



**Texas Children's<sup>®</sup>**

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Fiscal 2017 Annual Report

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# who we are

Texas Children's is a not-for-profit organization located in the Texas Medical Center in Houston, Texas. It is comprised of several entities, ranging from general pediatric care to obstetric and gynecological services. It also includes the country's first pediatric health maintenance organization, as well as a foundation which is the holder of investments administered for the sole benefit of Texas Children's Hospital. Through the combination of these entities, we create a healthier future for children and women throughout our global community by leading in patient care, education, and research.



# what we do



We drive innovation and focus relentlessly on positive outcomes. We believe in leading tirelessly every day so that we can extend our reach around the globe to find new and improved ways to help children and women get the care they deserve. We are never restricted by what has been done before, and we embrace the freedom to discover better methods. We create medical breakthroughs not just for today, but for years to come. We succeed when faced even with the most difficult cases through cross-disciplinary expertise and collaboration to improve outcomes and overall quality of life for our patients. We invest millions in education to ensure we have the best team to bring our mission to life. At Texas Children's, our patients and their families are at the heart of everything we do.

# where we're going

We opened the doors to our hospital in 1954 and have grown tremendously. We started with a three-story pediatric hospital, which has grown to be a multi-building pediatric campus in the Texas Medical Center. In addition, Texas Children's has expanded its line of service to provide obstetrics and gynecological care, as well as a pediatric facility in west Houston and The Woodlands. In fiscal year 2018 we plan to open the expansion of Legacy Tower in the Texas Medical Center. The 25-floor Legacy Tower will house 126 beds for pediatric and cardiovascular intensive care, six new operating rooms (ORs) with the latest technology to complement the hospital's existing 19 ORs, and will be the new home of Texas Children's Heart Center, including the outpatient clinic, four cardiovascular ORs and four catheterization labs. This vertical expansion will help reinvest in the programs needed to provide the highest level of care to our most critically ill patients. Texas Children's also plans to expand our pediatric and OB/GYN services into Austin, beginning with the opening of a welcome center, followed by a pediatric urgent care clinic by spring 2018.



*Texas Children's, 1954*



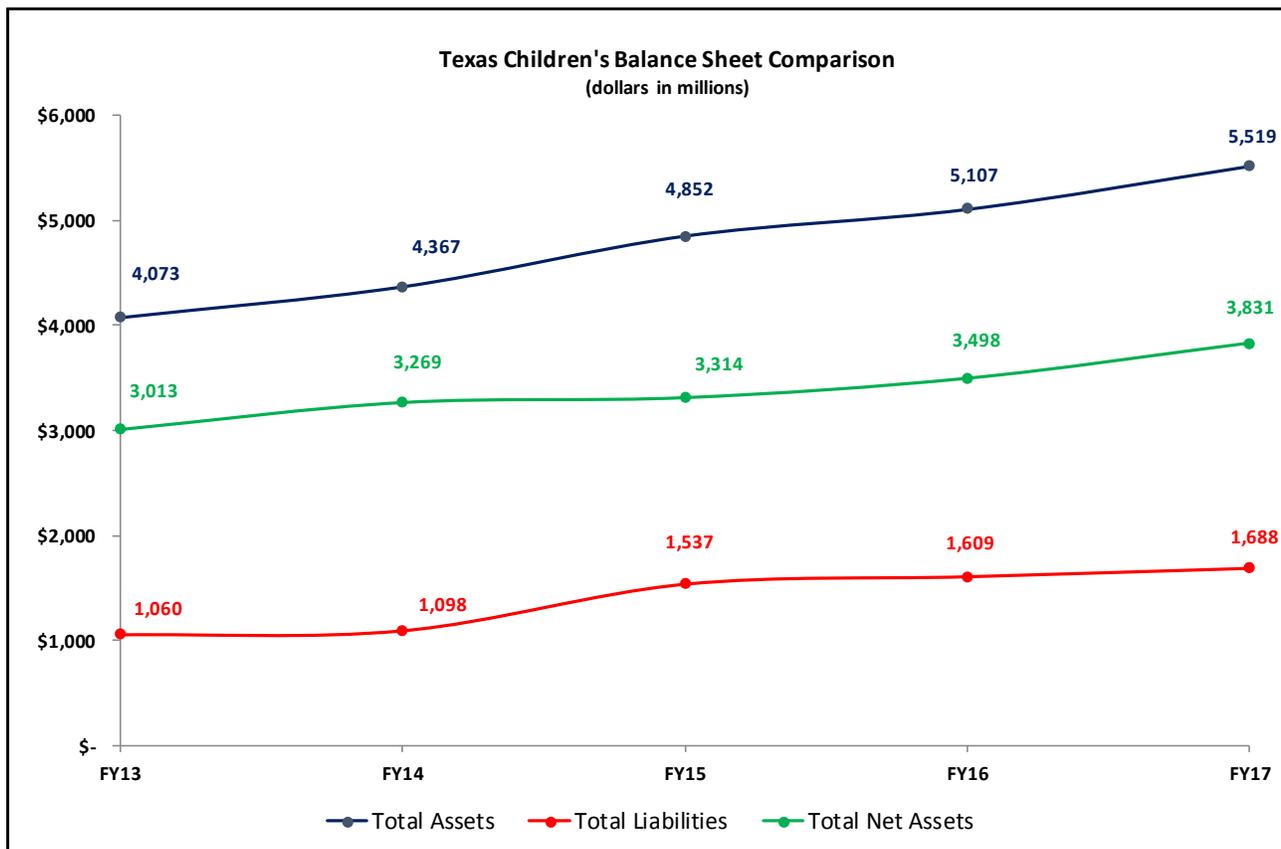
*Texas Children's, 2016*

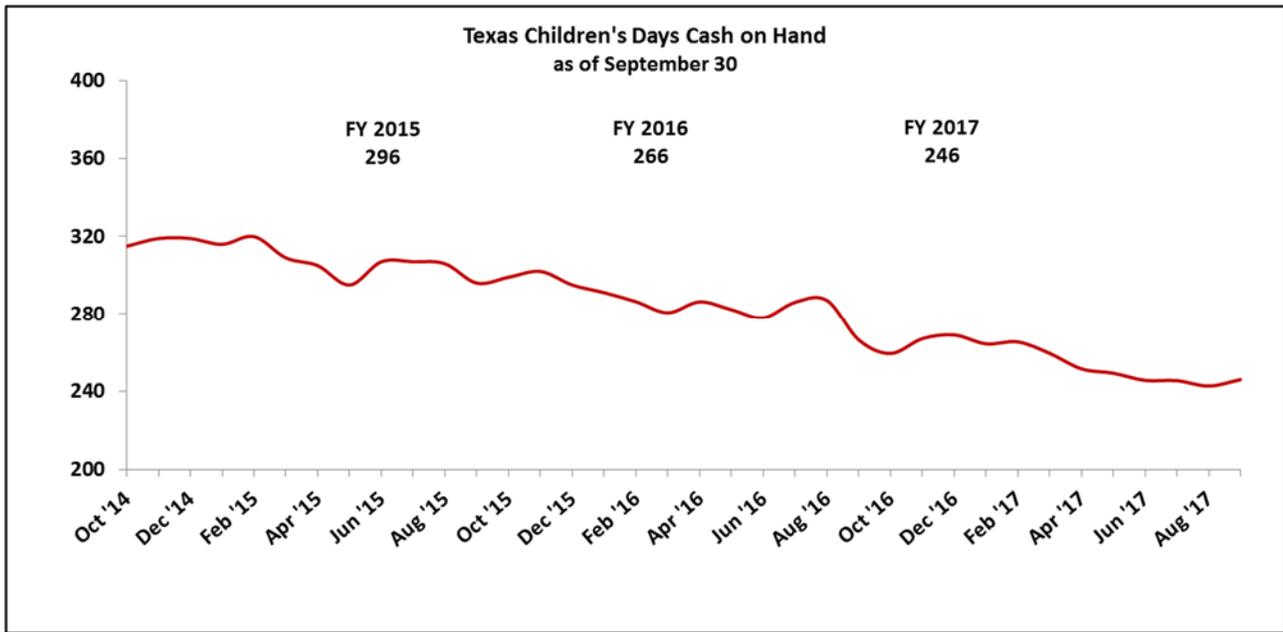
## U.S. News & World Report

The 2017-18 edition of Best Children’s Hospitals by *U.S. News & World Report* ranked Texas Children’s Hospital fourth in the country among the nearly 200 pediatric centers. For the ninth straight year, Texas Children’s Hospital was placed on the Best Children’s Hospital Honor Roll of best pediatric institutions. Texas Children’s is one of only 10 children’s hospitals across the country to achieve the Honor Roll designation, and the only hospital in Texas – and the southern U.S. – awarded this distinction. Over the last decade, no other pediatric hospital in the state has ever achieved an overall ranking as high as Texas Children’s. Each year, in addition to ranking pediatric hospitals overall, *U.S. News & World Report* also ranks the top 50 pediatric hospitals across 10 major subspecialties. This year, Texas Children’s Heart Center ranks as the best cardiology and heart surgery service in the country, and six other subspecialties were ranked in the top five.

## Financial Results – Texas Children’s

Texas Children’s balance sheet remains strong. As of September 30, 2017, total assets were \$5.52 billion and debt to capitalization was 21.6%. Days cash on hand was 246 as of September 30, 2017, a 20 day decrease from prior year end. This decrease was expected and was the result of expansion projects, both at Texas Children’s Medical Center campus and The Woodlands campus.





For the twelve months ended September 30, 2017, Texas Children's operating margin was \$15.6 million, which was a \$30.0 million decrease compared to prior year. Texas Children's Hospital's operating results improved from prior year, however, this was offset by losses generated by Texas Children's Health Plan. Texas Children's operating cash flow margin, which is calculated by adding back interest, depreciation, and amortization costs to operating income, was \$195.8 million, which was a decrease of \$2.5 million from prior year end.

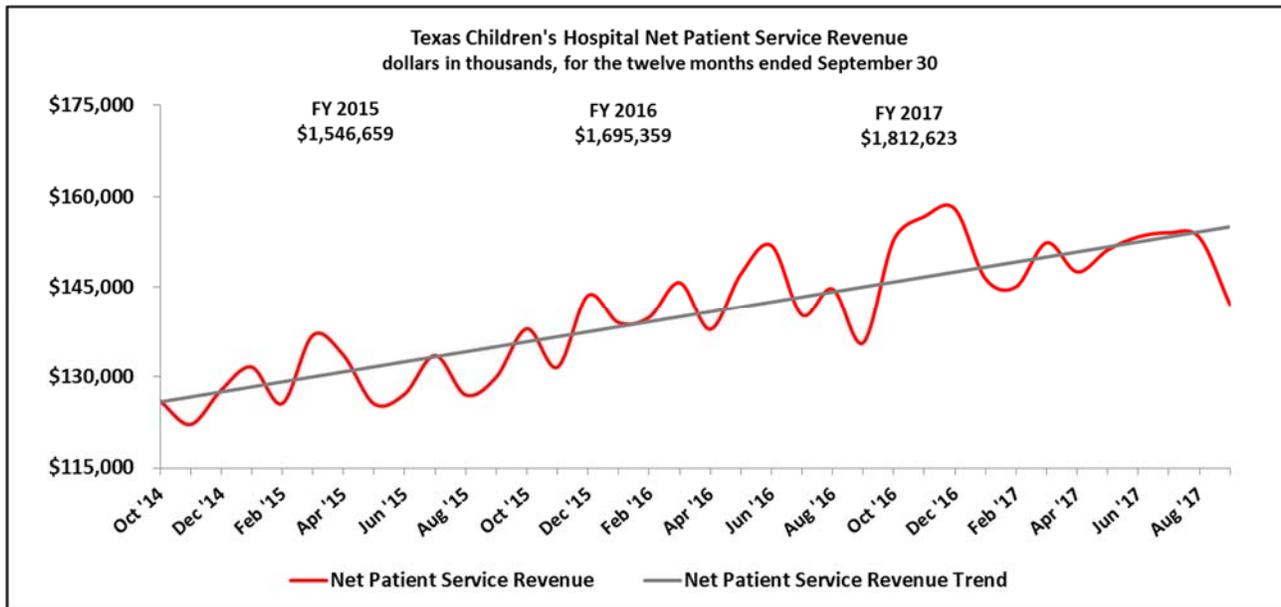
Hurricane Harvey had a negative impact on Texas Children's financial results in August and September of 2017. The storm forced closures of outpatient and clinic locations, and limited patient access to inpatient locations, resulting in reductions to patient volumes and net patient revenue. The closures resulted in fewer employee hours worked; however, a significant amount of premium labor expense was incurred at inpatient locations to compensate staff who remained on-site throughout the storm. Management estimates the storm resulted in \$21.0 million of lost net patient revenue, \$13.0 million of incremental salary expense, and \$1.0 million in property damage, resulting in a net margin impact of \$35.0 million. Texas Children's has a comprehensive insurance program that provides coverage for property damage and business interruption impact, and management expects to recover a portion of its financial losses.

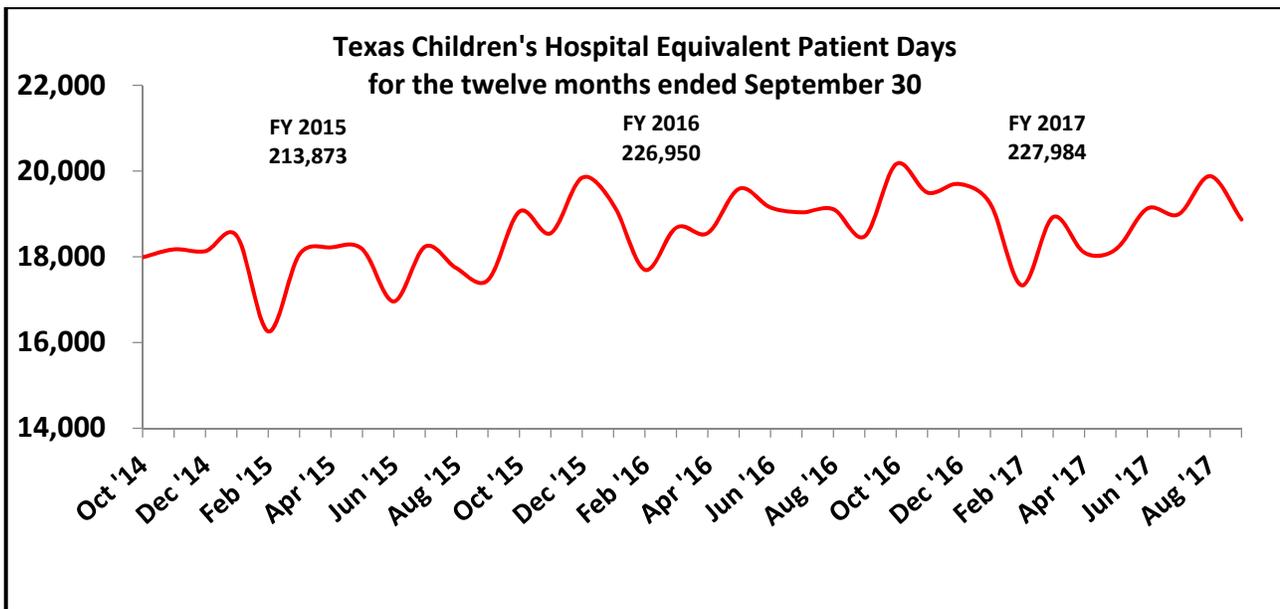
## Financial Results – Texas Children’s Hospital

Texas Children’s Hospital’s operating margin was \$83.9 million for the twelve months ended September 30, 2017, an increase of \$14.6 million or 21.1% from prior year. The growth in operating revenue of 8.6% outpaced the 8.1% growth in operating expenses in fiscal year 2017.

For the twelve months ended September 30, 2017, net patient service revenue increased \$117.3 million, or 6.9%, compared to prior year. The Medical Center campus, West campus and The Woodlands campus accounted for \$74.0 million, \$13.8 million, and \$62.3 million, respectively, of this increase. This was partially offset by Women’s Services net patient revenue, which decreased by \$32.8 million from prior year, primarily due to a 7.6% decrease in delivery volumes. This trend has been observed throughout the Houston market. During the twelve months of fiscal year 2017, acute and other care equivalent patient days increased 759 or 0.6%, while special care days increased 275 or 0.3%, driven mainly by The Woodlands campus. Surgery cases and surgery hours also increased 5.1% and 5.2%, respectively, compared to prior year.

Texas Children’s Woodlands campus, which opened inpatient operations in April 2017, has already exceeded revenue projections. For the twelve months ended September 30, 2017, The Woodlands campus net patient revenue was \$3.6 million or 4.9% favorable to budget.

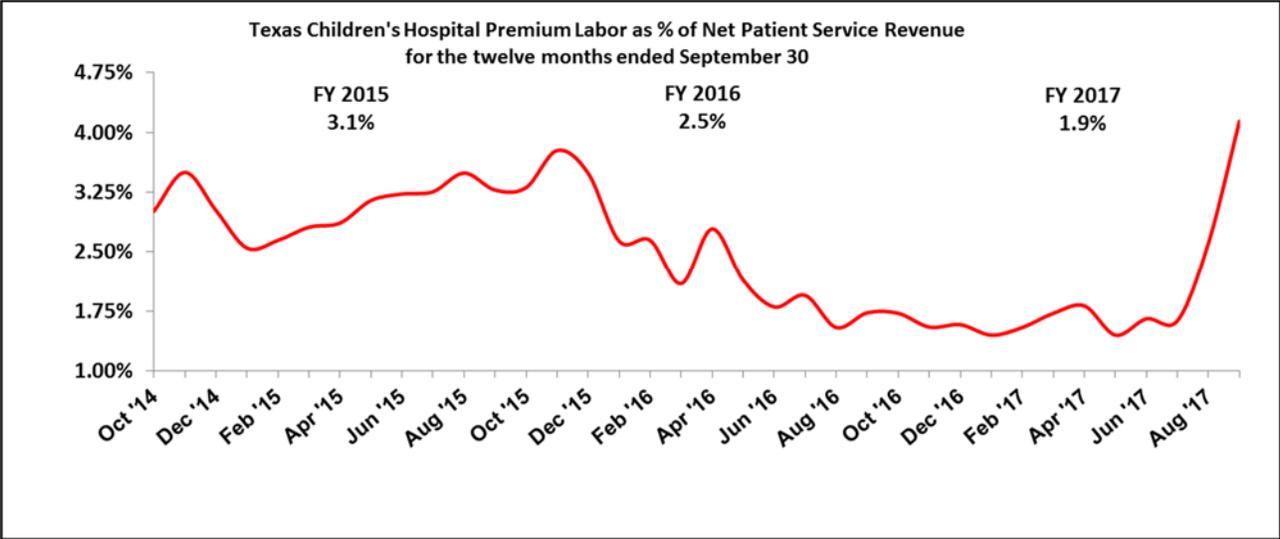
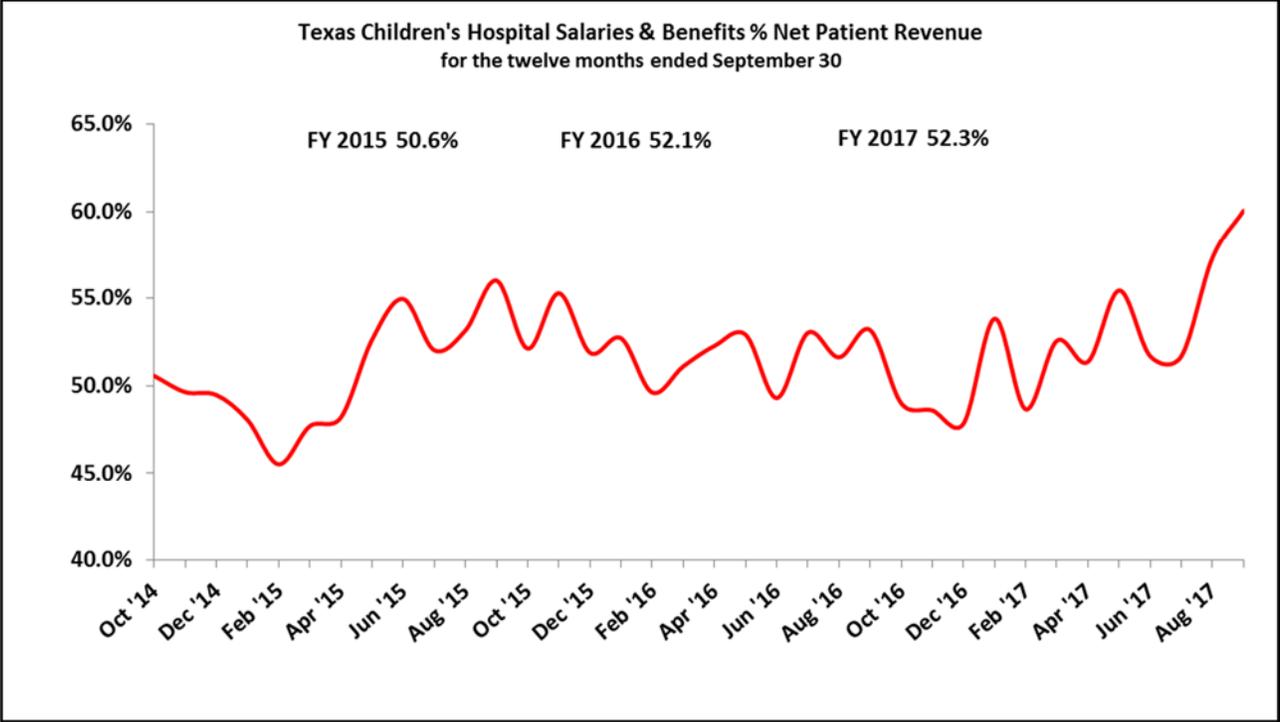




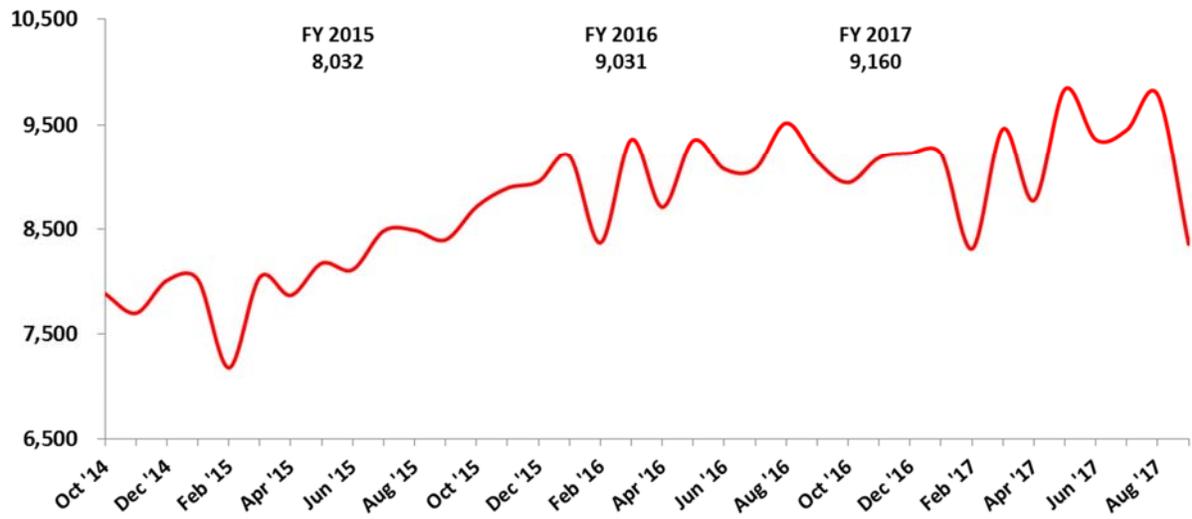
### Texas Children's Hospital Equivalent Patient Days by Campus for the twelve months ended September 30

	FY 2017	FY 2016	Increase (Decrease)	% Incr (Dec)
Medical Center Campus Acute and Other Care Days	84,136	83,590	546	0.7%
West Campus Acute and Other Care Days	11,250	10,956	294	2.7%
Pavilion for Women Acute and Other Care Days	31,447	34,610	(3,163)	(9.1%)
Woodlands Acute and Other Care Days	3,082	-	3,082	100.0%
<b>Total Acute and Other Care Days</b>	<b>129,915</b>	<b>129,156</b>	<b>759</b>	<b>0.6%</b>
Medical Center Campus Special Care Days	78,127	79,902	(1,775)	(2.2%)
West Campus Special Care Days	3,753	3,905	(152)	(3.9%)
Pavilion for Women Special Care Days	14,067	13,987	80	0.6%
Woodlands Special Care Days	2,122	-	2,122	100.0%
<b>Total Special Care Days</b>	<b>98,069</b>	<b>97,794</b>	<b>275</b>	<b>0.3%</b>
Medical Center Campus Equivalent Patient Days	162,263	163,492	(1,229)	(0.8%)
West Campus Equivalent Patient Days	15,003	14,861	142	1.0%
Pavilion for Women Equivalent Patient Days	45,514	48,597	(3,083)	(6.3%)
Woodlands Equivalent Patient Days	5,204	-	5,204	100.0%
<b>Total Equivalent Patient Days</b>	<b>227,984</b>	<b>226,950</b>	<b>1,034</b>	<b>0.5%</b>

TCH salaries and benefits as a percentage of net patient service revenue decreased from the prior year, except for August and September, which were impacted by Hurricane Harvey. This decrease was due to effective initiatives aimed at reducing premium labor and evaluating appropriate staffing needs in preparation for expansion projects. For the twelve months ended September 30, 2017, salaries and benefits as a percentage of net patient service revenue was 52.3%. However, for the ten months ended July 31, 2017, prior to Hurricane Harvey, salaries and benefits as a percentage of net patient service revenue was 51.1% compared to 52.1% in the twelve months ended September 30, 2016.

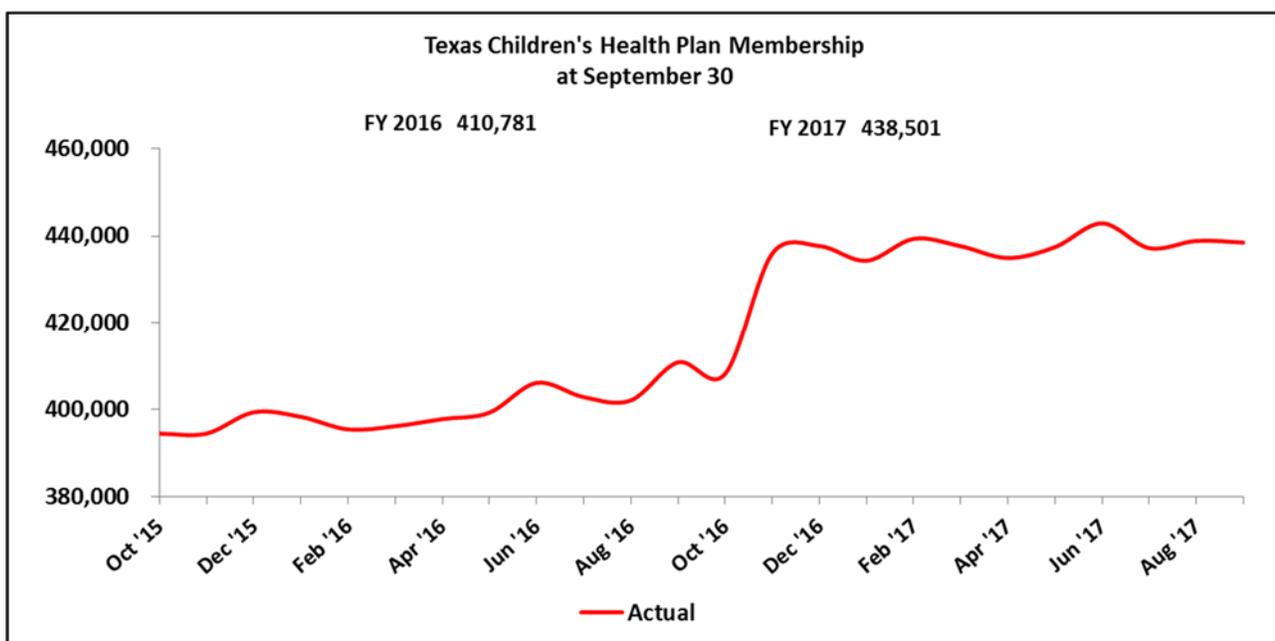
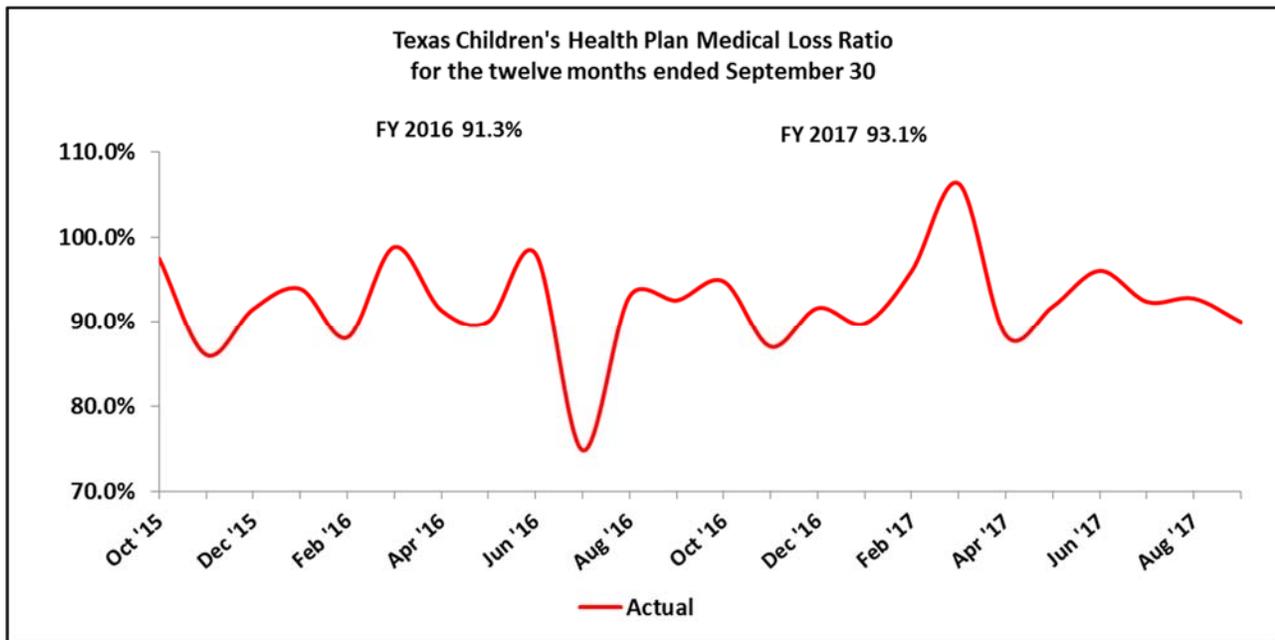


Texas Children's Hospital FTE's  
for the twelve months ended September 30



## Financial Results and Membership – Texas Children’s Health Plan

Texas Children’s Health Plan (TCHP) had an operating loss of \$53.1 million for the twelve months ended September 30, 2017. The loss was primarily driven by the launch of the STAR Kids program, which began in November 2016 and has added an additional 25,341 members to the Health Plan as of September 30, 2017. STAR Kids serves members who are more medically complex than other Medicaid populations and who require a higher level of care. In addition to increased medical costs, this program also requires a higher level of case management and care coordination, along with related increased information technology infrastructure. The Health Plan’s premium rate from the State of Texas at the launch of the STAR Kids program did not appropriately account for the higher acuity of TCHP’s STAR Kids members, which caused the majority of the loss for fiscal year 2017. Effective September 1, 2017, TCHP received a premium rate increase from the State, which has reduced the medical loss ratio to 90.0% for the month of September and is expected to result in a net increase in premium revenue of \$40.0 million. In addition to the rate increase, leadership also has several operational initiatives underway to continue to improve the performance of the Health Plan.





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## Report of Independent Auditors

### THE BOARD OF TRUSTEES TEXAS CHILDREN'S

We have audited the accompanying consolidated financial statements of Texas Children's, which comprise the consolidated balance sheets as of September 30, 2017 and 2016, 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 Texas Children's at September 30, 2017 and 2016, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.



Report continued

**SUPPLEMENTARY INFORMATION**

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating information is presented for purposes of additional analysis and is 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 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 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 is fairly stated, in all material respects, in relation to the financial statements as a whole.

*Ernst & Young LLP*

December 14, 2017

**Texas Children's  
Consolidated Balance Sheets**

(Dollars in thousands)

	<u>September 30, 2017</u>	<u>September 30, 2016</u>
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 216,235	\$ 253,351
Patient receivables, net of allowances of \$272,657 and \$202,603, in 2017 and 2016, respectively	303,784	257,444
Receivable for Medicaid and other supplemental reimbursements	30,021	30,104
Assets limited as to use, current portion	36,824	35,581
Other current assets	140,836	114,541
Investment-related receivable	<u>78,579</u>	<u>82,620</u>
Total current assets	<u>806,279</u>	<u>773,641</u>
Assets limited as to use	125,080	184,193
Investments	2,321,378	2,083,068
Property and equipment, net	2,171,787	1,999,174
Other assets	<u>94,584</u>	<u>67,009</u>
Total assets	<u>\$ 5,519,108</u>	<u>\$ 5,107,085</u>
<b>Liabilities and Net Assets</b>		
<b>Current liabilities:</b>		
Accounts payable and accrued expenses	\$ 451,260	\$ 370,130
Investment-related accrued expenses	104,572	80,087
Current portion of long-term debt	17,415	15,755
Current portion of capital lease obligations	9,203	8,142
Line of credit	21,200	-
Long-term debt subject to remarketing agreements	<u>150,000</u>	<u>50,000</u>
Total current liabilities	<u>753,650</u>	<u>524,114</u>
Long-term debt	773,068	893,858
Long-term capital lease obligations	3,905	10,190
Loss reserves for self-insurance program	36,988	35,871
Retirement plan liability	55,030	65,619
Other long-term liabilities	<u>65,445</u>	<u>79,682</u>
Total liabilities	<u>\$ 1,688,086</u>	<u>\$ 1,609,334</u>
<b>Net assets:</b>		
Unrestricted	3,462,459	3,152,099
Temporarily restricted	207,757	205,747
Permanently restricted	<u>160,806</u>	<u>139,905</u>
Total net assets	<u>\$ 3,831,022</u>	<u>\$ 3,497,751</u>
Total liabilities and net assets	<u>\$ 5,519,108</u>	<u>\$ 5,107,085</u>

See accompanying notes to consolidated financial statements.

**Texas Children's**  
**Consolidated Statements of Operations and Changes in Net Assets**

(Dollars in thousands)

	<b>Year Ended</b>	
	<b>September 30,</b>	
	<b>2017</b>	<b>2016</b>
	<u>2017</u>	<u>2016</u>
Changes in unrestricted net assets:		
Operating revenues:		
Patient service revenue, net of contractals and discounts \$	1,946,310	\$ 1,931,878
Less provision for doubtful accounts	<u>(78,925)</u>	<u>(73,854)</u>
Net patient service revenue	1,867,385	1,858,024
Premium revenue	1,483,693	969,867
Medicaid and other supplemental reimbursements	49,782	39,606
Grants	25,262	24,377
Other	89,181	69,605
Net assets released from restrictions for operations	<u>40,203</u>	<u>32,743</u>
Total operating revenues	<u>3,555,506</u>	<u>2,994,222</u>
Operating expenses:		
Salaries and benefits	1,210,419	1,109,169
Medical and hospital	989,648	618,480
Professional fees	470,808	428,102
Supplies and pharmaceuticals	274,018	250,325
Outside purchased services	164,731	144,696
Depreciation and amortization	158,633	129,134
Operation of plant	113,281	101,640
General and administrative	110,699	105,728
Enhanced mission support	26,126	37,751
Interest	<u>21,529</u>	<u>23,554</u>
Total operating expenses	<u>3,539,892</u>	<u>2,948,579</u>
Operating income	<u>15,614</u>	<u>45,643</u>
Nonoperating gains:		
Investment return	197,988	116,692
Change in interest rate swap valuation	20,655	(15,446)
Other	<u>(312)</u>	<u>(3,393)</u>
Net nonoperating gains	<u>218,331</u>	<u>97,853</u>
Revenues and gains in excess of expenses and losses	<u>\$ 233,945</u>	<u>\$ 143,496</u>

See accompanying notes to consolidated financial statements.

**Texas Children's**  
**Consolidated Statements of Operations and Changes in Net Assets** *(continued)*  
*(Dollars in thousands)*

	<b>Year Ended</b>	
	<b>September 30,</b>	
	<b>2017</b>	<b>2016</b>
	<u>          </u>	<u>          </u>
Changes in unrestricted net assets:		
Revenues and gains in excess of expenses		
and losses brought forward	\$ 233,945	\$ 143,496
Net assets released from restrictions for		
purchases of property, equipment and other	60,910	21,006
Change in pension liabilities	15,505	(20,862)
Change in unrestricted net assets	<u>310,360</u>	<u>143,640</u>
Changes in temporarily restricted net assets:		
Donor-restricted contributions	88,098	67,948
Investment return and other	7,160	21,833
Net assets released from restrictions	(100,811)	(53,249)
Change in beneficial interest in net assets of		
donor-restricted foundations	7,563	(4,690)
Change in temporarily restricted net assets	<u>2,010</u>	<u>31,842</u>
Changes in permanently restricted net assets:		
Donor-restricted contributions	15,943	3,651
Investment return and other	4,958	4,455
Change in permanently restricted net assets	<u>20,901</u>	<u>8,106</u>
Change in net assets	333,271	183,588
Net assets at beginning of year	<u>3,497,751</u>	<u>3,314,163</u>
Net assets at end of year	<u>\$ 3,831,022</u>	<u>\$ 3,497,751</u>

*See accompanying notes to consolidated financial statements.*

**Texas Children's  
Consolidated Statements of Cash Flows**

(Dollars in thousands)

	Year Ended September 30,	
	2017	2016
Operating activities:		
Change in net assets	\$ 333,271	\$ 183,588
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Change in beneficial interest in net assets of donor-restricted foundations	(7,563)	4,690
(Decrease) increase in pension liabilities	(15,505)	20,862
Net realized and unrealized gains on investments	(200,519)	(125,338)
Depreciation and amortization	158,633	129,134
(Decrease) increase in interest rate swap valuation	(20,655)	15,446
Provision for doubtful accounts	78,925	73,854
Temporarily and permanently restricted contributions received	(46,776)	(61,511)
Changes in assets and liabilities		
Increase in patient accounts receivable	(125,265)	(111,529)
Decrease (increase) in receivable for supplemental Medicaid reimbursements	83	(2,785)
Increase in other assets	(53,918)	(19,419)
Increase in accounts payable and accrued expenses	94,642	46,963
Increase in other liabilities	9,002	7,749
Total adjustments	<u>(128,916)</u>	<u>(21,884)</u>
Net cash provided by operating activities	<u>204,355</u>	<u>161,704</u>
Investing activities:		
Sales of investments, net	51,210	286,725
Purchases of property and equipment	<u>(344,636)</u>	<u>(534,829)</u>
Net cash used in investing activities	<u>(293,426)</u>	<u>(248,104)</u>
Financing activities:		
Borrowings under line-of-credit	21,200	-
Principal payment on long-term debt	(15,755)	(8,955)
Deferred financing costs	-	(126)
Principal payment on capital lease obligations	(5,224)	(7,853)
Temporarily and permanently restricted contributions received	39,297	45,829
Proceeds from sale of donated securities with restrictions	7,479	15,682
Permanently restricted investment return	<u>4,958</u>	<u>4,455</u>
Net cash provided by financing activities	<u>51,955</u>	<u>49,032</u>
Net decrease in cash and cash equivalents	(37,116)	(37,368)
Cash and cash equivalents at beginning of year	<u>253,351</u>	<u>290,719</u>
Cash and cash equivalents at end of year	<u>\$ 216,235</u>	<u>\$ 253,351</u>
Supplemental Disclosures:		
Cash paid for interest	\$ 30,405	\$ 28,277
Capital in accounts payable and accrued expenses	\$ 41,668	\$ 28,155

See accompanying notes to consolidated financial statements.

## 1. ORGANIZATION

The consolidated financial statements of Texas Children's include the entities described below. Intercompany balances and transactions have been eliminated in consolidation.

Texas Children's Hospital (TCH) primarily provides direct patient care and conducts educational and research activities within Houston and its surrounding communities. It is comprised of a 506 licensed-bed comprehensive tertiary care pediatric facility and a 115 licensed-bed facility, providing obstetrics and gynecological care, both located in Houston's Texas Medical Center (Medical Center), an 86 licensed-bed full service pediatric facility located in west Houston, and a 60 licensed-bed full-service pediatric facility located in The Woodlands.

Texas Children's Pediatrics (TCP) is a group of pediatric practices that provide primary care services and conduct educational activities. It acquires, manages, and affiliates with pediatric practices primarily in Houston and its surrounding counties.

Texas Children's Urgent Care (TCUC) is a group of clinics that provides pediatric urgent care.

Texas Children's Health Plan, Inc. (TCHP) operates a health maintenance organization (HMO), the first of its kind for pediatrics in the nation, and has a Certificate of Authority from the Texas Department of Insurance. It improves the quality, cost, and access of pediatric and obstetrical services delivered to health plan members in its service area.

Texas Children's Health Plan, Inc. – The Center for Women and Children (the Centers) operates two patient and family-centered primary care medical homes for TCHP's members. The Centers are designed to address the shortage of primary care for the Medicaid and Children's Health Insurance Program (CHIP) populations.

TCH Insurance Company, Ltd. (TCHICO) provides primary and excess professional malpractice and general liability coverage, as well as Owner Controlled Insurance Program (OCIP) coverage, by issuing insurance policies to other Texas Children's entities.

Texas Children's Hospital Foundation (TCHF) is operated for charitable, scientific, and educational purposes and, in accomplishment of such purposes, is administered solely for the benefit of TCH.

Texas Children's Women's Specialists (TCWS) provides administrative and staffing services to support the provision of obstetric and gynecological services by Texas Children's Physician Group (TCPG).

TCPG provides services in support of Texas Children's for Baylor College of Medicine (Baylor) faculty and other affiliated health care professionals who provide services at Texas Children's or participate in Texas Children's programs.

Texas Children's is the sole corporate member of TCH, TCP, TCHP, TCHF, TCWS, and TCPG, and is the sole shareholder of TCHICO. TCP is the sole corporate member of TCUC, and TCHP is the sole corporate member of the Centers.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### USE OF ESTIMATES

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

### CASH EQUIVALENTS

Texas Children's considers all highly liquid investments with a maturity of three months or less to be cash equivalents, except those subject to restrictions, which are reported as assets limited as to use in the consolidated balance sheets.

### NET PATIENT ACCOUNTS RECEIVABLE AND ACCRUED THIRD-PARTY PAYOR LIABILITIES

Patient receivables and related allowances for contractual adjustments and doubtful accounts are recorded on an accrual basis and at net realizable value in the consolidated balance sheets. For receivables associated with services provided to patients who have third-party coverage, Texas Children's analyzes contractually due amounts and provides estimated allowances.

The allowance for doubtful accounts is recorded based primarily on the aging of patient receivables and historical collection experience by major payor group. Texas Children's regularly reviews revenue source data related to these major payor groups in evaluating the sufficiency of the allowance for doubtful accounts.

Self-pay patient receivables include patients without insurance or government assistance. For self-pay patient receivables, Texas Children's records a provision for doubtful accounts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The allowance for doubtful accounts represents the difference between the standard rates (or the discounted rates negotiated or provided by the policy) and the amounts expected to be collected after all reasonable collection efforts have been exhausted. Texas Children's bad debt allowance for self-pay patients was 82% and 83% of self-pay accounts receivable as of September 30, 2017 and 2016, respectively, and self-pay write-offs totaled \$68,683 and \$68,923 for the years ended September 30, 2017 and 2016, respectively.

Amounts receivable or payable under TCH reimbursement agreements with the Medicaid and Medicare programs are subject to examination and retroactive adjustment. Provisions for estimated retroactive adjustments under such programs are provided in the period the related services are rendered and adjusted in future periods as final settlements are determined. Final settlement has been made for Medicaid and Medicare claims through the fiscal year ended September 30, 2014.

As of September 30, 2017 and 2016, third-party payor receivables of \$957 and \$2,696, respectively, are included in other current assets in the consolidated balance sheets. As of September 30, 2017 and 2016, third-party payor liabilities of \$1,767 and \$0, respectively, are included in accounts payable and accrued expenses in the consolidated balance sheets. TCH's third-party payor balances are impacted by changes in previous estimates as a result of tentative and final settlements, closure on years that are no longer subject to audits, resolution of reviews and investigations, and prior-year retroactive adjustments. It is reasonably possible that the recorded estimates may change by a material amount in the near term.

## INVESTMENTS AND INVESTMENT RETURN

Investments consist of fixed income securities, marketable equity securities, and interests in mutual funds, common trust funds, and exchange-traded funds that, in turn, invest in marketable securities. Additionally, TCH and TCHF hold ownership interests in certain limited liability partnerships and corporations that hold investments in hedge funds, private equity, real estate, managed futures, natural resources, and other investment categories (alternative investments).

Investments are reflected in the consolidated balance sheets as investments or assets limited as to use. Assets limited as to use represent investments limited for specific purposes. Investments and assets limited as to use are classified as noncurrent assets, except for those required for current obligations, which are classified as current assets.

Investments in marketable securities, fixed income securities, certain mutual funds, and exchange-traded funds with readily determinable fair values are reported at fair value. Investments in common trust funds and limited liability partnerships and corporations that do not have readily determinable fair values are recorded based on Texas Children's share of the underlying value of portfolio securities held by these funds, as reported to Texas Children's. Alternative investment positions are recorded at amounts as reported by the related investment managers. Alternative investments are accounted for under the equity method of accounting. Under this method, the equity in earnings includes changes in reported values in the underlying investments. Generally, the underlying investments are not readily marketable and the alternative investments may not be redeemable except in certain circumstances, and there can be no assurance that reported amounts will be ultimately realized.

Investment return includes interest and dividend income, realized and unrealized investment gains and losses, and earnings from investments accounted for under the equity method. Investment income on assets held for TCHICO and on invested bond proceeds is included in other operating revenues. All other investment return is recorded as nonoperating gains (losses) and is included in revenues and gains in excess of expenses and losses, unless investment return is restricted by donor or law. Investment return is initially recorded as unrestricted, temporarily restricted, or permanently restricted based on donor-imposed restrictions, if any. Restricted amounts are reflected as net assets released from restrictions in the consolidated statements of operations and changes in net assets to the extent they become available for use during the period.

Investment-related receivables primarily include receivables from brokers for unsettled trades and receivables from counterparties for forward and spot exchange contracts. Investment-related accrued expenses primarily include payables to brokers for unsettled trades and payables to counterparties for forward and spot exchange contracts.

## PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Donated property and equipment are recorded at fair value at the date of donation, which is then treated as cost. Depreciation of property and equipment is calculated using the straight-line method over the estimated useful lives of the assets. Property and equipment under capital lease obligations are amortized using the straight-line method over the shorter period of either the lease term or the asset's estimated useful life.

**IMPAIRMENT OF LONG-LIVED ASSETS**

When events or changes in circumstances indicate the carrying amount of property and equipment and intangible or other long-lived assets related to specifically acquired assets may not be recoverable, an evaluation of the recoverability of currently recorded costs is performed. When an evaluation is performed, the estimated value of undiscounted future net cash flows associated with the asset is compared to the asset's carrying value to determine whether a write-down to fair value is required. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Texas Children's did not recognize any material impairment of long-lived assets in fiscal years 2017 or 2016.

**OTHER ASSETS**

Other assets primarily include prepaid expenses, pledges, and inventory.

Pledges, less a provision for uncollectible amounts, are recorded as other assets in the year made. Unrestricted pledges are recorded as contributions within other operating revenues, and restricted pledges are recorded as increases in temporarily or permanently restricted net assets, depending on the donor restrictions received with the pledge. Pledges receivable represent unconditional promises to give and are primarily restricted for specific capital campaigns. Noncurrent pledges receivable have been discounted to their present value. Pledges receivable, net of discounts and allowances, are included in other current and noncurrent assets in the consolidated balance sheets.

Inventories are stated at the lower of cost, determined by the use of the first-in, first-out valuation method or market method, and are included in other current assets in the consolidated balance sheets. As of September 30, 2017 and 2016, Texas Children's had inventory of \$25,359 and \$21,568, respectively.

**INSURANCE PROGRAM**

Texas Children's is self-insured for professional and general liability insurance and maintains excess liability insurance coverage at varying levels. A provision is made for estimated losses and related expenses for risks not covered by insurance. This provision includes estimated amounts for asserted claims, reported incidents for which a claim has not been asserted, and claims incurred but not reported. The provision is based on specific claim loss estimates by management and on estimates of total annual losses by an independent actuary, taking into consideration the estimated future rate of inflation, using Texas Children's experience and similar industry experience.

## PREMIUM REVENUES

TCHP earns premium revenue from the state-funded Medicaid State of Texas Access Reform (STAR), Medicaid STAR Kids, and CHIP programs. For the fiscal years ended September 30, 2017 and 2016, TCHP's premium revenue was derived 58% and 86%, respectively, from its Medicaid STAR contract, 32% and 0%, respectively, from its Medicaid STAR Kids contract, and 10% and 14%, respectively, from its CHIP contract. TCHP recognizes revenue during the coverage period of the member agreement. Under these agreements, TCHP receives monthly payments based on the number of members, regardless of actual medical claims incurred. Premiums received prior to the coverage period are reflected as unearned premiums, which are included in accounts payable and accrued expenses in the consolidated balance sheets.

TCHP is subject to an experience rebate if operating income, as a percentage of revenue, is greater than the percentage set forth by the state. As of September 30, 2017 and 2016, TCHP had no estimated experience rebate liability.

## CONTRIBUTIONS

Texas Children's records unconditional contributions, including promises to contribute, as revenue when the commitment is received. Conditional contributions are recognized as revenue when the conditions on which they depend have been substantially met. Texas Children's reports gifts of cash and other assets as restricted support if they are received with donor restrictions that limit the use of the donated assets. When a donor restriction expires, that is, when a time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions.

## MEDICAL AND HOSPITAL EXPENSES

TCHP contracts with various health care providers for the provision of pediatric medical care to its members. TCHP compensates hospitals on either a payment methodology utilizing the All Patient Refined Diagnosis Related Group (APR-DRG) classification system, discounted fee-for-service or per diem basis. TCHP compensates physicians and other health care providers on a capitated basis or a discounted fee-for-service basis.

The cost to TCHP for health care services provided by contracted providers is accrued in the period in which it is provided to a member, based in part on estimates, including accruals for medical services provided but not billed, and estimates of claims incurred but not yet reported to TCHP, based on actuarial valuations. The methods utilized in determining estimates are continually reviewed, and any changes in estimates are reflected prospectively. As of September 30, 2017 and 2016, recorded accruals were \$40,582 and \$13,095, respectively, and are included in accounts payable and accrued expenses in the consolidated balance sheets.

## INTEREST EXPENSE

Interest expense includes the interest associated with Texas Children's debt, outstanding line of credit, net cash settlement activity related to interest rate swaps, and interest related to capital leases.

## INCOME TAXES

All Texas Children's entities are exempt from federal taxes under Section 501(c)(3) of the Internal Revenue Code, except for TCHICO, which is a taxable for-profit entity domiciled in the Cayman Islands.

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 as of September 30, 2017 or 2016.

## CLASSIFICATION OF ACTIVITIES AND FUNCTIONAL CLASSIFICATION OF EXPENSES

Transactions deemed to be ongoing, major, or central to the provision of health care services are reported as operating revenues and expenses. Peripheral or incidental transactions are reported as nonoperating gains and losses.

## RECLASSIFICATIONS

Certain prior year amounts have been reclassified for consistency with the current year presentation. Credit balances of \$20,082 in patient receivables have been reclassified within accounts payable and accrued expenses within the consolidated balance sheet for the year ended September 30, 2016. Principal payments on capital lease obligations of \$7,853 and proceeds from sale of donated securities with restrictions of \$15,682 have been reclassified as financing activities within the consolidated statement of cash flows for the year ended September 30, 2016.

## NEW ACCOUNTING PRONOUNCEMENTS

In August 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. This ASU requires management to assess a company's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. The provisions of ASU 2014-15 were effective for Texas Children's starting October 1, 2016. The adoption of this pronouncement did not have a material impact to Texas Children's consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest*. ASU 2015-03 requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in ASU 2015-03. The provisions of ASU 2015-03 were effective for Texas Children's starting October 1, 2016. The adoption of ASU 2015-03 resulted in a reclassification of \$6,673 from other assets to long-term debt as of September 30, 2016. As of September 30, 2017, debt issuance costs presented within long-term debt were \$6,340.

## PENDING ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 provides for a single comprehensive principles-based standard for the recognition of revenue across all industries through the application of the following five-step process:

- Step 1: Identify the contract(s) with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations in the contract.
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Among other provisions and in addition to expanded disclosure about the nature, amount, timing and uncertainty of revenue, as well as certain additional quantitative and qualitative disclosures, ASU 2014-09 changes the health care industry specific presentation guidance previously under ASU 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2014-09 is now effective for fiscal years beginning after December 15, 2017 and interim periods thereafter. Early application is permitted only for fiscal years beginning after December 15, 2016, including interim periods within that reporting period. Texas Children's does not plan to adopt the guidance early and is currently evaluating the impact on its consolidated financial statements from the adoption of this guidance.

In August 2016, FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. Under the new standard, the presentation of financial information for not-for-profits, specifically with respect to liquidity, financial performance, and cash flows, will be simplified and provide more relevant information to donors, grantors, creditors, and other users. This includes areas such as net asset classification, investment return, expenses, liquidity and availability of resources, and a change in the presentation of operating cash flows. ASU 2016-14 is effective for fiscal years beginning after December 15, 2017 and for interim periods within fiscal years beginning after December 15, 2018, and early adoption is permitted. Texas Children's does not plan to adopt the guidance early and is currently evaluating the impact on its consolidated financial statements from the adoption of this guidance.

In August 2016, FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230)*, which is intended to reduce diversity in practice on how certain transactions are classified in the statement of cash flows. The new standard addresses eight issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; distributions received from equity method investments; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, and early application is permitted. Texas Children's does not plan to adopt the guidance early and is currently evaluating the impact on its consolidated financial statements from the adoption of this guidance.

In February 2016, FASB issued ASU 2016-02, *Leases (Topic 842)*, which calls for the reporting of assets and liabilities arising from leases in a more transparent and neutral manner. The new standard requires companies that lease assets to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. The pronouncement will also require additional disclosures about the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 applies to organizations that enter into a lease or sublease but is subject to several exemptions, none of which apply to Texas Children's. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods thereafter, and early adoption is permitted. Texas Children's does not plan to adopt the guidance early and is currently evaluating the impact on its consolidated financial statements from the adoption of this guidance.

**3. INVESTMENTS AND INVESTMENT RETURN**

Investments are included in the consolidated balance sheets as follows:

	<b>September 30, 2017</b>	<b>September 30, 2016</b>
Investments	\$ 2,321,378	\$ 2,083,068
Assets limited as to use:		
Assets held by bond trustee	36,824	107,576
Assets held for insurance program	92,387	87,572
Assets restricted under statutory requirements	4,512	4,008
Beneficial interest in supporting foundations	28,181	20,618
Total assets limited as to use	<u>161,904</u>	<u>219,774</u>
Total investments and assets limited as to use	<u>\$ 2,483,282</u>	<u>\$ 2,302,842</u>

Investments, including assets limited as to use, include the following:

	<b>September 30, 2017</b>	<b>September 30, 2016</b>
Cash and cash equivalents	\$ 36,824	\$ 35,737
U.S. government fixed income securities	93,297	114,241
U.S. government agency securities	96,115	119,004
Municipal government securities	1,121	1,451
Foreign government fixed income securities	7,526	11,812
Corporate fixed income securities	254,350	324,489
Domestic equity securities	399,614	410,821
International equity securities	143,295	103,408
Alternative investments	1,422,709	1,161,012
Other	28,431	20,867
Total	<u>\$ 2,483,282</u>	<u>\$ 2,302,842</u>

## INVESTMENT RISKS

Texas Children's investments are subject to various types of risks, as described below:

### FIXED INCOME SECURITIES

This investment class includes investments in various fixed income instruments that include investment-grade and high-yield domestic and international bonds, preferred stocks, mortgage pools, and bonds issued by U.S. government agencies. This investment class also includes investments in common trust funds, mutual funds, and exchange-traded funds that hold investments in fixed income securities. The fixed income investments are exposed to various kinds and levels of risk, including interest rate risk, credit risk, foreign exchange risk, and liquidity risk.

### EQUITY SECURITIES

This investment class consists primarily of common equity securities of domestic and international companies. These securities trade through the major public domestic and international exchanges. This investment class also includes investments in common trust funds, mutual funds, and exchange-traded funds that hold investments in equity securities. The equity securities investments are exposed to various kinds and levels of risk, including market risk, individual security risk, foreign exchange risk and, for common equity of companies with a small market capitalization, liquidity risk.

### ALTERNATIVE INVESTMENTS

Alternative investments are domestic and international in nature and are invested with external investment managers who invest primarily in various alternative categories, including real estate, long and short equity positions, natural resources, private equity, managed futures, emerging markets, distressed enterprises and arbitrage positions. This investment class is subject to numerous risks that could lead to a greater likelihood of invested capital loss. Such risks include the following:

- **NON-REGULATION RISK** – These funds are not required to register with the U.S. Securities and Exchange Commission (SEC) and are not subject to regulatory controls. However, many of the alternative investment fund managers through which Texas Children's invest are SEC registered investment advisers.
- **LIMITED TRANSPARENCY** – As unregistered investment vehicles, funds are not required to disclose the holdings in their portfolios to investors.
- **INVESTMENT STRATEGY RISK** – The funds often employ sophisticated, complex investment strategies and may include speculative strategies or strategies that use leverage, which could result in volatile returns.
- **MINIMAL LIQUIDITY** – Many funds impose lock-up periods that prevent investors from redeeming their shares or impose penalties to redeem. The lock-up provisions of each investment vary, but when applicable, generally range from twelve months to three years. Notice requirements typically vary from fifteen to ninety days prior to the redemption date. In addition, private equity investments (a category of alternative investments) are self-funding and self-liquidating entities that typically endure for ten years or more.

**FAIR VALUE OF FINANCIAL INSTRUMENTS**

Texas Children's uses various inputs in determining the fair value of its investments and measures these assets on a quarterly basis. Financial assets and liabilities recorded at fair value in the consolidated balance sheets are categorized by the level of objectivity associated with the inputs used to measure their fair value. Authoritative guidance establishes a three-level hierarchy for disclosure of fair value measurements. The valuation hierarchy is based on the transparency of inputs to the valuation of an asset or liability as of the measurement date.

The three levels are defined as follows:

- LEVEL 1 – Inputs to the valuation methodology are quoted prices (unadjusted) in active markets for identical assets or liabilities at the measurement date.
- LEVEL 2 – Inputs to the valuation methodology include 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 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The inputs or methodology used for valuing securities are not necessarily an indication of the credit risk associated with investing in those securities. The following tables present the financial instruments carried at fair value as of September 30, 2017 and 2016, by the valuation hierarchy (as described above). The following tables do not include alternative investments and other investments as they are accounted for using the equity method of accounting.

Money market mutual funds that are included in cash and cash equivalents in the consolidated balance sheets are included in cash and cash equivalents in the tables. As of September 30, 2017 and 2016, Texas Children's had \$74,474 and \$36,250, respectively, in money market mutual funds. Derivative financial instruments that are included in investment-related receivables and investment-related accrued expenses in the consolidated balance sheets are included in the tables.

September 30, 2017

## FINANCIAL ASSETS AND LIABILITIES AT FAIR VALUE

as of September 30, 2017

	Level 1	Level 2	Level 3	Total
<b>ASSETS</b>				
Investments:				
Cash and cash equivalents	\$ 111,298	\$ -	\$ -	\$ 111,298
Derivative financial instruments	-	69,800	-	69,800
U.S. government fixed income securities	-	93,297	-	93,297
U.S. government agency securities	-	96,115	-	96,115
Municipal government securities	-	1,121	-	1,121
Foreign government fixed income securities	-	7,526	-	7,526
Corporate fixed income securities	-	254,350	-	254,350
Domestic equity securities	399,614	-	-	399,614
International equity securities	143,295	-	-	143,295
Total assets at fair value	\$ 654,207	\$ 522,209	\$ -	\$ 1,176,416
<b>LIABILITIES</b>				
Derivative financial instruments	\$ -	\$ 68,803	\$ -	\$ 68,803
Interest rate swap agreements	-	33,303	-	33,303
Total liabilities at fair value	\$ -	\$ 102,106	\$ -	\$ 102,106

## FINANCIAL ASSETS AND LIABILITIES AT FAIR VALUE

as of September 30, 2016

	Level 1	Level 2	Level 3	Total
<b>ASSETS</b>				
Investments:				
Cash and cash equivalents	\$ 71,987	-	-	\$ 71,987
Derivative financial instruments	-	64,589	-	64,589
U.S. government fixed income securities	-	114,241	-	114,241
U.S. government agency securities	-	119,004	-	119,004
Municipal government securities	-	1,451	-	1,451
Foreign government fixed income securities	-	11,812	-	11,812
Corporate fixed income securities	-	324,489	-	324,489
Domestic equity securities	410,820	-	-	410,820
International equity securities	103,408	-	-	103,408
Total assets at fair value	\$ 586,215	\$ 635,586	\$ -	\$ 1,221,801
<b>LIABILITIES</b>				
Derivative financial instruments	\$ -	\$ 64,914	\$ -	\$ 64,914
Interest rate swap agreements	-	53,958	-	53,958
Total liabilities at fair value	\$ -	\$ 118,872	\$ -	\$ 118,872

**FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE**

As of September 30, 2017 and 2016, Texas Children's financial instruments included cash and cash equivalents, accounts receivable, assets limited as to use, accounts payable and accrued expenses, estimated third-party payor settlements, and long-term debt. The carrying amounts reported in the consolidated balance sheets for these financial instruments, except for long-term debt, approximate their fair values.

The fair value of TCH's long-term debt is estimated based on the quoted market prices for the same issues. Expenses that would be incurred in an actual settlement are not taken into consideration. The estimated fair values of long-term debt are \$969,161 and \$1,001,990 as of September 30, 2017 and 2016, respectively. Settlement at the reported fair value may not be possible or may not be a prudent business decision.

Alternative investments are accounted for under the equity method of accounting. As of September 30, 2017 and 2016, Texas Children's had \$1,451,140 and \$1,181,879, respectively, in alternative investments and other investments, and had committed approximately \$260,100 of future funding to various alternative investments as of September 30, 2017.

**SUMMARY OF INVESTMENT RETURNS**

	Year Ended	
	September 30, 2017	September 30, 2016
Unrestricted:		
Dividends and interest, net of investment expenses	\$ 21,855	\$ 22,327
Net unrealized gains (losses)	13,143	(22,387)
Net realized gains	9,718	88,398
Equity in gains of alternative investments, not measured at fair value:		
Net unrealized gains	147,092	41,854
Net realized gains (losses)	18,448	(2,385)
Total unrestricted investment return	<u>\$ 210,256</u>	<u>\$ 127,807</u>
Temporarily restricted:		
Dividends and interest, net of investment expenses	\$ 10,931	\$ 12,989
Net unrealized (losses) gains	(3,771)	8,844
Total temporarily restricted investment return	<u>\$ 7,160</u>	<u>\$ 21,833</u>
Permanently restricted:		
Net unrealized gains (losses)	\$ 5,321	\$ (5,452)
Net realized (losses) gains	(363)	9,907
Total permanently restricted investment return	<u>\$ 4,958</u>	<u>\$ 4,455</u>

**4. PROPERTY AND EQUIPMENT**

Property and equipment, by major category, are as follows:

	<b>September 30, 2017</b>	<b>September 30, 2016</b>
Land and land improvements	\$ 138,730	\$ 138,889
Improvements to leased facilities	114,029	104,961
Buildings	1,404,076	1,108,144
Building and movable equipment under capital lease obligation	51,822	51,822
Fixed equipment	743,348	724,681
Movable equipment	605,439	508,541
Software	179,733	170,450
	<u>3,237,177</u>	<u>2,807,488</u>
Less accumulated depreciation	(1,357,628)	(1,204,312)
	1,879,549	1,603,176
Construction in progress	292,238	395,998
Net property and equipment	<u>\$ 2,171,787</u>	<u>\$ 1,999,174</u>

Interest cost is capitalized until the property under construction is placed in service. As of September 30, 2017 and 2016, the amount recorded as capitalized interest within construction in progress was \$4,580 and \$4,615, respectively.

TCH had remaining commitments of \$231,570 and \$239,348 on open construction and equipment contracts as of September 30, 2017 and 2016, respectively.

**5. PLEDGES AND CONTRIBUTIONS**

Pledges receivable are expected to be realized as follows:

	<b>September 30, 2017</b>	<b>September 30, 2016</b>
In one year or less	\$ 48,033	\$ 26,768
Between one year and five years	61,915	29,587
More than five years	1,060	397
Total pledges	<u>111,008</u>	<u>56,752</u>
Less present value discount	(8,453)	(2,735)
Less allowance for doubtful pledges	(2,128)	(1,668)
Net pledges receivable	<u>\$ 100,427</u>	<u>\$ 52,349</u>

As of September 30, 2017, temporarily restricted net assets included \$19,894 restricted for capital expansion, of which \$18,177 relates to pledges that had not yet been received.

## 6. BORROWINGS

### DEBT

Debt and capital lease obligations are as follows:

	<b>2017</b>	<b>2016</b>
TCH Revenue Bonds:		
Series 2008	\$ 286,400	\$ 288,075
Series 2009	131,130	135,536
Series 2010	58,629	61,881
Series 2015-1	211,514	220,794
Series 2015-2	50,000	50,000
Series 2015-3	110,000	110,000
Series 2015-4	99,150	100,000
Capital lease obligation	13,108	18,332
	<u>959,931</u>	<u>984,618</u>
Less current portion of long-term debt	(17,415)	(15,755)
Less current portion of capital lease obligations	(9,203)	(8,142)
Less long-term debt subject to remarketing agreements	(150,000)	(50,000)
Net of bond issuance cost	(6,340)	(6,673)
Total long-term debt and capital lease obligations	<u>\$ 776,973</u>	<u>\$ 904,048</u>

As of September 30, 2017, the aggregate annual maturities based on the scheduled maturities of long-term debt for the next five fiscal years are as follows:

<b>YEAR</b>	<b>AMOUNT</b>
2018	\$ 17,415
2019	18,600
2020	19,415
2021	20,535
2022	21,045

In 1995, 2008, 2009, 2010, and 2015, TCH Revenue Bonds were issued in several series by Harris County Health Facilities Development Corporation and the Harris County Cultural Education Facilities Finance Corporation under loan agreements with TCH. TCH and TCHF are currently the only members of the Obligated Group (each member of the obligated group is jointly and severally obligated to pay the debt). In 2014, TCH issued its Special Obligation Taxable Refunding Bond Series 2014.

The following bond series are defeased. They are no longer the obligation of the Obligated Group and are not included in the consolidated financial statements at September 30, 2017 or 2016.

### LEGALLY DEFEASED BONDS

	<b>SERIES 1995</b>	<b>SERIES 2014</b>
Issued Amount	\$69,225	\$91,985
Fiscal Year Defeased	1999	2015
Maturity Date	October 1, 2019	October 1, 2029
Outstanding Balance	\$14,165	\$79,075

September 30, 2017

The following bond series are outstanding:

**VARIABLE RATE BANK DIRECT PURCHASES**

	<b>SERIES 2008-1</b>	<b>SERIES 2008-2</b>	<b>SERIES 2008-3</b>	<b>SERIES 2015-4</b>
Issued Amount	\$100,000	\$100,000	\$100,000	\$100,000
Average Interest Rate 2017	1.23%	0.90%	0.90%	1.15%
Average Interest Rate 2016	0.91%	0.56%	0.66%	0.82%
Mandatory Tender Date	April 22, 2018	September 30, 2022	March 1, 2019	July 16, 2025
Final Maturity Date	October 1, 2041	October 1, 2041	October 1, 2041	October 1, 2042

The Series 2008-1 Bonds are subject to mandatory tender within one year. As such, the entire amount of the Series 2008-1 Bonds is classified as a current liability and is included in long-term debt subject to remarketing agreements in the consolidated balance sheets.

Subsequent to September 30, 2017, Texas Children's amended its Series 2008-2 Bonds Continuing Covenant Agreement to extend the Mandatory Tender date from July 30, 2018 to September 30, 2022.

**FIXED RATE BONDS**

	<b>SERIES 2009</b>	<b>SERIES 2010</b>	<b>SERIES 2015-1</b>
Issued Amount	\$200,000	\$78,210	\$195,720
Original Premium/(Discount)	(\$1,035)	\$1,869	\$30,013
Interest Rate	3.00% - 5.50%	3.00% - 5.00%	3.00% - 5.00%
Interest Payment Frequency	Semiannually	Semiannually	Semiannually
Final Maturity Date	October 1, 2039	October 1, 2029	October 1, 2034

TCH may redeem all of the outstanding Series 2009 Bonds in whole or in part on any date on or after October 1, 2019, at par plus accrued and unpaid interest.

TCH may redeem the Series 2010 Bonds with a stated maturity on and after October 1, 2020, in whole or in part on any date after October 1, 2019, at par plus accrued and unpaid interest.

TCH may redeem the Series 2015-1 Bonds with a stated maturity on and after October 1, 2026, in whole or in part on any date after October 1, 2025, at par plus accrued and unpaid interest.

**OTHER VARIABLE RATE BONDS**

	<b>SERIES 2015-2</b>	<b>SERIES 2015-3</b>
Issued Amount	\$50,000	\$110,000
Type	Windows Variable Rate	Floating Rate
Average Interest Rate 2017	0.95%	1.48%
Average Interest Rate 2016	0.45%	1.13%
Mandatory Tender Date	-	June 1, 2020
Final Maturity Date	October 1, 2045	October 1, 2045

The interest rate for the Series 2015-2 Bonds excludes fees related to a remarketing agent. The Series 2015-2 Bonds are subject to mandatory tender purchase 210 days after a tender notice from bondholders. Within the 210 day period, TCH can remarket the bonds, convert the bonds to a different mode or pay off the bonds. As such, the entire amount of the Series 2015-2 Bonds is classified as a current liability and is included in long-term debt subject to remarketing agreements in the consolidated balance sheets. As of September 30, 2017, no bonds have been tendered.

**Texas Children's**

**Notes to the Consolidated Financial Statements** (Dollars in thousands), continued

September 30, 2017

The Series 2015-3 Bonds are subject to mandatory tender on June 1, 2020, the mandatory purchase date. The Series 2015-3 Bonds are not subject to optional tender prior to the mandatory tender date.

TCH has the following capital lease obligations outstanding as of September 30, 2017:

<b>LEASED ASSET</b>	<b>FISCAL YEAR ENTERED</b>	<b>LEASE TERM</b>	<b>OBLIGATION</b>
Parking facility	2008	Thirty-year	\$ 3,292
Computer hardware	2014	Four-year	301
Computer hardware	2015	Four-year	98
Smartphones	2015	Four-year	668
Computer networking equipment	2015	Five-year	8,749

As of September 30, 2017, the scheduled future principal payments on capital lease obligations for each of the next five fiscal years are as follows:

<b>YEAR</b>	<b>AMOUNT</b>
2018	\$ 9,203
2019	3,035
2020	99
2021	99
2022	99

**LINE OF CREDIT**

TCH has a working capital line-of-credit agreement with a commercial bank that permits TCH to borrow up to \$100,000 bearing interest at the thirty-day daily London Interbank Offered Rate (LIBOR) plus a spread. TCH must pay an annual commitment fee on the unused portion of the commitment. Borrowings under the working capital agreement are taken as needed and repaid as operating funds become available. As of September 30, 2017 and 2016, Texas Children's had \$21,200 and \$0, respectively, outstanding.

**7. DERIVATIVE FINANCIAL INSTRUMENTS****INTEREST RATE SWAPS**

Texas Children's utilizes interest rate swap agreements to manage its interest rate exposure on its 2008-1 and 2008-2 Series bonds. As of September 30, 2017 and 2016, the fair value of both swap agreements was a liability of \$33,303 and \$53,959, respectively, and is included in other long-term liabilities in the consolidated balance sheets. Changes in the fair value of Texas Children's swaps are recorded as nonoperating gains (losses) and included in revenues and gains in excess of expenses and losses. For the years ended September 30, 2017 and 2016, the change in fair value resulted in a gain of \$20,655 and a loss of \$15,446, respectively.

TCH has the option to terminate both swap transactions in whole or in part with cash settlement. TCH may be required to post collateral to secure obligations that would be owed to the counterparty under such transaction if terminated, regardless of whether such transaction is actually terminated. TCH has complied with these provisions as required. TCH does not offset the fair value of the derivative financial instrument and fair value of any collateral posted.

The following table summarizes the agreements:

	<b>Series 2008-1</b>	<b>Series 2008-2</b>
Notional amount	\$100,000	\$93,175
Expiration date	October 1, 2041	October 1, 2041
Fixed rate TCH pays to counterparty	3.657% of the notional amount	1.834% of the notional amount
Variable rate TCH receives from counterparty	67% of the U.S. dollar one-month LIBOR rate	67% of the U.S. dollar one-month LIBOR rate
TCH option to terminate with a cash settlement	Yes	Yes
Collateral threshold	\$30,000	\$50,000
Collateral posted as of September 30, 2017	\$2,410	-
Collateral posted as of September 30, 2016	\$17,070	-

The interest rate swap contracts between TCH and third parties (counterparties) provide for the periodic exchange of payments between the parties based on changes in a defined index and a fixed rate and exposes TCH to market risk and credit risk. Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degrees of market risk that may be undertaken. Management also mitigates risk through periodic reviews of its derivative position in the context of its blended cost of capital. Credit risk is the risk that contractual obligations of the counterparties will not be fulfilled. Counterparty credit risk is managed by requiring high credit standards for TCH's counterparties. The counterparties to the contracts are financial institutions that carry an investment-grade credit rating. TCH does not anticipate nonperformance by its counterparties.

**OTHER DERIVATIVES**

Texas Children's utilizes forward and spot exchange contracts on foreign currencies as investment vehicles, which are included in investment-related receivables and investment-related accrued expenses in the consolidated balance sheets. Changes in the fair value of the contracts are recorded as nonoperating gains (losses) and included in revenues and gains in excess of expenses and losses.

**8. EMPLOYEE BENEFIT PLANS**

Texas Children's has a noncontributory cash balance pension plan covering substantially all employees. Under the plan, employees' annual pension benefits are a combination of a pay credit, which is equal to a percentage of their base pay, and an interest credit, which is equal to a percentage of their accumulated cash balance. Texas Children's funding policy is to contribute an amount at least equal to the minimum amount required under the Employee Retirement Income Security Act of 1974 (ERISA) and subsequent law changes amending ERISA.

The assumptions used in calculating the pension amounts recognized in Texas Children's consolidated financial statements include discount rates, interest crediting rates, expected return on plan assets, retirement and mortality rates, inflation rates, salary growth, and other factors. While Texas Children's believes the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect future pension obligations and expenses.

The plan's funded status, amounts included in the consolidated financial statements, and the assumptions used are as follows:

	<b>September 30, 2017</b>	<b>September 30, 2016</b>
<b>CHANGE IN PROJECTED BENEFIT OBLIGATION</b>		
Projected benefit obligation, beginning of year	\$ 366,621	\$ 307,846
Service cost	31,629	23,703
Interest cost	12,569	12,691
Plan amendments	-	(1,764)
Actuarial (gains) losses	(2,254)	31,699
Benefits paid	(11,945)	(7,554)
Projected benefit obligation (including \$369,630 and \$344,385 in 2017 and 2016, respectively, in accumulated benefit obligation), end of year	<u>\$ 396,620</u>	<u>\$ 366,621</u>
<b>CHANGE IN PLAN ASSETS</b>		
Fair value of plan assets, beginning of year	\$ 301,002	\$ 268,586
Actual return on plan assets	29,093	24,260
Employer contributions	23,440	15,710
Benefits paid	(11,945)	(7,554)
Fair value of plan assets, end of year	<u>\$ 341,590</u>	<u>\$ 301,002</u>
<b>FUNDED STATUS</b>		
Projected benefit obligation	\$ (396,620)	\$ (366,621)
Fair value of assets	<u>341,590</u>	<u>301,002</u>
Funded status recorded in retirement plan liability in the consolidated financial statements	<u>\$ (55,030)</u>	<u>\$ (65,619)</u>

Texas Children's

Notes to the Consolidated Financial Statements (Dollars in thousands), continued

September 30, 2017

<b>COMPONENTS OF NET PERIODIC COST</b>	<b>September 30, 2017</b>	<b>September 30, 2016</b>
Service cost	\$ 31,629	\$ 23,703
Interest cost	12,569	12,691
Expected return on plan assets	(19,957)	(17,905)
Prior service cost amortization	(95)	95
Recognized net actuarial loss	4,232	2,613
Net periodic cost included in salaries and benefits in the consolidated financial statements	<u>\$ 28,378</u>	<u>\$ 21,197</u>

**WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE  
BENEFIT OBLIGATIONS AT MEASUREMENT DATE**

Discount rate	3.77%	3.53%
Compensation projection rate	4.06	4.06

**WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE  
NET PERIODIC PENSION COST**

Discount rate	3.53%	4.25%
Expected long-term rate of return on plan assets	6.75	6.75
Compensation projection rate	4.06	4.06

As of September 30, 2017, unrestricted net assets were reduced by \$15,527 due to amounts arising from Texas Children's noncontributory cash balance pension plan that have not yet been recognized in net periodic benefit cost. Amounts recognized in unrestricted net assets expected to be recognized in net periodic benefit cost during fiscal year 2018 approximate \$2,292.

During fiscal year 2016, the plan was updated to permit lump sum distributions on terminated vested participant accounts from \$7 to \$15. The plan change resulted in a gain of \$1,764.

The weighted-average asset allocation categories, target, and actual percentages for September 30 are as follows:

	<b>TARGET</b>	<b>2017</b>	<b>2016</b>
Global equity	55%	55%	55%
Fixed income and cash	30	27	28
Absolute return	15	18	17
	<u>100%</u>	<u>100%</u>	<u>100%</u>

**Texas Children's**

**Notes to the Consolidated Financial Statements** (Dollars in thousands), continued

September 30, 2017

The primary investment objective of the plan investments is to earn the actuarial average annual nominal rate of return assumption (inclusive of inflation), net of management fees, over long time periods (rolling ten- and fifteen-year periods). The plan investments will seek to outperform a composite of market indices reflecting the plan's asset allocation policies and perform on par with other long-term pools with broadly similar investment objectives and policies.

	<u>ESTIMATED</u>
Expected contributions for fiscal year 2018	\$ 34,100
Expected benefit payments for fiscal years:	
2018	14,815
2019	16,975
2020	17,228
2021	18,593
2022	21,179
Subsequent five years consolidated	123,235

The value of the plan assets measured at fair value on a recurring basis was determined using the inputs as described in Note 3 as of September 30. The tables for fiscal years 2017 and 2016 do not include Level 3 alternative investments of \$139,863 and \$115,538, respectively, which are measured at fair value using net asset value as a practical expedient.

	<u>LEVEL 1</u>	<u>LEVEL 2</u>	<u>LEVEL 3</u>	<u>TOTAL</u>
<b>FISCAL YEAR 2017</b>				
Investments:				
Cash and cash equivalents	\$ 21,781	\$ -	\$ -	\$ 21,781
Domestic equity securities	77,061	-	-	77,061
International equity securities	32,383	-	-	32,383
U.S. government fixed income securities	-	13,133	-	13,133
U.S. agency securities	-	31,038	-	31,038
Corporate fixed income securities	-	26,331	-	26,331
Total assets at fair value	<u>\$ 131,225</u>	<u>\$ 70,502</u>	<u>\$ -</u>	<u>\$ 201,727</u>

	<u>LEVEL 1</u>	<u>LEVEL 2</u>	<u>LEVEL 3</u>	<u>TOTAL</u>
<b>FISCAL YEAR 2016</b>				
Investments:				
Cash and cash equivalents	\$ 12,095	\$ -	\$ -	\$ 12,095
Domestic equity securities	78,543	-	-	78,543
International equity securities	21,342	-	-	21,342
U.S. government fixed income securities	-	16,420	-	16,420
U.S. agency securities	-	32,859	-	32,859
Corporate fixed income securities	-	24,205	-	24,205
Total assets at fair value	<u>\$ 111,980</u>	<u>\$ 73,484</u>	<u>\$ -</u>	<u>\$ 185,464</u>

Additionally, Texas Children's maintains a tax-sheltered annuity plan that allows employees to defer a portion of their compensation through salary deductions. Texas Children's matches employee contributions to the plan, equal to 50% of an employee's elective deferral, up to a maximum of 3% of the employee's compensation on a per paycheck basis. Texas Children's expense for the matching contributions was \$20,085 and \$17,739 for fiscal years 2017 and 2016, respectively.

**9. COMMITMENTS AND CONTINGENCIES****INSURANCE PROGRAM**

TCHICO is a captive insurance company that provides primary coverage for professional and general liability exposures of Texas Children's and also provides excess liability coverage for amounts in excess of the primary policy limits, including OCIP for several Texas Children's expansion projects. TCH funds TCHICO's required insurance reserves. Funding amounts are based on actuarial recommendations.

As of September 30, 2017 and 2016, TCH recorded a liability of \$36,988 and \$35,871, respectively, based on a discount rate of 3.4%. This liability is presented as loss reserves for self-insurance program in the consolidated balance sheets. Investment income from the assets and the provision for estimated self-funded losses and administrative costs are reported in the consolidated statements of operations and changes in net assets.

Texas Children's has certain pending and threatened litigation and claims incurred in the ordinary course of business; however, management believes that the probable resolution of such contingencies will not exceed insurance coverage and self-insurance reserves and will not materially affect the consolidated financial position of Texas Children's or the results of its operations.

**REGULATORY COMPLIANCE**

Laws and regulations governing the Medicare and Medicaid programs and certain other third-party programs are complex and subject to interpretation. The United States Department of Justice and other federal agencies are increasing resources dedicated to regulatory investigations and compliance audits of health care providers. Texas Children's is subject to these regulatory efforts and monitors and responds to regulatory changes and any issues that may arise. Texas Children's intent is to be in compliance with all applicable laws and regulations, and it is not aware of any significant pending or threatened investigations involving allegations of potential wrongdoing.

**LEASE COMMITMENTS**

TCH, TCHP and TCP lease certain warehouse space, office equipment, and office space under operating leases expiring at various times through 2028. Certain leases include options for renewal. The following schedule presents future minimum rental payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of September 30, 2017:

Year ending September 30:	
2018	\$ 22,599
2019	20,557
2020	17,536
2021	15,478
2022	14,477
Thereafter	35,107
	<u>\$ 125,754</u>

Rental expense for fiscal years 2017 and 2016 was \$22,898 and \$21,795, respectively, and is included in outside purchased services in the consolidated statements of operations and changes in net assets.

## 10. TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Texas Children's funding sources include donors that have placed specific restrictions on the use of donated assets and, in certain instances, the use of the income derived from those assets. In addition, the Board of Trustees has designated funds for specific purposes to function as endowments. Funds held as net assets and revenues, expenses, gains, and losses are classified based on the existence or absence of donor-imposed restrictions.

Accordingly, net assets of Texas Children's and changes therein are classified and reported as follows:

- **UNRESTRICTED NET ASSETS** – Net assets that arise as a result of the operations of Texas Children's for its stated purposes and reported as revenues and gains in excess of expenses and losses, donations that are not subject to donor imposed restrictions, Board-designated funds held as endowments, and unrealized gains and losses on investments.
- **TEMPORARILY RESTRICTED NET ASSETS** – Net assets that are subject to donor-imposed restrictions based on the passage of time or the occurrence of a specific event. Temporarily restricted net assets include accumulated appreciation on temporarily and permanently restricted funds.
- **PERMANENTLY RESTRICTED NET ASSETS** – Net assets required to be maintained in perpetuity, with only the income to be used for Texas Children's activities, due to donor-imposed restrictions.

### INTERPRETATION OF RELEVANT LAW

Texas Children's follows the requirements of the Uniform Prudent Management of Institutional Funds Act as they relate to its permanently restricted endowments.

### RETURN OBJECTIVES AND RISK PARAMETERS

Texas Children's has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment, while seeking to maintain purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that Texas Children's must hold in perpetuity or for a donor-specific period, as well as Board-designated funds held as endowments.

To satisfy its long-term rate-of-return objectives, Texas Children's relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). Texas Children's targets a diversified asset allocation that consists of equities and fixed income securities.

### SPENDING POLICY

Texas Children's has a policy, unless otherwise specified by the donor, of appropriating for distribution each year the lesser of 5% of a three-year rolling average of the endowment market value or the actual three-year rolling average total return on its endowments, so long as the distribution does not decrease an endowed fund below its historical dollar value. In establishing this policy, Texas Children's considered the long-term expected return on its endowments. Accordingly, over the long term, Texas Children's expects the current spending policy to allow endowments to grow at an average of the long-term rate of inflation. This is consistent with Texas Children's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specific term, as well as to provide additional real growth through new gifts and investment return.

**11. NET PATIENT SERVICE REVENUE**

Amounts reimbursed for services rendered to patients covered under the Medicaid and Medicare programs are generally less than the established billing rates. TCH, TCP, and TCPG also provide services to beneficiaries of certain other third-party payor programs at amounts less than their established billing rates based on contractual arrangements. Differences between the established billing rates and amounts reimbursed are contractual adjustments. A summary of the payment arrangements with major third-party payors is as follows:

- **COMMERCIAL** – TCH, TCP, and TCPG have entered into payment agreements with certain commercial insurance carriers, HMOs, and preferred provider organizations. The basis for payment under these agreements includes discounts from established charges, agreed-upon fees per procedure, prospectively determined per diem rates, and case rates.
- **MEDICAID PROGRAMS** – TCH reimbursement rates for inpatient Medicaid enrollees are determined using the APR-DRG classification system. The remaining hospital services and all TCP and TCPG services rendered to Medicaid beneficiaries are reimbursed under prospectively determined rates according to a patient classification system that is based on clinical, diagnostic, and other factors.
- **MEDICAID MANAGED CARE PROGRAMS** – Certain Medicaid recipients are required to enroll in selected HMOs that contract with the Medicaid program to provide primary and acute care services to enrolled Medicaid recipients. TCH has contracted with these HMOs to provide services to pediatric Medicaid recipients. TCH reimbursement rates for inpatient Medicaid Managed Care STAR, CHIP, and other programs are determined using the APR-DRG classification system. Outpatient services are primarily reimbursed at a discount from established charges.

Patient service revenue, net of contractual allowances and discounts (but before the provision for doubtful accounts), by payor were as follows:

	Year Ended			
	September 30, 2017		September 30, 2016	
Commercial	\$ 1,349,358	69%	\$ 1,294,913	67%
Medicaid	127,236	7%	214,156	11%
Medicaid Managed Care	359,019	18%	299,126	16%
Self-pay and Other	110,697	6%	123,683	6%
Total All Payors	\$ 1,946,310	100%	\$ 1,931,878	100%

**12. CONCENTRATIONS OF CREDIT RISK**

TCH, TCP, and TCPG grant credit without collateral to their patients, most of whom are local residents of the geographies of the various health care centers and are insured under third-party payor agreements. The mix of net accounts receivable from patients and third-party payors is as follows:

	September 30, 2017	September 30, 2016
Commercial	68%	68%
Medicaid	7	12
Medicaid Managed Care	17	9
Self-pay and Other	8	11
Total All Payors	100%	100%

13. CHARITY CARE AND COMMUNITY BENEFIT

In accordance with its vision and mission, Texas Children's commits significant resources to promote the health and well-being of women and children. In support of this endeavor, Texas Children's recognizes that some of its most fragile constituents are women and children whose families are financially or medically indigent. To that end, Texas Children's provides medical treatment to patients unable to pay for treatment from their own resources or whose family or custodians are unable to pay for such treatment. Texas Children's ensures that charity care, indigent care, education, research and other sponsored community programs are available to all children and women, regardless of economic status. Therefore, Texas Children's maintains charity and community benefits programs, within limits, that are available to the entire community with equal consideration for those who are poor and underserved.

The categories included as programs and services for the poor and the underserved are as follows:

- **CHARITY CARE** – represents the unreimbursed cost of providing, funding, or otherwise financially supporting health care services to a patient classified as financially indigent or medically indigent and who has not been insured or partially insured by one of the available government-sponsored means-tested indigent care programs. Because the vast majority of financially or medically indigent pediatric and obstetrical patients qualify for government-sponsored indigent care programs, the amounts of charity care are much less than the unreimbursed cost of government-sponsored indigent care programs. In accordance with Texas Children's established policy and procedure, a patient classified as financially indigent or medically indigent will not be required to pay for the designated portion of the care received. Services designated as charity and provided to these patients are not reported as net patient service revenue in the consolidated statements of operations and changes in net assets. The cost of charity care includes both direct and indirect costs calculated based on the ratio of cost to charges. Texas Children's total cost of charity care was \$15,806 and \$17,700 for the years ended September 30, 2017 and 2016, respectively. Funds received to offset or subsidize charity services were \$1,642 and \$67 for the years ended September 30, 2017 and 2016, respectively.
- **UNREIMBURSED COST OF GOVERNMENT SPONSORED INDIGENT HEALTH CARE** – represents the cost of providing services to beneficiaries of public programs, including State Medicaid and indigent care programs, in excess of any payments received from all sources.
- **COMMUNITY BENEFITS** – represents the unreimbursed cost of providing services for the benefit of the entire community. These benefits include philanthropy, education, research and various other community-based healthcare programs. The majority of these benefits are for graduate medical education and academic research. Other benefits for the community target the poor and underserved and include Project Medical Home, immunizations for children, and various community-based health educational resources. These programs are not intended to be financially self-supporting.

TCH makes other public disclosures regarding the estimated cost of its charity and community benefit activities in various reports to the state of Texas, as well as in its federal tax return.

TCH receives other supplemental funding from non-governmental sources to support its delivery of health care to indigent populations. For the years ended September 30, 2017 and 2016, TCH recorded other supplemental funding of \$8,785 and \$24,269, respectively, which is included in other operating revenues in the consolidated statements of operations and changes in net assets.

**14. MEDICAID SUPPLEMENTAL PAYMENTS**

TCH participates in the Medicaid disproportionate share hospital (DSH) funding programs, established by the state of Texas and administered by Texas Health and Human Services Commission (HHSC). Funds are distributed to hospitals that provide a high volume of services to Medicaid and uninsured patients. DSH funds are subject to audit and recovery by HHSC in accordance with the federal DSH audit rule. For the years ended September 30, 2017 and 2016, Texas Children's did not recognize any DSH revenue.

On December 5, 2014, TCH and Seattle Children's Hospital filed a lawsuit in the United States District Court for the District of Columbia (Court) against the United States Department of Health and Human Service's Centers for Medicare and Medicaid Services (CMS), seeking a temporary restraining order and eventual injunction to prohibit CMS from enforcing a change to the Hospital Specific Limit (HSL) calculation. CMS first stated in its response to a frequently asked question (FAQ No. 33) that costs and payments from private insurers are to be included in the HSL calculation when Medicaid made no payment on the claim. The Court has temporarily enjoined CMS from enforcing, applying, or implementing the policy contained in FAQ No. 33 pending further order from the Court. CMS and HHSC are prohibited from recouping any DSH funds provided to TCH related to FAQ No. 33. The Court's final ruling is pending. As of September 30, 2017 and 2016, TCH recorded a liability related to DSH funds that may be recouped, pending final determination from the federal court, of \$30,722.

On April 3, 2017, CMS published rule 42 CFR 447229 (Final Rule) that amended the December 19, 2008 rule 73 CFR 777904 (2008 Rule), to make explicit that in determining the total costs of inpatient and outpatient hospital services for purposes of calculating the HSL, costs must take into account third-party payments, including private insurance payments. CMS asserts that the policy of including private insurance payments in the calculation of HSL was contained in the 2008 Rule and therefore, the Final Rule has retroactive application. The Final Rule became effective on June 2, 2017. Due to the temporary injunction discussed above, there is no financial impact at this time.

On May 8, 2017, the Children's Hospital Association of Texas (CHAT), Clinics of Minnesota, Gillette Children's Specialty Healthcare, Children's Hospital of the King's Daughters Incorporated and Seattle Children's Hospital filed a lawsuit in the United States District Court for the District of Columbia against CMS seeking a temporary and eventual permanent injunction to prohibit CMS from enforcing, applying, and implementing the Final Rule. As members of CHAT, TCH, along with 7 additional children's hospitals in Texas, are parties to the lawsuit.

The 1115 Healthcare Transformation Waiver (1115 Waiver) program is a five-year federally approved program designed to supplement the unreimbursed costs of providing care to Medicaid and uninsured patients as the state implements the expansion of Medicaid managed care services across the state. The program was established during fiscal year 2012 and has been extended through fiscal year 2017. There are two pools of funds established under the 1115 Waiver program: uncompensated care (UC) and delivery system reform incentive payment (DSRIP). The state uses intergovernmental transfers from state-owned and local governmental entities to draw down federal funds to finance both pools. TCH recognizes revenue related to its share of the UC pool upon completion of the uncompensated care application (referred to as the UC tool), when funding is deemed available, and collection is reasonably assured. The DSRIP pool provides payments to hospitals upon achieving certain goals and metrics that are intended to increase access to health care, improve the quality of care, and enhance the health of patients and families they serve. TCH recognizes DSRIP revenue upon achievement of these goals and metrics.

1115 Waiver revenue and its related receivable are as follows:

	Year Ended	
	September 30, 2017	September 30, 2016
UC	\$ 13,331	\$ 4,047
DSRIP	31,343	31,678
Total 1115 Waiver Revenue	<u>\$ 44,674</u>	<u>\$ 35,725</u>
1115 Waiver Receivable	<u>\$ 30,021</u>	<u>\$ 29,800</u>

Further, TCH has recorded a liability of \$14,278 for 2015 UC payments received during fiscal year 2016, as the 2015 UC application submitted by TCH indicates that the payment received could be subject to recoupment pending audit in fiscal year 2018.

## 15. ASSOCIATED ORGANIZATIONS

TCH has an affiliation agreement with Baylor. Under the terms of the agreement, Baylor conducts research and educational activities, and its physicians provide patient care services while utilizing TCH's facilities in the practical application of the teaching process. Mutual commitments include sharing of operational and research costs, including residents' and physicians' salaries. In addition, TCH has an agreement with Baylor relating to overhead operating costs of the adult surgical subspecialty departments that manage pediatric components. During fiscal years 2017 and 2016, Texas Children's recorded expense of \$470,808 and \$428,102, respectively, related to these agreements, which is included in professional fees in the accompanying consolidated statements of operations and changes in net assets. Amounts due to Baylor of \$46,380 and \$46,108 are included in accounts payable and accrued expenses in the consolidated balance sheets as of September 30, 2017 and 2016, respectively.

Texas Children's entered into an agreement with Baylor to provide enhanced mission support for graduate and undergraduate medical education. For the fiscal years ended September 30, 2017 and 2016, Texas Children's made payments to Baylor of \$20,742 and \$7,813, respectively. Additionally, as of September 30, 2017 and 2016, amounts due to Baylor of \$2,880 and \$5,557, respectively, were recorded in accounts payable and accrued expenses. For the fiscal years ended September 30, 2017 and 2016, Texas Children's recognized \$17,766 and \$30,997, respectively, in expenses which are included in enhanced mission support in the consolidated statements of operations and changes in net assets. As of September 30, 2017 and 2016, the amount recorded as prepaid expense was \$11,039 and \$3,456, respectively, which is included in other current assets in the consolidated balance sheets. These amounts are in addition to the professional fees disclosed above.

In fiscal year 2016, Texas Children's purchased the Baylor Clinic building and the O'Quinn Medical Tower within the Texas Medical Center from CHI St. Luke's Health Baylor College of Medicine Medical Center and St. Luke's Medical Tower Corporation (collectively, the sellers). As part of the sale and purchase agreement, certain space is leased back to the sellers, which is a joint venture between CHI St. Luke's Health and Baylor. For the years ended September 30, 2017 and 2016, Texas Children's recognized \$9,468 and \$323, respectively, of rent revenue from the sellers. Additionally, as of September 30, 2017 and 2016, Texas Children's recorded a tenant improvement allowance liability owed to the sellers of \$36 and \$1,888, respectively.

TCH has a beneficial interest in the net assets of The Gordon and Mary Cain Pediatric Neurology Research Foundation (Cain Foundation), which is restricted for pediatric neurology programs and is included in temporarily restricted net assets. The Cain Foundation supports research, teaching, treatment, and related activities with respect to pediatric neurological disorders. The assets held by the Cain Foundation include primarily investments in debt and equity securities. TCH and the Cain Foundation are financially interrelated organizations in that the Cain Foundation manages assets for the sole benefit of TCH. The beneficial interest in the net assets of the Cain Foundation was \$24,913 and \$18,795 as of September 30, 2017 and 2016, respectively, and is included in assets limited as to use in the consolidated balance sheets and within alternative investments and other investments as referenced in Footnote 3.

#### **16. HURRICANE HARVEY IMPACT**

In August 2017, the Texas Gulf Coast was affected by Hurricane Harvey, which caused major flooding and resulted in major disruptions to individuals and businesses in the affected region. Certain Texas Children's locations were closed temporarily due to the storm. Texas Children's has a comprehensive insurance program that provides coverage for property damage and business interruption impact. For the year ended September 30, 2017, the costs incurred to repair or replace destroyed or damaged assets and asset impairments due to the storm did not have a material impact to Texas Children's consolidated financial statements. Because of uncertainties concerning the ultimate determination of recoveries related to business interruption claims, no such amounts are recognized until the underlying claims are resolved with the insurers. For the year ended September 30, 2017, no insurance recoveries were recorded due to the storm.

#### **17. SUBSEQUENT EVENTS**

Texas Children's evaluated events and transactions occurring subsequent to September 30, 2017 through December 14, 2017, the date of issuance of the financial statements. During this period, Texas Children's completed an extension for Series 2008-2 Bonds. The Mandatory Tender date has been extended from July 30, 2018 to September 30, 2022. There were no other subsequent events requiring recognition in the consolidated financial statements. Additionally, there were no non-recognized subsequent events requiring disclosure.

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# Texas Children's



Supplementary Information

**Texas Children's  
Consolidating Balance Sheet  
As of September 30, 2017**  
(Dollars in thousands)

	Texas Children's Hospital	Texas Children's Hospital Foundation	Obligated Group Eliminations	Combined Obligated Group	Texas Children's Pediatrics	Texas Children's Health Plan	TCH Insurance Company Ltd.	Texas Children's Women's Specialists	Texas Children's Physician Group	Eliminations	Total
<b>Assets:</b>											
<b>Current assets</b>											
Cash and cash equivalents	\$ 6,905	\$ 83,437	\$ -	\$ 90,342	\$ 22,584	\$ 99,235	\$ 154	\$ -	\$ 3,920	\$ -	\$ 216,235
Patient receivables, net of allowances	340,998	-	-	340,998	7,505	-	-	-	19,902	(64,621)	303,784
Receivable for Medicaid and other supplemental reimbursements	30,021	-	-	30,021	-	-	-	-	-	-	30,021
Assets limited as to use, current portion	36,824	-	-	36,824	-	-	-	-	-	-	36,824
Other current assets	128,987	-	-	128,987	7,250	13,462	11,038	47,262	88,560	(155,723)	140,836
Investment-related receivable	-	77,191	-	77,191	-	1,388	-	-	-	-	78,579
<b>Total current assets</b>	<b>543,735</b>	<b>160,628</b>	<b>-</b>	<b>704,363</b>	<b>37,339</b>	<b>114,085</b>	<b>11,192</b>	<b>47,262</b>	<b>112,382</b>	<b>(220,344)</b>	<b>806,279</b>
Assets limited as to use	2,046,182	-	(2,017,941)	28,241	-	4,512	92,387	-	-	(60)	125,080
Investments	256,785	2,218,103	(256,535)	2,218,353	-	103,025	-	-	-	-	2,321,378
Property and equipment, net	2,102,335	-	-	2,102,335	27,452	34,932	-	6,468	600	-	2,171,787
Other assets	88,773	-	-	88,773	5,163	648	-	-	-	-	94,584
Amounts due from affiliate	55,228	-	-	55,228	-	-	-	-	-	(55,228)	-
Investment in subsidiary	59,413	-	-	59,413	-	-	-	-	-	(59,413)	-
<b>Total assets</b>	<b>\$ 5,152,451</b>	<b>\$ 2,378,731</b>	<b>\$ (2,274,476)</b>	<b>\$ 5,256,706</b>	<b>\$ 69,954</b>	<b>\$ 257,202</b>	<b>\$ 103,579</b>	<b>\$ 53,730</b>	<b>\$ 112,982</b>	<b>\$ (335,045)</b>	<b>\$ 5,519,108</b>
<b>Liabilities and Net Assets (Deficit):</b>											
<b>Current liabilities</b>											
Accounts payable and accrued expenses	\$ 318,313	\$ 256,535	\$ (256,535)	\$ 318,313	\$ 38,586	\$ 149,892	\$ 8,398	\$ 65,514	\$ 91,144	\$ (220,587)	\$ 451,260
Investment-related accrued expenses	-	104,255	-	104,255	-	317	-	-	-	-	104,572
Current portion of long-term debt	17,415	-	-	17,415	-	-	-	-	-	-	17,415
Current portion of capital lease obligations	9,203	-	-	9,203	-	-	-	-	-	-	9,203
Line of credit	21,200	-	-	21,200	-	-	-	-	-	-	21,200
Long-term debt subject to remarketing	150,000	-	-	150,000	-	-	-	-	-	-	150,000
<b>Total current liabilities</b>	<b>516,131</b>	<b>360,790</b>	<b>(256,535)</b>	<b>620,386</b>	<b>38,586</b>	<b>150,209</b>	<b>8,398</b>	<b>65,514</b>	<b>91,144</b>	<b>(220,587)</b>	<b>753,650</b>
Long-term debt	773,068	-	-	773,068	-	-	-	-	-	-	773,068
Long-term capital lease obligations	3,905	-	-	3,905	-	-	-	-	-	-	3,905
Loss reserves for self-insurance program	-	-	-	-	-	-	36,988	-	-	-	36,988
Retirement plan liability	55,030	-	-	55,030	-	-	-	-	-	-	55,030
Other long-term liabilities	55,120	-	-	55,120	-	10,330	54,978	-	4	(54,987)	65,445
<b>Total liabilities</b>	<b>1,403,254</b>	<b>360,790</b>	<b>(256,535)</b>	<b>1,507,509</b>	<b>38,586</b>	<b>160,539</b>	<b>100,364</b>	<b>65,514</b>	<b>91,148</b>	<b>(275,574)</b>	<b>1,688,086</b>
<b>Net assets (deficit):</b>											
Unrestricted	3,380,634	2,017,941	(2,017,941)	3,380,634	31,368	96,663	3,215	(11,784)	21,834	(59,471)	3,462,459
Temporarily restricted	207,757	-	-	207,757	-	-	-	-	-	-	207,757
Permanently restricted	160,806	-	-	160,806	-	-	-	-	-	-	160,806
<b>Total net assets (deficit)</b>	<b>3,749,197</b>	<b>2,017,941</b>	<b>(2,017,941)</b>	<b>3,749,197</b>	<b>31,368</b>	<b>96,663</b>	<b>3,215</b>	<b>(11,784)</b>	<b>21,834</b>	<b>(59,471)</b>	<b>3,831,022</b>
<b>Total liabilities and net assets (deficit)</b>	<b>\$ 5,152,451</b>	<b>\$ 2,378,731</b>	<b>\$ (2,274,476)</b>	<b>\$ 5,256,706</b>	<b>\$ 69,954</b>	<b>\$ 257,202</b>	<b>\$ 103,579</b>	<b>\$ 53,730</b>	<b>\$ 112,982</b>	<b>\$ (335,045)</b>	<b>\$ 5,519,108</b>

**Texas Children's  
Consolidating Statement of Operations and Changes in Net Assets**  
Year ended September 30, 2017  
(Dollars in thousands)

	Texas Children's Hospital	Texas Children's Hospital Foundation	Obligated Group Eliminations	Combined Obligated Group	Texas Children's Pediatrics	Texas Children's Health Plan	TCH Insurance Company Ltd.	Texas Children's Women's Specialists	Texas Children's Physician Group	Eliminations	Total
Changes in unrestricted net assets:											
Operating revenues:											
Patient service revenue, net of contractals and discounts	\$ 1,875,152	\$ -	\$ -	\$ 1,875,152	\$ 205,398	\$ -	\$ -	\$ -	\$ 260,263	\$ (394,503)	\$ 1,946,310
Less provision for doubtful accounts	(62,529)	-	-	(62,529)	(2,810)	-	-	-	(13,586)	-	(78,925)
Net patient service revenue	1,812,623	-	-	1,812,623	202,588	-	-	-	246,677	(394,503)	1,867,385
Premium revenue	-	-	-	-	-	1,483,708	10,570	-	-	(10,585)	1,483,693
Medicaid and other supplemental reimbursements	49,626	-	-	49,626	6,435	-	-	-	-	(6,279)	49,782
Grants	24,527	-	-	24,527	35	700	-	-	-	-	25,262
Other	96,347	-	-	96,347	2,167	67	7,600	6,754	204,104	(227,858)	89,181
Net assets released from restrictions for operations	40,118	-	-	40,118	85	-	-	-	-	-	40,203
Total operating revenues	2,023,241	-	-	2,023,241	211,310	1,484,475	18,170	6,754	450,781	(639,225)	3,555,506
Operating expenses:											
Salaries and benefits	947,769	-	-	947,769	142,013	74,030	-	4,377	42,230	-	1,210,419
Medical and hospital	-	-	-	-	-	1,380,968	17,901	-	-	(409,221)	989,648
Professional fees	270,857	-	-	270,857	2	19	-	4	393,278	(193,352)	470,808
Supplies and pharmaceuticals	225,563	-	-	225,563	43,529	2	-	1,175	3,749	-	274,018
Outside purchased services	129,948	-	-	129,948	17,415	36,101	92	2,146	8,719	(29,690)	164,731
Depreciation and amortization	141,975	-	-	141,975	6,991	8,485	-	800	382	-	158,633
Operation of plant	106,684	-	-	106,684	3,625	2,929	8	-	35	-	113,281
General and administrative	68,880	-	-	68,880	5,005	35,011	169	626	1,964	(956)	110,699
Enhanced mission support	26,126	-	-	26,126	-	-	-	-	-	-	26,126
Interest	21,529	-	-	21,529	-	-	-	-	-	-	21,529
Total operating expenses	1,939,331	-	-	1,939,331	218,580	1,537,545	18,170	9,128	450,357	(633,219)	3,539,892
Operating income (loss)	83,910	-	-	83,910	(7,270)	(53,070)	-	(2,374)	424	(6,006)	15,614
Nonoperating gains (losses):											
Investment return	1,150	195,236	-	196,386	-	1,602	-	-	-	-	197,988
Change in interest rate swap valuation	20,655	-	-	20,655	-	-	-	-	-	-	20,655
Other	(6,421)	103	-	(6,318)	-	-	-	-	-	6,006	(312)
Net nonoperating gains	15,384	195,339	-	210,723	-	1,602	-	-	-	6,006	218,331
Revenues and gains in excess (deficiency) of expenses and losses	\$ 99,294	\$ 195,339	\$ -	\$ 294,633	\$ (7,270)	\$ (51,468)	\$ -	\$ (2,374)	\$ 424	\$ -	\$ 233,945

**Texas Children's**  
**Consolidating Statement of Operations and Changes in Net Assets, *continued***  
**Year ended September 30, 2017**  
*(Dollars in thousands)*

	Texas Children's Hospital	Texas Children's Hospital Foundation	Obligated Group Eliminations	Combined Obligated Group	Texas Children's Pediatrics	Texas Children's Health Plan	TCH Insurance Company Ltd.	Texas Children's Women's Specialists	Texas Children's Physician Group	Eliminations	Total
<b>Changes in unrestricted net assets:</b>											
Revenues and gains in excess (deficiency) of expenses and losses brought forward	\$ 99,294	\$ 195,339	\$ -	\$ 294,633	\$ (7,270)	\$ (51,468)	\$ -	\$ (2,374)	\$ 424	\$ -	\$ 233,945
Net assets released from restrictions for purchases of property, equipment and other	60,910	-	-	60,910	-	-	-	-	-	-	60,910
Change in pension liabilities	15,505	-	-	15,505	-	-	-	-	-	-	15,505
Equity transfer	(7,036)	(18,964)	-	(26,000)	-	26,000	-	-	-	-	-
Contributed capital	-	-	-	-	2,231	-	-	-	-	(2,231)	-
Beneficial interest in Texas Children's Hospital Foundation	176,375	-	(176,375)	-	-	-	-	-	-	-	-
<b>Change in unrestricted net assets</b>	<b>345,048</b>	<b>176,375</b>	<b>(176,375)</b>	<b>345,048</b>	<b>(5,039)</b>	<b>(25,468)</b>	<b>-</b>	<b>(2,374)</b>	<b>424</b>	<b>(2,231)</b>	<b>310,360</b>
<b>Changes in temporarily restricted net assets:</b>											
Donor-restricted contributions	88,098	-	-	88,098	-	-	-	-	-	-	88,098
Investment return and other	7,160	-	-	7,160	-	-	-	-	-	-	7,160
Net assets released from restrictions	(100,811)	-	-	(100,811)	-	-	-	-	-	-	(100,811)
Change in beneficial interest in net assets of donor-restricted foundations	7,563	-	-	7,563	-	-	-	-	-	-	7,563
<b>Change in temporarily restricted net assets</b>	<b>2,010</b>	<b>-</b>	<b>-</b>	<b>2,010</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,010</b>
<b>Changes in permanently restricted net assets:</b>											
Donor-restricted contributions	15,943	-	-	15,943	-	-	-	-	-	-	15,943
Investment return and other	4,958	-	-	4,958	-	-	-	-	-	-	4,958
<b>Change in permanently restricted net assets</b>	<b>20,901</b>	<b>-</b>	<b>-</b>	<b>20,901</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>20,901</b>
<b>Change in net assets</b>	<b>367,959</b>	<b>176,375</b>	<b>(176,375)</b>	<b>367,959</b>	<b>(5,039)</b>	<b>(25,468)</b>	<b>-</b>	<b>(2,374)</b>	<b>424</b>	<b>(2,231)</b>	<b>333,271</b>
Net assets (deficit) at beginning of year	3,381,238	1,841,566	(1,841,566)	3,381,238	36,407	122,131	3,215	(9,410)	21,410	(57,240)	3,497,751
<b>Net assets (deficit) at end of year</b>	<b>\$ 3,749,197</b>	<b>\$ 2,017,941</b>	<b>\$ (2,017,941)</b>	<b>\$ 3,749,197</b>	<b>\$ 31,368</b>	<b>\$ 96,663</b>	<b>\$ 3,215</b>	<b>\$ (11,784)</b>	<b>\$ 21,834</b>	<b>\$ (59,471)</b>	<b>\$ 3,831,022</b>

**Texas Children's**  
**Condensed Consolidating Statement of Cash Flows**  
**Year ended September 30, 2017**  
*(Dollars in thousands)*

	Texas Children's Hospital	Texas Children's Hospital Foundation	Obligated Group Eliminations	Combined Obligated Group	Texas Children's Pediatrics	Texas Children's Health Plan	TCH Insurance Company Ltd.	Texas Children's Women's Specialists	Texas Children's Physician Group	Eliminations	Total
<b>Operating activities:</b>											
Net cash provided by (used in) operating activities	\$ 157,989	\$ (8,430)	\$ 4,460	\$ 154,019	\$ 3,739	\$ 48,994	\$ (2,708)	\$ -	\$ 311	\$ -	\$ 204,355
<b>Investing activities:</b>											
Sales (purchases) of investments, net	91,017	(31,183)	(4,460)	55,374	-	(6,946)	2,782	-	-	-	51,210
(Purchases) sales of property and equipment	(336,390)	-	-	(336,390)	(8,327)	78	-	-	3	-	(344,636)
Net cash (used in) provided by investing activities	(245,373)	(31,183)	(4,460)	(281,016)	(8,327)	(6,868)	2,782	-	3	-	(293,426)
<b>Financing activities:</b>											
Borrowings under line-of-credit	21,200	-	-	21,200	-	-	-	-	-	-	21,200
Principal payment on long-term debt	(15,755)	-	-	(15,755)	-	-	-	-	-	-	(15,755)
Principal payment on capital lease obligations	(5,224)	-	-	(5,224)	-	-	-	-	-	-	(5,224)
Temporarily and permanently restricted contributions received	39,297	-	-	39,297	-	-	-	-	-	-	39,297
Proceeds from sale of donated securities with restrictions	-	7,479	-	7,479	-	-	-	-	-	-	7,479
Permanently restricted investment return	4,958	-	-	4,958	-	-	-	-	-	-	4,958
Net cash provided by financing activities	44,476	7,479	-	51,955	-	-	-	-	-	-	51,955
Net (decrease) increase in cash and cash equivalents	(42,908)	(32,134)	-	(75,042)	(4,588)	42,126	74	-	314	-	(37,116)
Cash and cash equivalents at beginning of year	49,813	115,571	-	165,384	27,172	57,109	80	-	3,606	-	253,351
Cash and cash equivalents at end of year	\$ 6,905	\$ 83,437	\$ -	\$ 90,342	\$ 22,584	\$ 99,235	\$ 154	\$ -	\$ 3,920	\$ -	\$ 216,235
<b>Supplemental Disclosures</b>											
Cash paid for interest	\$ 30,405	\$ -	\$ -	\$ 30,405	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 30,405
Capital in accounts payable and accrued expenses	\$ 41,250	\$ -	\$ -	\$ 41,250	\$ 418	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 41,668