$ 23,238	\$ 24,023
2013 Reserve Funds	4,940	15,614
2013 Interest Funds	197	651
2013 Revenue Funds	81	173
Total assets held in trust by third-party trustee	<u>\$ 28,456</u>	<u>\$ 40,461</u>

An independent third-party trustee, designated in the 2012A Loan and Trust Agreements under which the Hospital's Series 2012A Bonds were issued, is the custodian of certain assets designated under the Hospital's Series 2012A Bonds and the Hospital's Series 2013 A-1, 2013 A-2, 2013 A-3, and 2013B Bonds.

6. Contributions Receivable

Contributions receivable consisted of the following:

	December 31	
	2019	2018
Amounts due in:		
Less than one year	\$ 8,560	\$ 6,904
Greater than one year	7,519	5,562
Total	<u>16,079</u>	<u>12,466</u>
Less allowance for uncollectible contributions and present value discount	<u>(2,610)</u>	<u>(2,143)</u>
Contributions receivable, at net present value	13,469	10,323
Less current portion, at net present value	<u>(8,198)</u>	<u>(6,583)</u>
Long-term contributions receivable, at net present value	<u>\$ 5,271</u>	<u>\$ 3,740</u>

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

7. Property and Equipment

Property and equipment, by major category, consisted of the following:

	December 31	
	2019	2018
Land and land improvements	\$ 43,222	\$ 41,086
Buildings and improvements	628,155	617,368
Leasehold improvements	36,404	32,674
Equipment	257,141	235,371
Assets under lease arrangements	15,113	15,113
	980,035	941,612
Less accumulated depreciation and amortization	(466,400)	(418,742)
	513,635	522,870
Construction-in-progress	17,325	15,857
Net property and equipment	\$ 530,960	\$ 538,727

Accumulated amortization for property and equipment held under lease arrangements totaled approximately \$12,712 at December 31, 2019, compared with \$12,533 at December 31, 2018.

The Hospital capitalizes costs associated with software developed internally or obtained for internal use. Such capitalized costs (included in equipment) totaled approximately \$50,060 at December 31, 2019, compared with \$46,300 at December 31, 2018. Capitalized software development costs are amortized on a straight-line basis, based upon an estimated useful life of three to ten years for the related asset, beginning when the asset is ready for its intended use. Amortization of capitalized software development costs for the year ended December 31, 2019, totaled approximately \$3,948, compared with \$4,121 for the year ended December 31, 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

8. Leases

The Company leases office facilities, outpatient clinics, and equipment under operating and financing-type leases. Effective January 1, 2019, the Company adopted FASB ASU 2016-02, *Leases (Topic 842)*, which requires leases to be recognized on the consolidated balance sheet using the modified retrospective approach allowing it to apply the provisions of the updated lease guidance at the effective date, without adjusting the comparative period presented. ASU 2016-02 requires the rights and obligations arising from lease contracts to be recognized as assets and liabilities on the consolidated balance sheet.

The Company also elected to adopt certain transitional provisions for all existing leases as of January 1, 2019, which primarily related to not reassessing the lease classification as operating or finance as well as management's determination as to whether a contract contained a lease arrangement. The Company has elected to exclude non-lease components from the minimum rent payment used to calculate the right of use assets and liabilities. The Company uses a risk-free discount rate commensurate with the lease term to determine the present value of lease payments and rental escalation clauses and renewal options are factored into management's determination of lease payments, when appropriate.

Operating lease costs, included in operating expense on the consolidated statement of operations, are as follows:

	Year Ended December 31, 2019
Operating leases	\$ 11,089
Variable and short-term leases	2,639
Total operating lease costs	<u>\$ 13,728</u>

The Company paid \$11,151 for the year ended December 31, 2019, for lease liabilities recorded on the consolidated balance sheet and included in operating cash flows on the consolidated statement of cash flows. As of December 31, 2019, the weighted average discount rate used to determine operating lease obligation was 2.7% and the weighted average lease term was 21.9 years.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

8. Leases (continued)

The undiscounted cash flows reconciled to the operating lease obligation recorded on the consolidated balance sheet, are as follows:

	December 31, 2019
Total minimum lease payments	\$ 178,091
Less amount of lease payments representing interest	(51,980)
Present value of future minimum lease payments	126,111
Less current obligation under leases	(10,870)
Long-term lease obligations	\$ 115,241

The Company accounts for all rent holidays, tenant improvement allowances, and escalation clauses by recognizing the total operating lease rent expense on a straight-line basis over the term of each operating lease. Rent expense, included in operating expenses, totaled \$10,112 for the year ended December 31, 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

9. Long-Term Debt

The components of long-term debt, consisting of long-term bonds payable and long-term notes, are as follows:

	December 31	
	2019	2018
Series 2012A bonds	\$ 236,320	\$ 246,830
Series 2013A-1 bonds	–	75,000
Series 2013A-2 bonds	–	75,000
Series 2013A-3 bonds	75,000	75,000
Series 2013B bonds	50,000	50,000
Series 2019A bonds	79,625	–
Series 2019B bonds	79,625	–
Series 2012A bonds original issue premium	7,016	7,992
Series 2013B bonds original issue premium	2,795	2,898
Series 2012 unamortized debt issuance costs	(3,203)	(3,472)
Series 2013 unamortized debt issuance costs	(1,556)	(3,716)
Series 2019 unamortized debt issuance costs	(1,731)	–
Notes payable	11,945	26,147
	535,836	551,679
Less current portion of debt	(11,606)	(11,341)
Long-term debt, less current portion	\$ 524,230	\$ 540,338

In September 2012, the Hospital issued \$284,600 of Series 2012A Revenue Refunding Bonds (Series 2012A Bonds) through the Arizona Health Facilities Authority (the Authority). The Series 2012A Bonds are collateralized by substantially all of the Hospital's assets under, and pursuant to, a Master Trust Indenture (2012A MTI) dated September 1, 2012. The 2012A Bonds bear interest at a weighted average fixed rate of 4.6%. The Series 2012A Bonds mature on February 1, 2042. Amounts held in the debt service reserve fund are classified as assets limited as to use at December 31, 2019 and 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

9. Long-Term Debt (continued)

In February 2013, the Hospital issued three series of 2013A Revenue Refunding Bonds (Series A-1, A-2, and A-3, collectively, the Series 2013A Bonds) and issued Series 2013B Revenue Bonds (the Series 2013B Bonds) through the Authority. The Series 2013A Bonds and the Series 2013B Bonds are collectively referred to as the Series 2013 Bonds. The Series 2013A Bonds were issued for \$75,000 for each series and the 2013B Bonds were issued for \$50,000. The Series 2013A Bonds are variable rate and bear interest at the Securities Industry and Financial Markets Association (SIFMA) Index, a rate determined on the basis of the seven-day high grade market index of tax-exempt variable rate demand obligations, plus 1.85%. At December 31, 2019 and 2018, the interest rate for the Series 2013A Bonds was 3.5%. The 2013B Bonds bear interest at a weighted average fixed rate of 4.3%. All of the Series 2013 Bonds mature by February 1, 2048. The Series 2013 Bonds are equally collateralized with the Series 2012A Bonds by substantially all of the Hospital's assets under, and pursuant to, the 2012A MTI as supplemented by the Series 2013A and 2013B loan agreements.

In May 2019, the Hospital issued \$159,250 of Series 2019A and 2019B (the Series 2019 Bonds) Revenue Refunding Bonds through the Arizona Industrial Development Authority to refund and refinance \$150,000 of the then-outstanding Series 2013A-1 and Series 2013A-2 Bonds. As a result of the refunding and refinancing of the then-outstanding Series 2013A-1 and Series 2013A-2 Bonds, the Hospital recorded a loss on extinguishment of debt of \$1,998 in 2019. The Series 2019 Bonds are collateralized by substantially all of the Hospital's assets under, and pursuant to, a Master Indenture that was made and entered into as of May 1, 2019 (2019 MTI). The 2019 MTI supplemented and amended certain provisions of the 2012A MTI. The Series 2019 Bonds are daily variable rate and will mature by February 1, 2048. The 2019A and 2019B bonds are backed by five-year letters of credit that provide coverage for payment of principal and interest on the Series 2019 Bonds, including the purchase price of unremarketed tendered bonds. The letters of credit will provide for 49 days of interest at the 12% maximum rate with an anticipated expiration date of May 13, 2024. At December 31, 2019, the interest rates for the Series 2019A and 2019B Bonds were 1.7% and 1.6%, respectively.

In May 2019, upon the issuance of the Series 2019 Bonds, the Hospital refunded and refinanced the remaining \$14,214 outstanding from a non-revolving line of credit. The interest rate on this line of credit was the London Interbank Offered Rate (LIBOR) plus 0.9% and it was set to mature on February 1, 2020. The line of credit was originally entered into by the Hospital as a result of

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

9. Long-Term Debt (continued)

the Hospital exercising its option to purchase the facility in Avondale, Arizona, where it operates an ambulatory clinic and urgent care center, for \$12,835. The option was part of the operating lease agreement executed in 2013. Additional funds received under the line of credit were used for the buy-out of several equipment operating leases.

Future maturities of long-term debt are as follows:

2020	\$ 11,050
2021	17,690
2022	9,851
2023	10,308
2024	10,795
Thereafter	461,772
Unamortized net premiums and net issuance costs	2,764
Total	<u>\$ 524,230</u>

The 2012A MTI, Loan and Trust Agreements for the Series 2012A Bonds and Series 2013 Bonds, the 2019 MTI, and the Loan Agreements for the Series 2019A and 2019B Bonds contain certain restrictive covenants, including, but not limited to, the following: restriction of the incurrence of additional borrowings; maintenance of defined liquidity ratios, such as maximum annual debt service coverage ratio and days cash on hand ratio; maintenance of tax-exempt status; and the delivery of audited financial statements within 150 days of the Company's fiscal year-end. The Company is in compliance with all covenants as of December 31, 2019.

10. Interest Rate Swaps

In 2006, the Company entered into four forward-dated interest rate swaps. With the issuance of the Series 2013 Bonds (refer to Note 9), three swap agreements were amended to change the variable receiving rate component from LIBOR to the SIFMA Municipal Swap Index and increase the fixed payment rate for seven years. At the end of seven years, the payment rates for all amended swaps revert to the rates in effect prior to the amendment.

The first swap agreement hedges a notional amount of \$112,500 (the First Swap). As of the date of issuance of the Series 2013 Bonds, the fixed-rate portion was changed to 5.0%.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

10. Interest Rate Swaps (continued)

The second swap agreement hedges a notional amount of \$62,500 (the Second Swap). As of the date of the issuance of the Series 2013 Bonds, the fixed-rate portion of the swaps was changed to 4.8%.

The third swap hedges a notional amount of \$50,000 (the Third Swap). As of the date of the issuance of the Series 2013 Bonds, the fixed-rate portion of the swaps was changed to 4.8%.

The fourth swap is a basis swap with an initial notional amount of \$225,000 (the Basis Swap). The Hospital pays 67.0% of the one-month LIBOR plus 0.5% and receives 67.0% of the five-year USD ISDA Swap Rate plus 0.2% from the counterparty. The notional amount of the Basis Swap decreases over the term of the agreement.

The First Swap, Second Swap, and Third Swap all expire on February 1, 2042. The Basis Swap expires on January 5, 2041. All four of the Hospital's interest rate swap agreements require the Company to post collateral when the combined mark-to-market values of the swaps exceed a net liability threshold as determined by the Company's credit rating and the Company's days cash on hand ratio, up to a maximum posting threshold of \$80,000. The threshold was \$30,000 at December 31, 2019, compared with \$25,000 at December 31, 2018. At December 31, 2019, the Hospital had collateral outstanding with a counterparty of \$53,071, compared with \$36,500 at December 31, 2018. The collateral outstanding with a counterparty is included in assets limited as to use.

The fair value of the swaps is determined based on contractual terms and discounted at the prevailing swap curve on the respective valuation date. The mark-to-market adjustment for these swaps during 2019 resulted in a loss of approximately \$20,261, compared with a gain of \$10,500 during 2018, as presented on the accompanying consolidated statements of operations and changes in net assets. The net effect of the interest rate swaps recorded in interest expense was to increase the overall cost of borrowing in 2019 by approximately \$6,151, compared with \$4,800 in 2018. All of the Company's derivative instruments were in liability positions at both December 31, 2019 and 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

11. Fair Value

A summary of the Company's financial assets, included in short-term investments and assets limited as to use, and liabilities measured at fair value on a recurring basis follows:

December 31, 2019					
	Total	Level 1	Level 2	Level 3	Valuation Technique ¹
Assets					
Cash and cash equivalents	\$ 89,240	\$ 89,240	\$ —	\$ —	a
Mutual funds – domestic	445,735	445,735	—	—	a
Mutual funds – foreign	131,753	131,753	—	—	a
Government mortgage-backed securities	31,658	—	31,658	—	a
Corporate bonds	39,316	—	39,316	—	a
Foreign government obligations	1,028	—	1,028	—	a
U.S. government agency obligations	47,446	—	47,446	—	a
Total assets	<u>\$ 786,176</u>	<u>\$ 666,728</u>	<u>\$ 119,448</u>	<u>\$ —</u>	
Liabilities					
Interest rate swaps	\$ 79,667	\$ —	\$ 79,667	\$ —	c
Total liabilities	<u>\$ 79,667</u>	<u>\$ —</u>	<u>\$ 79,667</u>	<u>\$ —</u>	
December 31, 2018					
	Total	Level 1	Level 2	Level 3	Valuation Technique ¹
Assets					
Cash and cash equivalents	\$ 80,941	\$ 80,941	\$ —	\$ —	a
Mutual funds – domestic	351,940	351,940	—	—	a
Mutual funds – foreign	100,518	100,518	—	—	a
Common stock	8,968	8,968	—	—	a
Government mortgage-backed securities	20,744	—	20,744	—	a
Corporate bonds	20,109	—	20,109	—	a
U.S. government agency obligations	79,479	—	79,479	—	a
Total assets	<u>\$ 662,699</u>	<u>\$ 542,367</u>	<u>\$ 120,332</u>	<u>\$ —</u>	
Liabilities					
Interest rate swaps	\$ 59,406	\$ —	\$ 59,406	\$ —	c
Total liabilities	<u>\$ 59,406</u>	<u>\$ —</u>	<u>\$ 59,406</u>	<u>\$ —</u>	

¹ Refer to Note 1 for discussion and definitions of valuation techniques.

No financial instruments were subject to Level 3 fair value measurements in 2019 or 2018.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

11. Fair Value (continued)

Transfers to/from Levels 1, 2, and 3 are recognized at the end of the reporting period. There were no transfers between levels for the years ended December 31, 2019 or 2018. Significant observable inputs include municipal bonds, market credit reports, treasury yields, and maturity dates.

12. Restricted Net Assets

Net assets with donor restrictions were available for the following purposes:

	December 31	
	2019	2018
Subject to expenditure for a specified purpose:		
Patient care programs	\$ 48,454	\$ 44,977
Purchase of property and equipment	6,072	7,299
Charitable remainder trusts, net	328	232
	54,854	52,508
Subject to company spending policy and appropriation:		
Investments in perpetuity, which once appropriated, are expendable to support various hospital programs	19,962	14,198
Total net assets with donor restrictions	\$ 74,816	\$ 66,706

13. Net Patient Service Revenue

Approximately 44.5% and 45.0% of net patient service revenue as of December 31, 2019 and 2018, respectively, was derived from AHCCCS. Under this program, payment for certain services rendered to AHCCCS patients is reimbursed on a basis other than billed charges. The Hospital also provides services to the beneficiaries of certain other payors at amounts other than published rates. The difference between charges generated by patients and the amount reimbursable is reflected in net patient service revenue.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

13. Net Patient Service Revenue (continued)

The Hospital has determined that the nature, amount, timing, and uncertainty of revenue and cash flows are affected by the payors, the lines of business that render services to patients, and the timing of when revenue is recognized and billed. Net patient service revenue, by payor, follows:

	December 31	
	2019	2018
AHCCCS	\$ 426,009	\$ 385,925
Contracted health care agreements	412,351	381,284
Other commercial payors	14,583	15,017
Patients and other	104,666	74,487
Total net patient service revenue	<u>\$ 957,609</u>	<u>\$ 856,713</u>

Net patient service revenue recorded by patient type follows:

	December 31	
	2019	2018
Inpatient	\$ 500,649	\$ 425,013
Outpatient	316,073	308,389
Physician	140,887	123,311
Total net patient service revenue	<u>\$ 957,609</u>	<u>\$ 856,713</u>

The policy of the Hospital is to reflect disproportionate share funds, graduate medical education funding, and other AHCCCS supplemental payments in net patient service revenue. Management has made estimates and assumptions based on its past experience in these programs to determine the recorded revenue, but actual results may differ from the estimates.

The Hospital also recorded funding for graduate medical education from a federal program specific to children's hospitals totaling \$2,798 in 2019, compared with \$3,114 in 2018. The Hospital recorded \$38,228 in AHCCCS graduate medical education funding in 2019, compared with \$30,833 in 2018. The non-federal share of these amounts was funded by the University of Arizona and Valleywise Health Medical Center (formerly, Maricopa Integrated Health System) through an intergovernmental agreement with AHCCCS in accordance with Arizona Revised Statute § 36-2903.01(G)(9)(f).

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

13. Net Patient Service Revenue (continued)

The Hospital received additional AHCCCS funding through the Access to Professional Services Initiative (APSI), a program consisting of Medicaid Managed Care directed payments and non-federal funding. Beginning in October 2019, APSI increased its funding from a 40.0% increase from negotiated rates with AHCCCS to an 85.0% increase, paid in a lump sum rather than per claim.

Beginning in October 2019, the Hospital also began receiving funding from the Pediatric Services Initiative (PSI), which provides funding amounts 36.0% higher than negotiated rates with AHCCCS plans and is paid in lump-sum payments.

14. Charity and Uncompensated Care

In accordance with its mission and vision, the Hospital commits significant resources to promote the health and well-being of children and their families. The shortfall of reimbursements received from AHCCCS for the cost of providing medical care to AHCCCS patients is classified by the Hospital as uncompensated care, after applying proceeds of supplemental payments, to partially offset the costs not directly reimbursed. Unreimbursed costs for services and supplies provided under the Hospital's charity care policy, including uncompensated care, are as follows:

	December 31	
	2019	2018
Charity care	\$ 3,787	\$ 5,389
AHCCCS uncompensated cost of care, net of supplemental revenue	<u>92,365</u>	<u>80,946</u>
Total net charity and uncompensated care	<u>\$ 96,152</u>	<u>\$ 86,335</u>

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

15. Functional Expenses

The Company provides healthcare services and education and performs research. As a result of additional analysis of the characteristics of certain functional expenses during the preparation of the 2019 financial statement disclosures, the Company has reallocated expenses between functional classifications previously reported at December 31, 2018 to be consistent with the presentation at December 31, 2019. These changes had no impact on the accompanying consolidated financial statements. The following table presents operating expenses, as presented on the consolidated statements of operations by the Company's major operating functions and nature of the expense:

	Year Ended December 31, 2019					
	Healthcare Services	Research	Medical Education	General and Administrative	Fundraising	Total
Employee compensation and benefits	\$ 428,785	\$ 9,540	\$ 18,397	\$ 83,490	\$ 5,459	\$ 545,671
Supplies, purchased services, and professional fees	261,639	1,259	2,362	20,662	1,741	287,663
Operating and other expenses	38,323	427	1,769	6,254	1,873	48,646
Depreciation and amortization	-	-	-	49,637	-	49,637
Interest	26,649	-	-	-	-	26,649
Total functional expenses	<u>\$ 755,396</u>	<u>\$ 11,226</u>	<u>\$ 22,528</u>	<u>\$ 160,043</u>	<u>\$ 9,073</u>	<u>\$ 958,266</u>

	Year Ended December 31, 2018					
	Healthcare Services	Research	Medical Education	General and Administrative	Fundraising	Total
Employee compensation and benefits	\$ 382,204	\$ 8,890	\$ 16,917	\$ 67,496	\$ 5,327	\$ 480,834
Supplies, purchased services, and professional fees	233,725	810	2,265	17,208	1,449	255,457
Operating and other expenses	28,719	336	1,536	12,299	1,477	44,367
Depreciation and amortization	-	-	-	49,438	-	49,438
Interest	26,757	-	-	-	-	26,757
Total functional expenses	<u>\$ 671,405</u>	<u>\$ 10,036</u>	<u>\$ 20,718</u>	<u>\$ 146,441</u>	<u>\$ 8,253</u>	<u>\$ 856,853</u>

16. Commitments and Contingencies

Self-Insurance. The Hospital maintains insurance through a combination of purchased and self-insurance programs for professional malpractice, general liability, and employee health insurance claims. Under its self-insured professional malpractice and general liability programs, the Hospital contributes actuarially determined amounts to the Captive to fund estimated ultimate losses.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

16. Commitments and Contingencies (continued)

The self-insured, claims-made professional malpractice and general liability coverage has a limit of \$3,000 per claim and a \$12,000 annual aggregate. Claims in excess of this self-insured retention are insured through excess liability policies up to an aggregate of \$50,000. The Company has accrued the estimated cost of professional liability that is known and that has been incurred but not reported at both December 31, 2019 and 2018, based on amounts determined by independent actuarial consultants. The Company has recorded approximately \$29,671 as of December 31, 2019, on the consolidated balance sheets within current liabilities and other liabilities for this estimated professional liability, compared with \$30,361 as of December 31, 2018. As of December 31, 2019, the Company has recorded a receivable from excess insurance carriers for claims in excess of retained limits of \$4,485, compared with \$2,426 as of December 31, 2018. The Company discounted its receivable and liability at both December 31, 2019 and 2018, by 2.0% to reflect the ultimate payment pattern of claims.

The Company is involved in litigation arising during the normal course of business. There are known workers' compensation claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents arising from services provided to patients that may be asserted. However, management does not believe that the asserted or unasserted claims will exceed the total amount of insurance coverage.

Industry and Regulatory Environment. 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, and governmental health care program participation requirements; reimbursement for patient services; and Medicare fraud and abuse. 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 the Company is in compliance with fraud and abuse and other applicable government laws and regulations.

Phoenix Children's Hospital and Affiliates

Notes to Consolidated Financial Statements (continued) *(Dollars in Thousands)*

17. Subsequent Events

In December 2019, the novel coronavirus (COVID-19) was identified in China and began to spread to other geographic locations. The spread of COVID-19 has become an international public health emergency that has created significant capital market volatility, affected the economy in general, and the healthcare industry specifically. Due to the volatility in the economy and financial markets, the Company will likely experience decreased volumes and operating revenues and increased operating expenses, negatively impacting the Company's financial condition. In order to provide flexibility for the ongoing working capital needs of the organization, management negotiated a \$75,000 line of credit with a financial institution, of which no draws have been initiated to date. Management will continue monitor market and business conditions and to mitigate potential losses.

The Company evaluated events after December 31, 2019, and through May 1, 2020, the date the financial statements were issued, and determined any events or transactions occurring during this period that would require recognition or disclosure are appropriately addressed in these financial statements.

Supplementary Information



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Report of Independent Auditors on Supplementary Information

The Board of Directors
Phoenix Children's Hospital and Affiliates

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements of Phoenix Children's Hospital and Affiliates as of December 31, 2019 and 2018, and for the years then ended, taken as a whole. The accompanying 2019 and 2018 consolidating balance sheets and statements of operations and changes in net assets are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the 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 consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Ernst + Young LLP

May 1, 2020

Phoenix Children's Hospital and Affiliates

Consolidating Balance Sheets
(Dollars in Thousands)

	December 31, 2019							December 31, 2018						
	PCH	Captive	Foundation	PCCD	PCPD	Eliminations	Total	PCH	Captive	Foundation	PCCD	PCPD	Eliminations	Total
Assets														
Current assets:														
Cash and cash equivalents	\$ 41,398	\$ 1,434	\$ 3,015	\$ 624	\$ 2,424	\$ -	\$ 48,895	\$ 40,332	\$ 1,429	\$ 1,869	\$ 148	\$ 1,550	\$ -	\$ 45,328
Short-term investments	609,191	-	351	-	-	-	609,542	507,458	-	557	-	-	-	508,015
Accounts receivable, net	166,815	-	-	-	-	-	166,815	143,976	-	-	-	-	-	143,976
Contributions receivable, net	-	-	8,198	-	-	-	8,198	-	-	6,583	-	-	-	6,583
Inventory	17,132	-	-	-	-	-	17,132	14,868	-	-	-	-	-	14,868
Other current assets	25,975	1,710	832	19	-	-	28,536	21,545	3,508	599	30	131	-	25,813
Due (to) from affiliates	(102,685)	32,102	64,663	6,229	(309)	-	-	(101,833)	29,473	60,677	11,822	(139)	-	-
Total current assets	757,826	35,246	77,059	6,872	2,115	-	879,118	626,346	34,410	70,285	12,000	1,542	-	744,583
Assets limited as to use	129,536	-	47,098	-	-	-	176,634	113,317	-	41,367	-	-	-	154,684
Long-term contributions receivable, net	-	-	5,271	-	-	-	5,271	-	-	3,740	-	-	-	3,740
Operating lease right-of-use assets	142,704	-	793	-	14,887	(44,088)	114,296	-	-	-	-	-	-	-
Property and equipment, net	521,437	-	-	95	9,428	-	530,960	528,116	-	-	247	10,364	-	538,727
Other long-term assets	43,815	1,662	149	-	-	(3,521)	42,105	43,407	-	149	-	-	(3,521)	40,035
Total assets	\$ 1,595,318	\$ 36,908	\$ 130,370	\$ 6,967	\$ 26,430	\$ (47,609)	\$ 1,748,384	\$ 1,311,186	\$ 34,410	\$ 115,541	\$ 12,247	\$ 11,906	\$ (3,521)	\$ 1,481,769
Liabilities and net assets														
Current liabilities:														
Accounts payable, accrued liabilities, and other	\$ 109,890	\$ 3,606	\$ 285	\$ 916	\$ -	\$ -	\$ 114,697	\$ 93,870	\$ 3,075	\$ 693	\$ 891	\$ 13	\$ -	\$ 98,542
Current portion of operating lease liabilities	12,174	-	201	-	613	(2,118)	10,870	-	-	-	-	-	-	-
Current portion of long-term debt	11,606	-	-	-	-	-	11,606	11,341	-	-	-	-	-	11,341
Total current liabilities	133,670	3,606	486	916	613	(2,118)	137,173	105,211	3,075	693	891	13	-	109,883
Operating lease liabilities, less current portion	142,441	-	812	-	14,517	(42,529)	115,241	-	-	-	-	-	-	-
Interest rate swap obligations	79,667	-	-	-	-	-	79,667	59,406	-	-	-	-	-	59,406
Long-term debt, less current portion	512,284	-	-	-	11,946	-	524,230	528,404	-	-	-	11,934	-	540,338
Other liabilities	64,556	20,621	111	-	-	-	85,288	64,167	20,694	125	-	326	-	85,312
Total liabilities	932,618	24,227	1,409	916	27,076	(44,647)	941,599	757,188	23,769	818	891	12,273	-	794,939
Net assets (deficit):														
Without donor restrictions:														
Controlling interest	645,930	12,681	70,915	3,782	(646)	(2,962)	729,700	537,398	10,641	64,617	7,150	(367)	(3,521)	615,918
Noncontrolling interest	-	-	-	2,269	-	-	2,269	-	-	-	4,206	-	-	4,206
Total without donor restrictions	645,930	12,681	70,915	6,051	(646)	(2,962)	731,969	537,398	10,641	64,617	11,356	(367)	(3,521)	620,124
With donor restrictions	16,770	-	58,046	-	-	-	74,816	16,600	-	50,106	-	-	-	66,706
Total net assets (deficit)	662,700	12,681	128,961	6,051	(646)	(2,962)	806,785	553,998	10,641	114,723	11,356	(367)	(3,521)	686,830
Total liabilities and net assets	\$ 1,595,318	\$ 36,908	\$ 130,370	\$ 6,967	\$ 26,430	\$ (47,609)	\$ 1,748,384	\$ 1,311,186	\$ 34,410	\$ 115,541	\$ 12,247	\$ 11,906	\$ (3,521)	\$ 1,481,769

Phoenix Children's Hospital and Affiliates

Consolidating Statements of Operations and Changes in Net Assets
(Dollars in Thousands)

	Year Ended December 31, 2019							Year Ended December 31, 2018						
	PCH	Captive	Foundation	PCCD	PCPD	Eliminations	Total	PCH	Captive	Foundation	PCCD	PCPD	Eliminations	Total
Revenues:														
Net patient service revenue	\$ 957,609	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 957,609	\$ 856,713	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 856,713
Other operating revenue	46,099	6,840	-	8,732	1,568	(17,713)	45,526	29,190	6,506	-	6,724	1,568	(15,243)	28,745
Donations, gifts, and contributions	-	-	18,171	-	-	-	18,171	-	-	14,592	-	-	-	14,592
Net assets released from restrictions used for operations	11,207	-	-	-	-	-	11,207	9,346	-	-	-	-	-	9,346
	1,014,915	6,840	18,171	8,732	1,568	(17,713)	1,032,513	895,249	6,506	14,592	6,724	1,568	(15,243)	909,396
Expenses:														
Employee compensation and benefits	536,271	-	6,990	2,410	-	-	545,671	472,228	-	6,401	2,205	-	-	480,834
Supplies, purchased services, and professional fees	293,420	99	2,580	241	-	(8,677)	287,663	259,512	92	2,322	72	-	(6,541)	255,457
Operating and other expenses	49,661	4,705	2,627	12	677	(9,036)	48,646	46,595	3,720	2,063	14	677	(8,702)	44,367
Depreciation and amortization	48,537	-	-	152	948	-	49,637	48,295	-	-	152	991	-	49,438
Interest	26,427	-	-	-	222	-	26,649	26,535	-	-	-	222	-	26,757
	954,316	4,804	12,197	2,815	1,847	(17,713)	958,266	853,165	3,812	10,786	2,443	1,890	(15,243)	856,853
Income (loss) from operations	60,599	2,036	5,974	5,917	(279)	-	74,247	42,084	2,694	3,806	4,281	(322)	-	52,543
Other income (loss):														
Net investment income (loss)	60,478	4	505	-	-	-	60,987	(30,600)	-	(127)	-	-	-	(30,727)
Change in fair value of interest rate swaps	(20,261)	-	-	-	-	-	(20,261)	10,497	-	-	-	-	-	10,497
Loss on debt extinguishment	(1,998)	-	-	-	-	-	(1,998)	-	-	-	-	-	-	-
Total other income (loss)	38,219	4	505	-	-	-	38,728	(20,103)	-	(127)	-	-	-	(20,230)
Excess (deficiency) of revenues over expenses	98,818	2,040	6,479	5,917	(279)	-	112,975	21,981	2,694	3,679	4,281	(322)	-	32,313
Less excess of revenues over expenses attributable to noncontrolling interest	-	-	-	2,219	-	-	2,219	-	-	-	1,605	-	-	1,605
Excess (deficiency) of revenues over expenses attributable to Phoenix Children's Hospital and Affiliates	98,818	2,040	6,479	3,698	(279)	-	110,756	21,981	2,694	3,679	2,676	(322)	-	30,708

Phoenix Children's Hospital and Affiliates

Consolidating Statements of Operations and Changes in Net Assets (continued)
(Dollars in Thousands)

	Year Ended December 31, 2019						Year Ended December 31, 2018							
	PCH	Captive	Foundation	PCCD	PCPD	Eliminations	Total	PCH	Captive	Foundation	PCCD	PCPD	Eliminations	Total
Net assets without donor restrictions:														
Controlling interest:														
Excess (deficiency) of revenue over expenses	\$ 98,818	\$ 2,040	\$ 6,479	\$ 3,698	\$ (279)	\$ -	\$ 110,756	\$ 21,981	\$ 2,694	\$ 3,679	\$ 2,676	\$ (322)	\$ -	\$ 30,708
Net assets released from restriction for purchase of property and equipment	5,591	-	-	-	-	-	5,591	2,337	-	-	-	-	-	2,337
Cumulative effect of change in accounting principle	(2,943)	-	(181)	-	-	559	(2,565)	-	-	-	-	-	-	-
Other	7,066	-	-	(7,066)	-	-	-	500	-	-	-	-	-	500
Change in controlling interest	108,532	2,040	6,298	(3,368)	(279)	559	113,782	24,818	2,694	3,679	2,676	(322)	-	33,545
Noncontrolling interest:														
Excess of revenues over expenses attributable to noncontrolling interest	-	-	-	2,219	-	-	2,219	-	-	-	1,605	-	-	1,605
Capital distribution to noncontrolling interest	-	-	-	(4,156)	-	-	(4,156)	-	-	-	-	-	-	-
Change in noncontrolling interest	-	-	-	(1,937)	-	-	(1,937)	-	-	-	1,605	-	-	1,605
Net assets with donor restrictions:														
Donations, gifts, and contributions	2,220	-	20,918	-	-	-	23,138	5,972	-	16,516	-	-	-	22,488
Net assets released from restrictions used for operations and purchase of property and equipment	(2,050)	-	(14,748)	-	-	-	(16,798)	(1,850)	-	(9,833)	-	-	-	(11,683)
Investment income	-	-	1,770	-	-	-	1,770	-	-	397	-	-	-	397
Change in net assets with donor restrictions	170	-	7,940	-	-	-	8,110	4,122	-	7,080	-	-	-	11,202
Change in net assets (deficit)	108,702	2,040	14,238	(5,305)	(279)	559	119,955	28,940	2,694	10,759	4,281	(322)	-	46,352
Net assets, beginning of year	553,998	10,641	114,723	11,356	(367)	(3,521)	686,830	525,058	7,947	103,964	7,075	(45)	(3,521)	640,478
Net assets, end of year	\$ 662,700	\$ 12,681	\$ 128,961	\$ 6,051	\$ (646)	\$ (2,962)	\$ 806,785	\$ 553,998	\$ 10,641	\$ 114,723	\$ 11,356	\$ (367)	\$ (3,521)	\$ 686,830

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