



**Texas Children's<sup>®</sup>**



Fiscal 2018 Annual Report

## Table of Contents

	<u>Page</u>
Management's Discussion and Analysis (unaudited)	2
Report of Independent Auditors	8
Consolidated Balance Sheets	10
Consolidated Statements of Operations and Changes in Net Assets	11
Consolidated Statements of Cash Flows	13
Notes to the Consolidated Financial Statements	14
Consolidating Balance Sheet	40
Consolidating Statement of Operations and Changes in Net Assets	41
Condensed Consolidating Statement of Cash Flows	43

# who we are

Texas Children's is a not-for-profit organization located in the Texas Medical Center in Houston, Texas and the surrounding communities. 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 (OB/GYN) care, as well as pediatric facilities in west Houston and The Woodlands. In fiscal year 2018, we opened the expansion of Legacy Tower in the Texas Medical Center. The 25-floor Legacy Tower houses 132 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 is the new home of Texas Children's Heart Center, including the outpatient clinic, four cardiovascular ORs and four catheterization labs. This vertical expansion reinvested in the programs needed to provide the highest level of care to our most critically ill patients. In 2018, Texas Children's began expanding our pediatric and OB/GYN services into Austin, beginning with the opening of a welcome center, followed by pediatric primary care and urgent care clinics.



Texas Children's, 1954



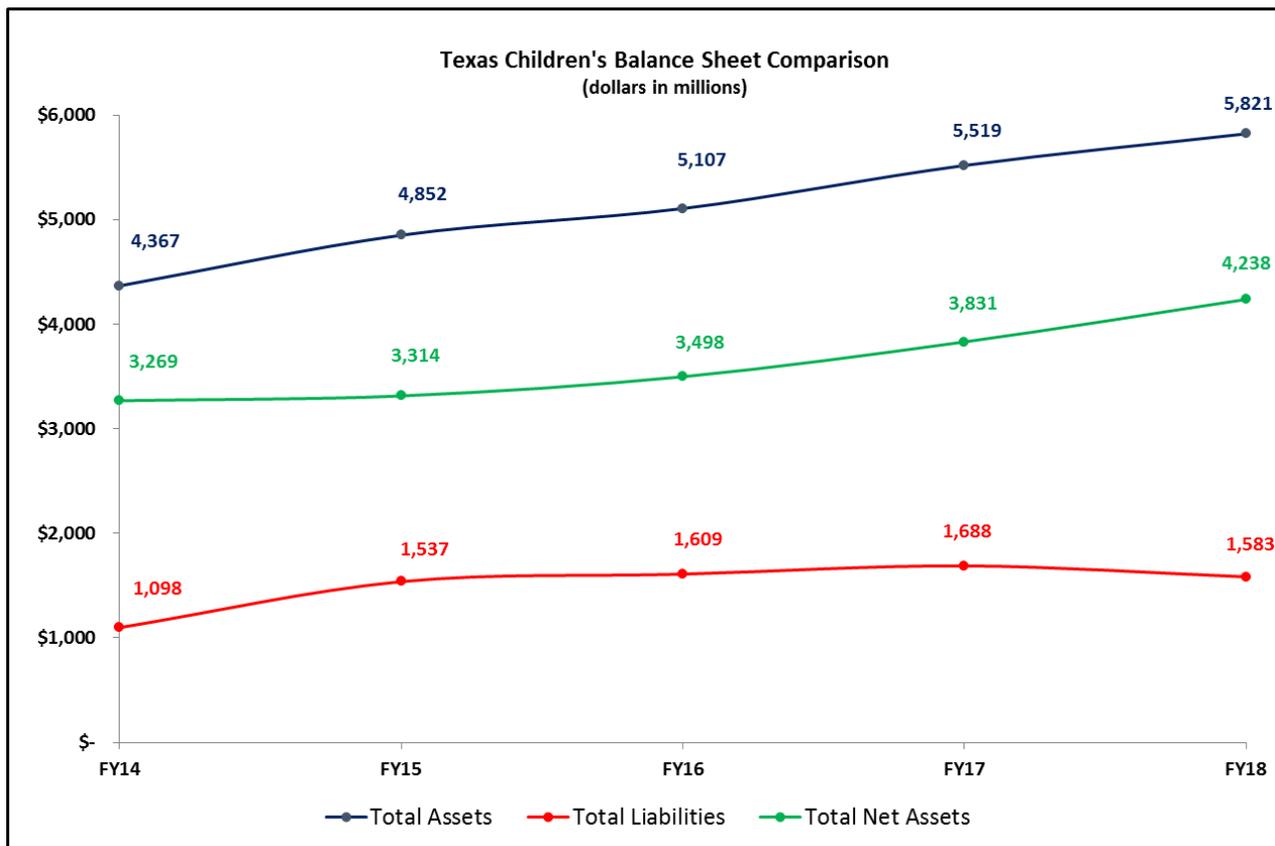
Texas Children's, 2018

## U.S. News & World Report

The 2018-19 edition of Best Children’s Hospitals by *U.S. News & World Report* ranked Texas Children’s Hospital fourth in the country among nearly 200 pediatric centers. For the tenth straight year, Texas Children’s Hospital placed on the Best Children’s Hospital Honor Roll of best pediatric institutions. Texas Children’s Hospital is one of only 10 children’s hospitals across the country to achieve the Honor Roll designation, and is 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 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. For the second straight year, Texas Children’s Heart Center ranked as the best cardiology and heart surgery service in the country. The pulmonology care program also achieved best in the country ranking, along with four additional subspecialties that are among the top five programs nationally.

## Financial Results – Texas Children’s

Texas Children’s consolidated balance sheets remain strong. As of September 30, 2018, total assets were \$5.82 billion and debt to capitalization was 18.2%. Days cash on hand was 232 as of September 30, 2018, a 14 day decrease from prior year end. This decrease was the result of planned capital expenditures for expansion projects.



For the twelve months ended September 30, 2018, Texas Children’s operating income was \$113.2 million, which was an increase of \$97.6 million compared to prior year. Texas Children’s operating cash flow, which is calculated by adding back interest, depreciation, and amortization costs to operating income, was \$306.7 million for the twelve months ended September 30, 2018, which was an increase of \$110.9 million from prior year.

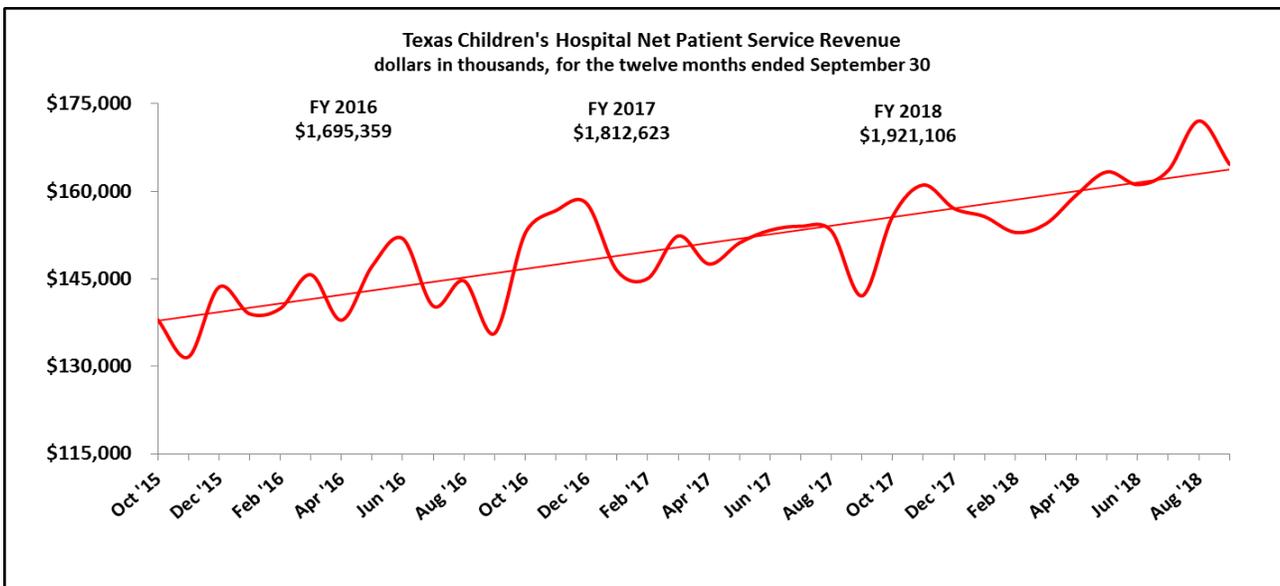
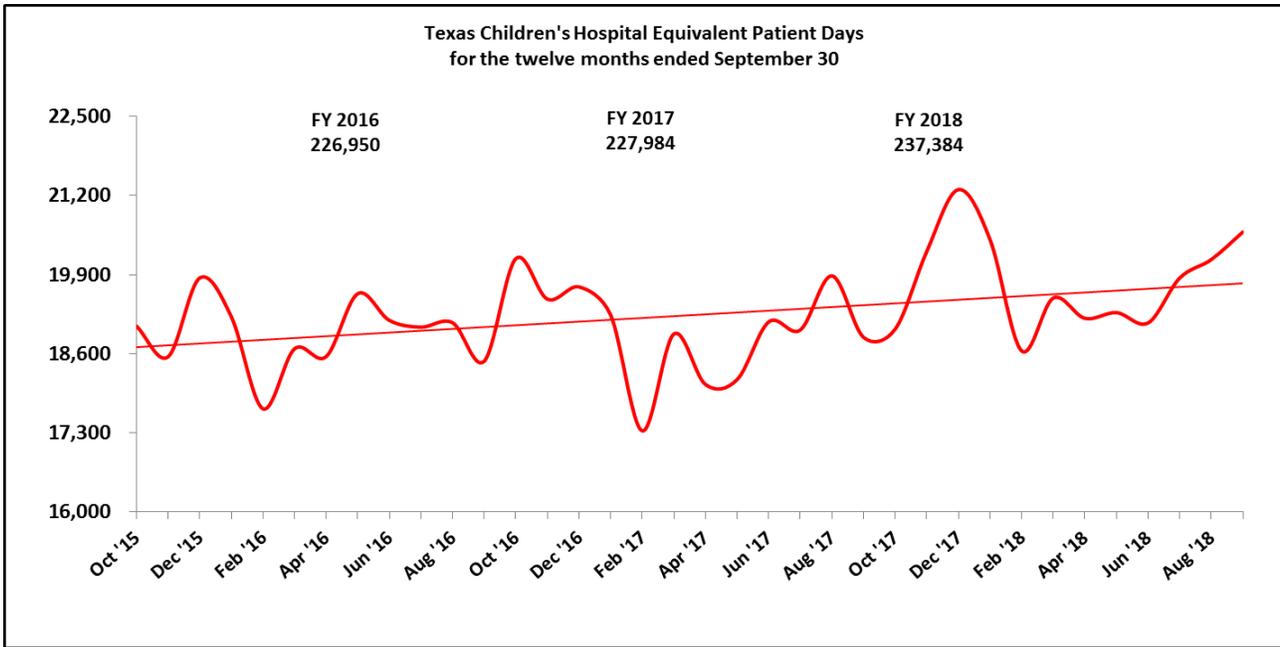
As described in Footnote 14 to the consolidated financial statements, on March 2, 2018, the United States District Court for the District of Columbia issued a final judgment vacating a Centers for Medicare and Medicaid Services (CMS) rule that allowed the agency to include private insurance payments, even when Medicaid does not pay for the patient’s care, in the calculation that determines the amount hospitals are eligible to receive in supplemental Medicaid funding. Based on the judgment, during the twelve months ended September 30, 2018, Texas Children’s recognized \$45.0 million in revenue for disproportionate share hospital (DSH) and uncompensated care (UC) funds that had been received in cash and reserved in prior years. Additionally, Texas Children’s recognized \$61.3 million of DSH and UC revenue related to the current fiscal year.

<b>Texas Children's Statistical Summary for the twelve months ended September 30</b>				
	<u>FY 2018 Actual</u>	<u>FY 2017 Actual</u>	<u>Increase</u>	<u>%Increase</u>
<b>Admissions</b>	<b>34,455</b>	<b>33,366</b>	<b>1,089</b>	<b>3.3%</b>
<b>Average Daily Census</b>	<b>650</b>	<b>625</b>	<b>25</b>	<b>4.0%</b>
<b>Surgery Cases</b>	<b>37,447</b>	<b>33,655</b>	<b>3,792</b>	<b>11.3%</b>
<b>Surgery Hours</b>	<b>58,095</b>	<b>53,884</b>	<b>4,211</b>	<b>7.8%</b>
<b>Emergency Room Visits</b>	<b>152,316</b>	<b>126,112</b>	<b>26,204</b>	<b>20.8%</b>
<b>Urgent Care Encounters</b>	<b>123,326</b>	<b>87,242</b>	<b>36,084</b>	<b>41.4%</b>
<b>Births</b>	<b>6,401</b>	<b>5,719</b>	<b>682</b>	<b>11.9%</b>

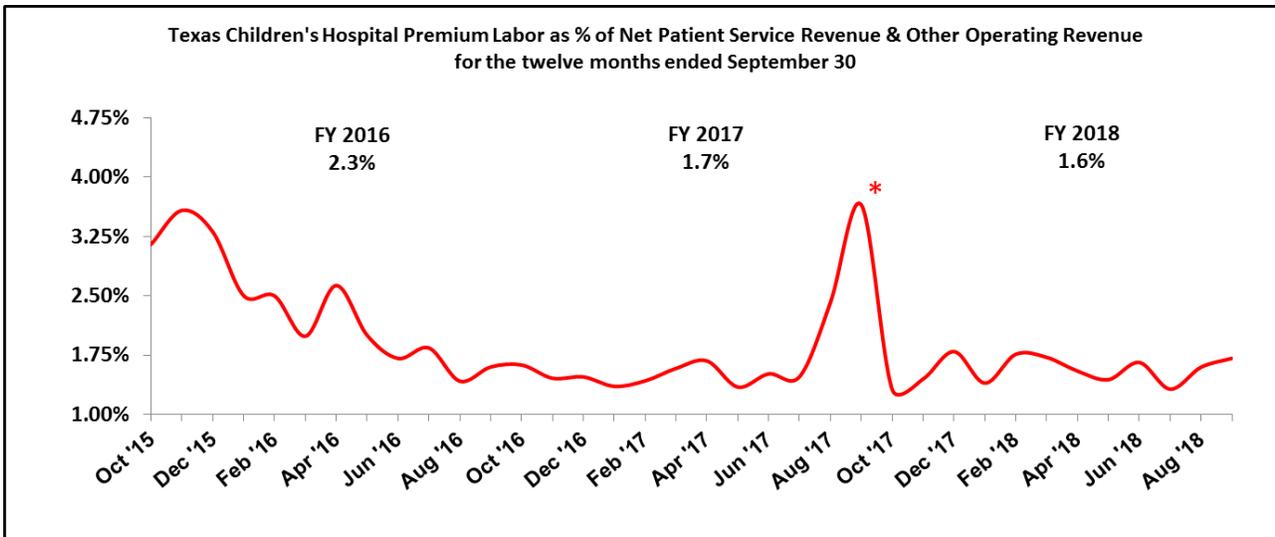
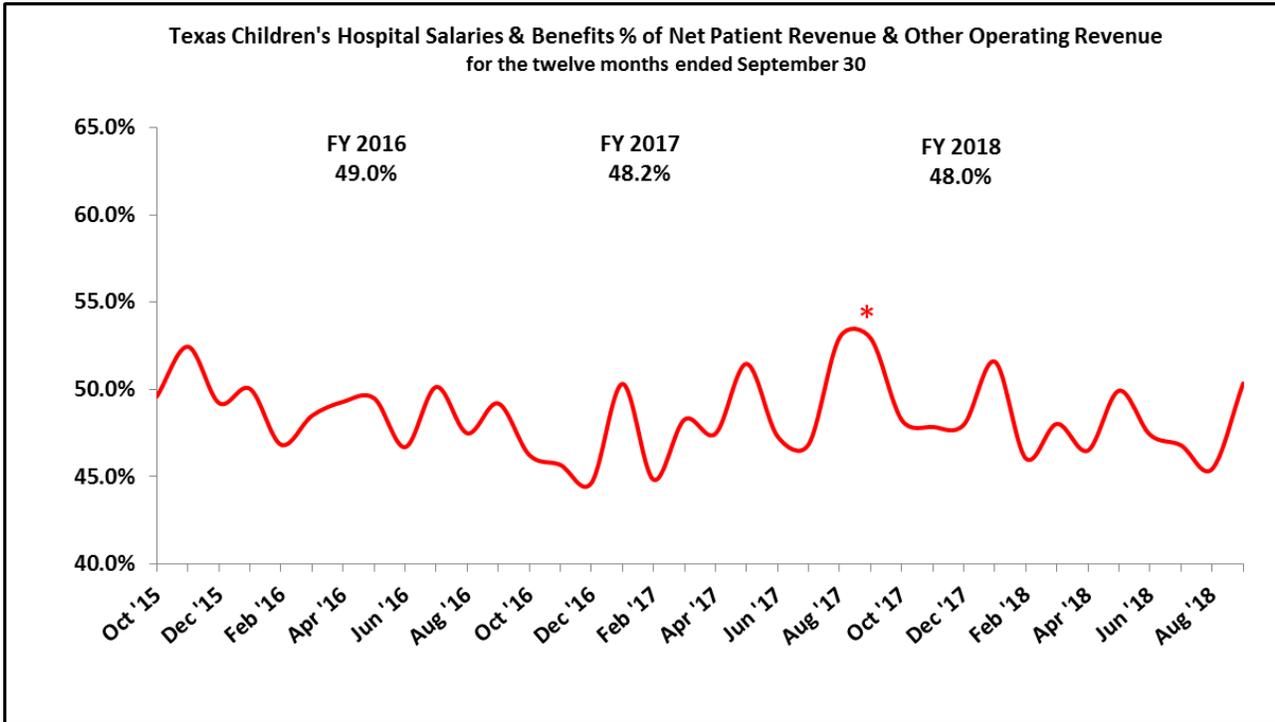
## Financial Results – Texas Children’s Hospital

Texas Children’s Hospital’s operating income was \$132.5 million for the twelve months ended September 30, 2018, an increase of \$48.6 million from prior year.

For the twelve months ended September 30, 2018, net patient service revenue increased \$108.5 million, or 6.0%, compared to prior year. The Woodlands hospital, which opened inpatient operations in April 2017, accounted for the majority of the increase. During fiscal year 2018, total equivalent patient days increased 9,400 or 4.1%, driven mainly by The Woodlands hospital. Surgery cases and surgery hours also increased 11.3% and 7.8%, respectively, compared to prior year.



Texas Children’s Hospital continues to closely monitor expenses. For the twelve months ended September 30, 2018, salaries and benefits as a percentage of net patient service revenue and other revenue was 48.0%, compared to 48.2% in prior year. Texas Children’s Hospital had full time equivalents of 10,243 and 9,160 for the twelve months ended September 30, 2018 and 2017, respectively.

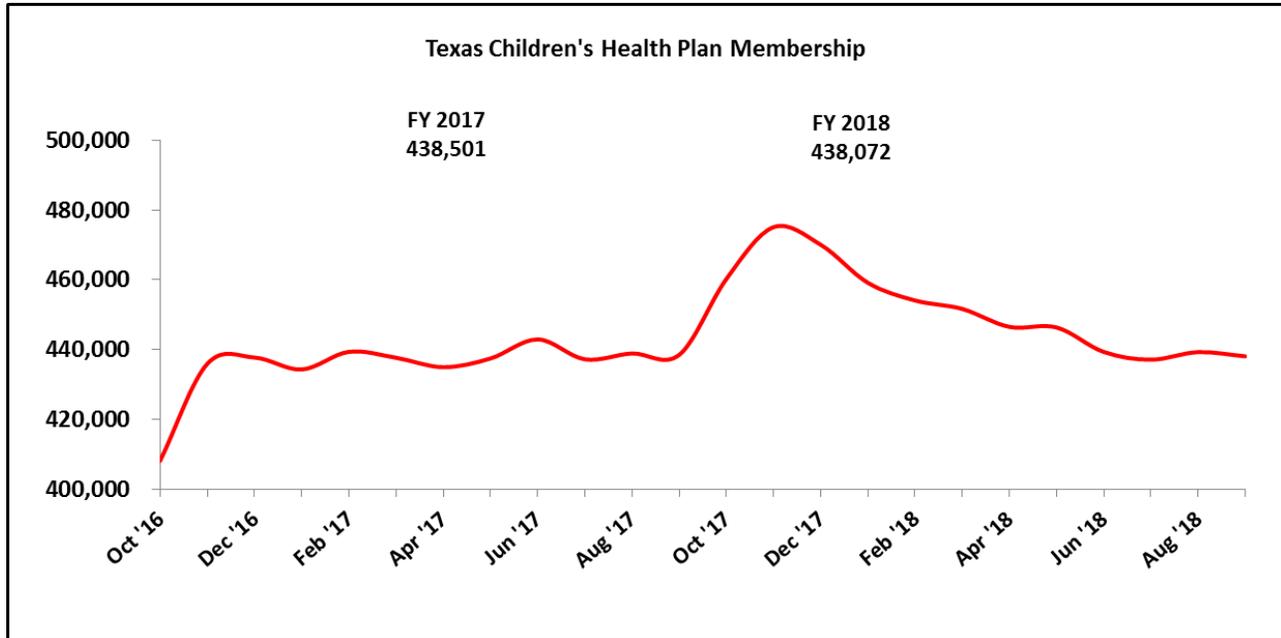


\* The increase during the fourth quarter of fiscal year 2017 was due to additional expenses associated with Hurricane Harvey.

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

Texas Children’s Health Plan had an operating loss of \$8.9 million for the twelve months ended September 30, 2018, which was a \$44.2 million improvement from prior year. Several initiatives to optimize financial performance impacted the financial results, including premium rate increases from the state that became effective September 1, 2017 and September 1, 2018. The medical loss ratio improved to 91.7% in fiscal year 2018, compared to 93.1% in prior year.

Membership of 438,072 at September 30, 2018 was consistent with prior year end. Due to Hurricane Harvey, the state of Texas automatically re-enrolled all Medicaid members in the first quarter of fiscal year 2018 to eliminate the burden of enrollment for displaced individuals. Membership subsequently decreased, as the automatic enrollment period ended and certain members were no longer eligible for Medicaid.





Ernst & Young LLP  
5 Houston Center  
Suite 1200  
1401 McKinney Street  
Houston, TX 77010

Tel: +1 713 750 1500  
Fax: +1 713 750 1501  
ey.com

## 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, 2018 and 2017, 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, 2018 and 2017, 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.

## **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 13, 2018

**Texas Children's  
Consolidated Balance Sheets**

(Dollars in thousands)

	<u>September 30, 2018</u>	<u>September 30, 2017</u>
Assets:		
Current assets		
Cash and cash equivalents	\$ 198,359	\$ 216,235
Patient receivables, net of allowances of \$383,762 and \$272,657, as of 2018 and 2017, respectively	353,670	303,784
Receivable for Medicaid and other supplemental reimbursements	409	30,021
Assets limited as to use, current portion	37,571	36,824
Other current assets	183,189	140,836
Investment-related receivable	<u>88,934</u>	<u>78,579</u>
Total current assets	862,132	806,279
Assets limited as to use	100,868	125,080
Investments	2,400,641	2,321,378
Property and equipment, net	2,315,020	2,171,787
Other assets	<u>142,774</u>	<u>94,584</u>
Total assets	<u>\$ 5,821,435</u>	<u>\$ 5,519,108</u>
Liabilities and net assets:		
Current liabilities		
Accounts payable and accrued expenses	\$ 456,329	\$ 451,260
Investment-related accrued expenses	89,872	104,572
Current portion of long-term debt	18,600	17,415
Current portion of capital lease obligations	2,996	9,203
Line of credit	5,000	21,200
Long-term debt subject to remarketing agreements	<u>141,500</u>	<u>150,000</u>
Total current liabilities	714,297	753,650
Long-term debt	759,825	773,068
Long-term capital lease obligations	870	3,905
Loss reserves for self-insurance program	40,297	36,988
Retirement plan liability	22,255	55,030
Other long-term liabilities	<u>45,952</u>	<u>65,445</u>
Total liabilities	<u>1,583,496</u>	<u>1,688,086</u>
Net assets:		
Unrestricted	3,826,121	3,462,459
Temporarily restricted	226,817	207,757
Permanently restricted	<u>185,001</u>	<u>160,806</u>
Total net assets	<u>4,237,939</u>	<u>3,831,022</u>
Total liabilities and net assets	<u>\$ 5,821,435</u>	<u>\$ 5,519,108</u>

See accompanying notes to consolidated financial statements.

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

(Dollars in thousands)

	Year Ended September 30,	
	2018	2017
Changes in unrestricted net assets:		
Operating revenues:		
Patient service revenue, net of contractals and discounts	\$ 2,019,362	\$ 1,946,310
Less provision for doubtful accounts	(74,333)	(78,925)
Net patient service revenue	1,945,029	1,867,385
Premium revenue	1,666,796	1,483,693
Medicaid and other supplemental reimbursements	116,283	49,782
Grants	29,345	25,262
Other	96,085	89,181
Net assets released from restrictions for operations	44,018	40,203
Total operating revenues	<u>3,897,556</u>	<u>3,555,506</u>
Operating expenses:		
Salaries and benefits	1,288,672	1,210,419
Medical claims	1,031,650	989,648
Professional fees	515,493	470,808
Supplies and pharmaceuticals	314,563	274,018
Outside purchased services	180,096	164,731
Depreciation and amortization	171,610	158,633
Operation of plant	118,784	113,281
General and administrative	119,025	110,699
Enhanced mission support	22,601	26,126
Interest	21,843	21,529
Total operating expenses	<u>3,784,337</u>	<u>3,539,892</u>
Operating income	<u>113,219</u>	<u>15,614</u>
Nonoperating gains (losses):		
Investment return	163,261	197,988
Change in interest rate swap valuation	14,709	20,655
Other	(115)	(312)
Net nonoperating gains	<u>177,855</u>	<u>218,331</u>
Revenues and gains in excess of expenses and losses	<u>\$ 291,074</u>	<u>\$ 233,945</u>

See accompanying notes to consolidated financial statements.

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

*(Dollars in thousands)*

	Year Ended	
	September 30,	
	<u>2018</u>	<u>2017</u>
Changes in unrestricted net assets:		
Revenues and gains in excess of expenses and losses brought forward	\$ 291,074	\$ 233,945
Net assets released from restrictions for purchases of property, equipment and other	15,298	60,910
Change in pension liabilities	34,020	15,505
Other	<u>23,270</u>	<u>-</u>
Change in unrestricted net assets	<u>363,662</u>	<u>310,360</u>
Changes in temporarily restricted net assets:		
Donor-restricted contributions	92,723	88,098
Investment return and other	8,771	7,160
Net assets released from restrictions	(57,844)	(100,811)
Change in beneficial interest in net assets of donor-restricted foundations	<u>(24,590)</u>	<u>7,563</u>
Change in temporarily restricted net assets	<u>19,060</u>	<u>2,010</u>
Changes in permanently restricted net assets:		
Donor-restricted contributions	13,641	15,943
Investment return and other	<u>10,554</u>	<u>4,958</u>
Change in permanently restricted net assets	<u>24,195</u>	<u>20,901</u>
Change in net assets	406,917	333,271
Net assets at beginning of year	<u>3,831,022</u>	<u>3,497,751</u>
Net assets at end of year	\$ <u>4,237,939</u>	\$ <u>3,831,022</u>

*See accompanying notes to consolidated financial statements.*

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

(Dollars in thousands)

	Year Ended	
	September 30,	
	<u>2018</u>	<u>2017</u>
Operating activities:		
Change in net assets	\$ 406,917	\$ 333,271
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	1,546	(7,563)
Decrease in pension liabilities	(34,020)	(15,505)
Net realized and unrealized gains on investments	(169,563)	(200,519)
Depreciation and amortization	171,610	158,633
Decrease in interest rate swap valuation	(14,709)	(20,655)
Provision for doubtful accounts	74,333	78,925
Temporarily and permanently restricted contributions received	(41,927)	(46,776)
Changes in assets and liabilities		
Increase in patient receivables	(124,219)	(125,265)
Decrease in receivable for Medicaid and other supplemental reimbursements	29,612	83
Increase in other assets	(88,161)	(53,918)
Increase in accounts payable and accrued expenses	16,020	94,642
(Decrease) increase in other liabilities	(5,828)	9,002
Total adjustments	<u>(185,306)</u>	<u>(128,916)</u>
Net cash provided by operating activities	<u>221,611</u>	<u>204,355</u>
Investing activities:		
Sales of investments, net	80,454	51,210
Purchases of property and equipment	<u>(325,721)</u>	<u>(344,636)</u>
Net cash used in investing activities	<u>(245,267)</u>	<u>(293,426)</u>
Financing activities:		
(Repayments on) borrowings under line-of-credit	(16,200)	21,200
Principal payment on long-term debt	(17,415)	(15,755)
Principal payment on capital lease obligations	(9,242)	(5,224)
Temporarily and permanently restricted contributions received	34,959	39,297
Proceeds from sale of donated securities with restrictions	6,968	7,479
Temporarily and permanently restricted investment return	6,710	4,958
Net cash provided by financing activities	<u>5,780</u>	<u>51,955</u>
Net decrease in cash and cash equivalents	(17,876)	(37,116)
Cash and cash equivalents at beginning of year	216,235	253,351
Cash and cash equivalents at end of year	\$ <u>198,359</u>	\$ <u>216,235</u>
Supplemental Disclosures:		
Cash paid for interest	\$ 33,139	\$ 30,405
Capital in accounts payable and accrued expenses	\$ 30,717	\$ 41,668

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 680 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, and has expanded into Austin in fiscal year 2018.

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 and general liability coverage, as well as property 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.

The Gordon and Mary Cain Pediatric Neurology Research Foundation (Cain Foundation) supports scientific and educational purposes with respect to pediatric neurological disorders, solely for the benefit of TCH.

Texas Children's is the sole corporate member of TCH, TCP, TCHP, TCHF, TCWS, TCPG, and Cain Foundation 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% of self-pay accounts receivable as of September 30, 2018 and 2017, and self-pay write-offs totaled \$80,247 and \$68,683 for the twelve months ended September 30, 2018 and 2017, 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 twelve months ended September 30, 2016.

As of September 30, 2018 and 2017, third-party payor receivables of \$194 and \$957, respectively, are included in other current assets in the consolidated balance sheets. As of September 30, 2018 and 2017, third-party payor liabilities of \$672 and \$1,767, 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 in the consolidated balance sheets.

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 2018 or 2017.

**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, 2018 and 2017, Texas Children's had inventory of \$26,031 and \$25,359, 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. Premium revenue was derived from the various programs as follows:

	Year Ended	
	September 30, 2018	September 30, 2017
Medicaid STAR	55 %	58 %
Medicaid STAR Kids	36	32
CHIP	9	10
Total	100 %	100 %

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, 2018 and 2017, 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 CLAIMS 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, 2018 and 2017, recorded accruals were \$70,499 and \$40,582, 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, 2018 and 2017. The Tax Cuts and Jobs Act (the Act) was enacted on December 22, 2017. The Act includes several provisions that could impact Texas Children's, including new excise taxes on executive compensation, increases to unrelated business taxable income (UBTI) by the amount of certain fringe benefits for which a deduction is not allowed, and the computation of UBTI separately for each unrelated trade or business. Further, the Act reduces the US federal corporate tax rate from a maximum of 35% to 21%. Texas Children's will continue to evaluate the impact of the Act as further regulatory guidance is issued.

## 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.

## PENDING ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. The adoption of the new accounting standard will impact the presentation of the Texas Children's consolidated statements of operations and changes in net assets for a significant component of its provision for doubtful accounts. After adoption of the new standard, what is currently classified as the provision for doubtful accounts will be reflected as an implicit price concession as defined in the standard, and will no longer be separately stated as a reduction to net patient service revenue. Texas Children's will consider certain changes in the financial status of a third-party payor not assessed at the date of service, for example, a bankruptcy, as bad debt expense within general and administrative expense.

Texas Children's will adopt ASU 2014-09 by applying the full retrospective method effective October 1, 2018. The full retrospective method requires application of the provisions of ASU 2014-09 for all periods presented. Texas Children's has completed the assessment of the impact of the new standard on various reimbursement programs that represent variable consideration and concluded that the accounting for these programs under ASU 2014-09 is substantially consistent with Texas Children's historical accounting. These include supplemental state Medicaid programs, disproportionate share payments and settlements with third-party payors. While the adoption of ASU 2014-09 will have a material effect on the presentation of net patient service revenue in Texas Children's consolidated statements of operations and changes in net assets, and on certain disclosures, it will not materially impact the consolidated results of operations or cash flows. The cumulative effect of the change in accounting principle effective October 1, 2018, if any, will be immaterial.

In August 2016, the 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. ASU 2016-14 is effective for Texas Children’s beginning October 1, 2018. After adoption of the new standard, what is currently classified as temporarily and permanently restricted net assets will be reflected as assets with donor restrictions within the consolidated balance sheets. The new standard also requires enhanced disclosures on liquidity, availability of resources, and endowments, which will be reflected in the footnotes to the consolidated financial statements. Texas Children’s does not anticipate ASU 2016-14 will have a significant impact on the consolidated financial statements.

In August 2016, the 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. Texas Children’s will adopt this standard within the consolidated financial statements beginning October 1, 2018. Texas Children’s does not anticipate ASU 2016-15 will have a significant impact on the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which calls for the reporting of assets and liabilities arising from leases in a more transparent 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 in the process of identifying the complete population to evaluate the impact on its consolidated financial statements from the adoption of this guidance.

In March 2017, the FASB issued ASU No. 2017-07 “*Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.*” The ASU is intended to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The amendment applies to all entities offering a defined benefit pension plan, other postretirement benefit plans, or other types of benefits accounted for under Topic 715. The amendments in the ASU require an employer to report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. The amendments in this ASU are effective for annual periods beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. The amendments in this ASU should be applied retrospectively for the presentation of the service cost component and the other components of net periodic pension cost and net periodic postretirement benefit cost in the income statement and prospectively, on and after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic postretirement benefit in assets. 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, 2018</b>	<b>September 30, 2017</b>
Investments	\$ 2,400,641	\$ 2,321,378
Assets limited as to use:		
Assets held by bond trustee	37,571	36,824
Assets held for insurance program	92,752	92,387
Assets restricted under statutory requirements	4,525	4,512
Beneficial interest in supporting foundations	3,591	28,181
Total assets limited as to use	<u>138,439</u>	<u>161,904</u>
Total investments and assets limited as to use	<u>\$ 2,539,080</u>	<u>\$ 2,483,282</u>

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

	<b>September 30, 2018</b>	<b>September 30, 2017</b>
Cash and cash equivalents	\$ 37,571	\$ 36,824
U.S. government fixed income securities	76,420	93,297
U.S. government agency securities	83,736	96,115
Municipal government securities	990	1,121
Foreign government fixed income securities	9,385	7,526
Corporate fixed income securities	275,755	254,350
Domestic equity securities	485,804	399,614
International equity securities	88,173	143,295
Alternative investments	1,477,405	1,422,709
Other	3,841	28,431
Total	<u>\$ 2,539,080</u>	<u>\$ 2,483,282</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 input 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, 2018 and 2017, by caption and 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, 2018 and 2017, Texas Children's had \$112,700 and \$74,474, 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 also included in the tables.

September 30, 2018

**FINANCIAL ASSETS AND LIABILITIES AT FAIR VALUE**  
as of September 30, 2018

	Level 1	Level 2	Level 3	Total
<b>ASSETS</b>				
Investments:				
Cash and cash equivalents	\$ 150,271	\$ -	\$ -	\$ 150,271
Derivative financial instruments	-	71,304	-	71,304
U.S. government fixed income securities	13,416	63,004	-	76,420
U.S. government agency securities	-	83,736	-	83,736
Municipal government securities	-	990	-	990
Foreign government fixed income securities	-	9,385	-	9,385
Corporate fixed income securities	-	275,755	-	275,755
Domestic equity securities	485,804	-	-	485,804
International equity securities	88,173	-	-	88,173
Interest rate swap agreement	-	2,424	-	2,424
Total assets at fair value	<u>\$ 737,664</u>	<u>\$ 506,598</u>	<u>\$ -</u>	<u>\$ 1,244,262</u>
<b>LIABILITIES</b>				
Derivative financial instruments	\$ -	\$ 71,249	\$ -	\$ 71,249
Interest rate swap agreement	-	21,018	-	21,018
Total liabilities at fair value	<u>\$ -</u>	<u>\$ 92,267</u>	<u>\$ -</u>	<u>\$ 92,267</u>

**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	10,434	82,863	-	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	<u>\$ 664,641</u>	<u>\$ 511,775</u>	<u>\$ -</u>	<u>\$ 1,176,416</u>
<b>LIABILITIES</b>				
Derivative financial instruments	\$ -	\$ 68,803	\$ -	\$ 68,803
Interest rate swap agreements	-	33,303	-	33,303
Total liabilities at fair value	<u>\$ -</u>	<u>\$ 102,106</u>	<u>\$ -</u>	<u>\$ 102,106</u>

**FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE**

As of September 30, 2018 and 2017, 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 \$934,305 and \$969,161 as of September 30, 2018 and 2017, 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, 2018 and 2017, Texas Children's had \$1,481,246 and \$1,451,140, respectively, in alternative investments and other investments, and had committed approximately \$276,400 of future funding to various alternative investments as of September 30, 2018.

**SUMMARY OF INVESTMENT RETURNS**

	Year Ended	
	September 30, 2018	September 30, 2017
Unrestricted:		
Dividends and interest, net of investment expenses	\$ 18,889	\$ 21,855
Net unrealized gains	25,343	13,143
Net realized gains	27,427	9,718
Equity in gains of alternative investments, not measured at fair value:		
Net unrealized gains	30,821	147,092
Net realized gains	66,647	18,448
Total unrestricted investment return	<u>\$ 169,127</u>	<u>\$ 210,256</u>
Temporarily restricted:		
Dividends and interest, net of investment expenses	\$ 10,279	\$ 11,616
Net unrealized losses	(1,814)	(3,771)
Net realized gains (losses)	306	(685)
Total temporarily restricted investment return	<u>\$ 8,771</u>	<u>\$ 7,160</u>
Permanently restricted:		
Dividends and interest, net of investment expenses	\$ (3,569)	\$ (3,278)
Net unrealized gains	7,312	5,321
Net realized gains	6,811	2,915
Total permanently restricted investment return	<u>\$ 10,554</u>	<u>\$ 4,958</u>

#### 4. PROPERTY AND EQUIPMENT

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

	<b>September 30, 2018</b>	<b>September 30, 2017</b>
Land and land improvements	\$ 139,800	\$ 138,730
Improvements to leased facilities	122,550	114,029
Buildings	1,678,536	1,404,076
Building and movable equipment under capital lease obligation	43,351	51,822
Fixed equipment	819,892	743,348
Movable equipment	725,351	605,439
Software	194,610	179,733
	<u>3,724,090</u>	<u>3,237,177</u>
Less accumulated depreciation	(1,484,369)	(1,357,628)
	<u>2,239,721</u>	<u>1,879,549</u>
Construction in progress	75,299	292,238
Net property and equipment	<u>\$ 2,315,020</u>	<u>\$ 2,171,787</u>

Interest cost is capitalized until the property under construction is placed in service. As of September 30, 2018 and 2017, the amount recorded as capitalized interest within construction in progress was \$924 and \$4,580, respectively.

TCH had remaining commitments of \$97,159 and \$231,570 on open construction and equipment contracts as of September 30, 2018 and 2017, respectively.

#### 5. PLEDGES AND CONTRIBUTIONS

Pledges receivable are expected to be realized as follows:

	<b>September 30, 2018</b>	<b>September 30, 2017</b>
In one year or less	\$ 37,603	\$ 48,033
Between one year and five years	75,287	61,915
More than five years	60,832	1,060
Total pledges	<u>173,722</u>	<u>111,008</u>
Less present value discount	(34,257)	(8,453)
Less allowance for doubtful pledges	(3,474)	(2,128)
Net pledges receivable	<u>\$ 135,991</u>	<u>\$ 100,427</u>

As of September 30, 2018, temporarily restricted net assets included \$15,953 restricted for capital expansion, of which \$12,998 relates to pledges that had not yet been received.

**6. BORROWINGS**

**DEBT**

Debt and capital lease obligations are as follows:

	<b>September 30, 2018</b>	<b>September 30, 2017</b>
TCH Revenue Bonds:		
Series 2008	\$ 284,700	\$ 286,400
Series 2009	126,615	131,130
Series 2010	55,251	58,629
Series 2015-1	201,063	211,514
Series 2015-2	50,000	50,000
Series 2015-3	110,000	110,000
Series 2015-4	98,300	99,150
Capital lease obligations	3,866	13,108
	<u>929,795</u>	<u>959,931</u>
Less current portion of long-term debt	(18,600)	(17,415)
Less current portion of capital lease obligations	(2,996)	(9,203)
Less long-term debt subject to remarketing agreements	(141,500)	(150,000)
Net of bond issuance cost	(6,004)	(6,340)
Total long-term debt and capital lease obligations	<u>\$ 760,695</u>	<u>\$ 776,973</u>

As of September 30, 2018, 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>
2019	\$ 18,600
2020	19,415
2021	20,535
2022	21,620
2023	22,800

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, 2018 or 2017.

**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	\$9,695	\$72,855

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 2018	1.85%	1.87%	1.71%	2.00%
Average Interest Rate 2017	1.23%	0.90%	0.90%	1.15%
Mandatory Tender Date	April 3, 2028	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 2008-3 Bonds are subject to mandatory tender within one year. As such, the entire amount of the Series 2008-3 Bonds is included in current liabilities in the consolidated balance sheets.

**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 2018	1.46%	2.04%
Average Interest Rate 2017	0.95%	1.48%
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, 2018, no bonds have been tendered.

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.

**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.

**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, 2018 and 2017, Texas Children's had \$5,000 and \$21,200, 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. At September 30, 2018 and 2017, the fair value of 2008-1 swap agreement was a liability of \$21,018 and \$30,100, respectively, and is included in other long-term liabilities in the consolidated balance sheets. As of September 30, 2018 and 2017, the fair value of the 2008-2 swap agreement was an asset of \$2,424 and a liability of \$3,203, respectively, and is included in other assets and 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, 2018 and 2017, the change in fair value resulted in a gain of \$14,709 and \$20,655, 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	\$92,325
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	67% of the U.S. dollar one-month LIBOR
TCH option to terminate with a cash settlement	Yes	Yes
Collateral threshold	\$30,000	\$50,000
Collateral posted as of September 30, 2018	-	-
Collateral posted as of September 30, 2017	\$2,410	-

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, 2018</b>	<b>September 30, 2017</b>
<b>CHANGE IN PROJECTED BENEFIT OBLIGATION</b>		
Projected benefit obligation, beginning of year	\$ 396,620	\$ 366,621
Service cost	32,697	31,629
Interest cost	14,008	12,569
Actuarial losses	(28,283)	(2,254)
Benefits paid	(12,823)	(11,945)
Projected benefit obligation (including \$380,038 and \$369,630 in 2018 and 2017, respectively, in accumulated benefit obligation), end of year	<u>\$ 402,219</u>	<u>\$ 396,620</u>
<b>CHANGE IN PLAN ASSETS</b>		
Fair value of plan assets, beginning of year	\$ 341,590	\$ 301,002
Actual return on plan assets	25,117	29,093
Employer contributions	26,080	23,440
Benefits paid	(12,823)	(11,945)
Fair value of plan assets, end of year	<u>\$ 379,964</u>	<u>\$ 341,590</u>
<b>FUNDED STATUS</b>		
Projected benefit obligation	\$ (402,219)	\$ (396,620)
Fair value of plan assets	379,964	341,590
Funded status recorded in other long-term liabilities in the consolidated financial statements	<u>\$ (22,255)</u>	<u>\$ (55,030)</u>

**Texas Children's**

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

September 30, 2018

<b>COMPONENTS OF NET PERIODIC PENSION COST</b>	<b>September 30,</b>	<b>September 30,</b>
	<b>2018</b>	<b>2017</b>
Service cost	\$ 32,697	\$ 31,629
Interest cost	14,008	12,569
Expected return on plan assets	(21,263)	(19,957)
Prior service cost amortization	(95)	(95)
Recognized net actuarial loss	1,977	4,232
Net periodic pension cost included in salaries and benefits in the consolidated financial statements	<u>\$ 27,324</u>	<u>\$ 28,378</u>

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

Discount rate	4.21%	3.77%
Compensation projection rate	4.06	4.06

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

Discount rate	3.77%	3.53%
Expected long-term rate of return on plan assets	6.25	6.75
Compensation projection rate	4.06	4.06

As of September 30, 2018, unrestricted net assets were reduced by \$34,020 of amounts arising from Texas Children's noncontributory cash balance pension plan that have not yet been recognized in net periodic benefit cost.

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

	<b>TARGET</b>	<b>2018</b>	<b>2017</b>
Global equity	55 %	58 %	55 %
Fixed income and cash	30	30	27
Absolute return	15	12	18
	<u>100 %</u>	<u>100 %</u>	<u>100 %</u>

**Texas Children's**

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

September 30, 2018

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 2019	\$ 39,480
Expected benefit payments for fiscal years:	
2019	40,761
2020	20,303
2021	20,041
2022	21,359
2023	22,614
Subsequent five years consolidated	136,288

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 2018 and 2017 do not include Level 3 alternative investments of \$154,670 and \$139,863, 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 2018</b>				
Investments:				
Cash and cash equivalents	\$ 5,131	\$ -	\$ -	\$ 5,131
Domestic equity securities	100,649	-	-	100,649
International equity securities	21,832	-	-	21,832
U.S. government fixed income securities	-	9,977	-	9,977
U.S. agency securities	-	72,586	-	72,586
Corporate fixed income securities	-	15,119	-	15,119
Total assets at fair value	<u>\$ 127,612</u>	<u>\$ 97,682</u>	<u>\$ -</u>	<u>\$ 225,294</u>

	<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>

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 \$22,247 and \$20,085 for the twelve months ended September 30, 2018 and 2017, 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 under a retrospectively rated policy whereby the premiums are accrued based on the experience of Texas Children's. The policy also provides excess liability coverage for amounts in excess of the primary policy limits. TCH funds TCHICO's required insurance reserves. Funding amounts are based on actuarial recommendations.

As of September 30, 2018 and 2017, Texas Children's recorded a liability of \$40,297 and \$36,988, 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 2031. 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, 2018:

Year ending September 30:		
2019	\$	22,849
2020		23,048
2021		21,306
2022		20,370
2023		18,820
Thereafter		48,080
	\$	<u>154,473</u>

Rental expense for the twelve months ended September 30, 2018 and 2017 was \$24,856 and \$22,898, 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 5% of a three-year rolling average of the endowment market value, 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, 2018		September 30, 2017	
Commercial	\$ 1,437,978	71 %	\$ 1,349,358	69 %
Medicaid	115,304	6	127,236	7
Medicaid Managed Care	349,218	17	359,019	18
Self-pay and other	116,862	6	110,697	6
Total All Payors	\$ 2,019,362	100 %	\$ 1,946,310	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, 2018	September 30, 2017
Commercial	67 %	68 %
Medicaid	7	7
Medicaid Managed Care	18	17
Self-pay and Other	8	8
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 benefit 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 medically indigent or financially 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 \$24,844 and \$15,806 for the years ended September 30, 2018 and 2017, respectively. Funds received to offset or subsidize charity services were \$2,892 and \$1,642 for the years ended September 30, 2018 and 2017, 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 health care 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.

#### 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 rule 73 CFR 777904, December 19, 2008 (DSH Audit Rule).

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. On June 1, 2018, the Court issued an order in favor of the hospitals granting their motion for summary judgment. The Court concluded that CMS' policy set forth in FAQ No. 33 was "promulgated without appropriate notice-and-comment procedures in violation of the Administrative Procedures Act." Further, the Court found that the policy embodied in FAQ No. 33 is not supported by the Medicaid Act. On August 3, 2018, CMS appealed the ruling.

On April 3, 2017, CMS published rule 42 CFR 447229 (Final Rule) that amended the DSH Audit 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 asserted that the policy of including private insurance payments in the calculation of HSL was contained in the 2008 Rule and, therefore, the Final Rule had retroactive application. The Final Rule became effective on June 2, 2017.

On May 8, 2017, the Children's Hospital Association of Texas (CHAT), Children's Hospital and Clinics of Minnesota, Gillette Children's Specialty Healthcare, Children's Hospital of the King's Daughters and Seattle Children's Hospital filed a second 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. On March 2, 2018, the Court issued an order granting the hospitals' motion for summary judgment and vacating the Final Rule, which effectively nullified the policy set forth in FAQ No. 33. On May 4, 2018, CMS appealed the ruling.

For the twelve months ended September 30, 2018, TCH recognized \$64,402 of DSH revenue, of which \$30,722 was related to 2011 and 2014 DSH funds previously received that have met the revenue recognition requirements as the Court's order vacated the Final Rule. As such, the loss contingency is considered resolved, as recoupment of funds is deemed less than a remote possibility. Texas Children's does not believe that CMS's appeals of the rulings will be successful. Additionally, Texas Children's recognized \$33,680 of DSH revenue related to the current fiscal year. DSH revenue is recognized in Medicaid and other supplemental reimbursements reported in the consolidated statements of operations and changes in net assets. For the twelve months ended September 30, 2017, TCH did not recognize any DSH revenue. As of September 30, 2018 and 2017, TCH recorded a liability of \$0 and \$30,722, respectively, related to previously received DSH funds that may have been recouped if there had been an unfavorable ruling from the Court.

The 1115 Healthcare Transformation Waiver (1115 Waiver) program is a 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. 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, 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. The program was established during fiscal year 2012 and was extended through December 31, 2017. On December 21, 2017, CMS approved an extension of the 1115 Waiver effective from January 1, 2018 through September 30, 2022. The 1115 Waiver extension provides for level funding to supplement the unreimbursed costs of providing care to Medicaid and uninsured patients through September 30, 2019. Per the special terms and conditions of the 1115 Waiver extension, the UC funding pool will be reassessed for October 1, 2020 through September 30, 2022, and the DSRIP funding pool will be reduced for October 1, 2020 through September 30, 2021 with funding expiring thereafter.

For the twelve months ended September 30, 2018, TCH recognized \$41,911 related to the UC pool, of which \$14,278 was related to previously received UC funds that have met the revenue recognition requirements since the Court's order vacated the Final Rule. The loss contingency is considered resolved, as recoupment of funds is deemed less than a remote possibility.

1115 Waiver revenue and its related receivable are as follows:

	September 30, 2018	September 30, 2017
UC	\$ 41,911	\$ 13,331
DSRIP	6,497	31,343
Total 1115 Waiver Revenue	<u>\$ 48,408</u>	<u>\$ 44,674</u>
1115 Waiver Receivable	<u>\$ -</u>	<u>\$ 30,021</u>

For DSH and UC funding earned in prior years but not yet received due to litigation regarding the Final Rule and the HSL calculation, HHSC will perform the calculation to determine the allocation of funds based on the Court's order. TCH's allocation information is not available at this time. As such, no revenues have been recognized for potential DSH and UC funding earned in prior years but not yet received.

**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, TCPG has an agreement with Baylor relating to overhead operating costs of the adult surgical subspecialty departments that manage pediatric components. During the twelve months ended September 30, 2018 and 2017, Texas Children's recorded expense of \$515,493 and \$470,808, 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 \$47,330 and \$46,380 are included in accounts payable and accrued expenses in the consolidated balance sheets as of September 30, 2018 and 2017, respectively.

Texas Children's entered into an agreement with Baylor to provide enhanced mission support for graduate and undergraduate medical education. For the twelve months ended September 30, 2018 and 2017, Texas Children's made payments to Baylor of \$19,801 and \$20,742, respectively. Additionally, as of September 30, 2018 and 2017, amounts due to Baylor of \$1,365 and \$2,880, respectively, were recorded in accounts payable and accrued expenses. For the twelve months ended September 30, 2018 and 2017, Texas Children's recognized \$13,201 and \$17,766, respectively, in expenses which are included in enhanced mission support in the consolidated statement of operations and changes in net assets. As of September 30, 2018 and 2017, the amount recorded as prepaid expense was \$20,365 and \$11,039, respectively, which is included in other current assets in the consolidated balance sheets. These amounts are not included in the professional fees disclosed above.

In the year ended September 30, 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, 2018 and 2017, Texas Children's recognized \$10,151 and \$9,468, respectively, of rent revenue from the sellers.

**16. SUBSEQUENT EVENTS**

Texas Children's evaluated events and transactions occurring subsequent to September 30, 2018 through December 13, 2018, the date of issuance of the consolidated financial statements. During this period, there were no subsequent events requiring recognition in the consolidated financial statements. Additionally, there were no non-recognized subsequent events requiring disclosure.

---

# Texas Children's



Supplementary Information

**Texas Children's  
Consolidating Balance Sheet  
As of September 30, 2018**  
(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	Cain Foundation	Eliminations	Total
Assets:												
Current assets												
Cash and cash equivalents	\$ 18,158	\$ 28,757	\$ -	\$ 46,915	\$ 20,399	\$ 120,906	\$ 179	\$ -	\$ 9,751	\$ 209	\$ -	\$ 198,359
Patient receivables, net of allowances	370,516	-	-	370,516	8,754	-	-	-	27,373	-	(52,973)	353,670
Receivable for Medicaid and other supplemental reimbursements	409	-	-	409	-	-	-	-	-	-	-	409
Assets limited as to use, current portion	37,571	-	-	37,571	-	-	-	-	-	-	-	37,571
Other current assets	158,414	-	-	158,414	5,501	37,337	13,306	56,353	88,861	-	(176,583)	183,189
Investment-related receivable	-	88,416	-	88,416	-	501	-	-	-	17	-	88,934
<b>Total current assets</b>	<b>585,068</b>	<b>117,173</b>	<b>-</b>	<b>702,241</b>	<b>34,654</b>	<b>158,744</b>	<b>13,485</b>	<b>56,353</b>	<b>125,985</b>	<b>226</b>	<b>(229,556)</b>	<b>862,132</b>
Assets limited as to use	1,981,670	-	(1,978,019)	3,651	-	4,525	92,752	-	-	-	(60)	100,868
Investments	296,654	2,247,058	(296,404)	2,247,308	-	130,289	-	-	-	23,044	-	2,400,641
Property and equipment, net	2,254,333	-	-	2,254,333	30,714	23,663	-	5,949	361	-	-	2,315,020
Other assets	136,973	-	-	136,973	5,151	650	-	-	-	-	-	142,774
Amounts due from affiliate	52,647	-	-	52,647	-	-	-	-	-	-	(52,647)	-
Investment in subsidiary	111,824	-	-	111,824	-	-	-	-	-	-	(111,824)	-
<b>Total assets</b>	<b>\$ 5,419,169</b>	<b>\$ 2,364,231</b>	<b>\$ (2,274,423)</b>	<b>\$ 5,508,977</b>	<b>\$ 70,519</b>	<b>\$ 317,871</b>	<b>\$ 106,237</b>	<b>\$ 62,302</b>	<b>\$ 126,346</b>	<b>\$ 23,270</b>	<b>\$ (394,087)</b>	<b>\$ 5,821,435</b>
Liabilities and net assets (deficit):												
Current liabilities												
Accounts payable and accrued expenses	\$ 290,089	\$ 296,404	\$ (296,404)	\$ 290,089	\$ 38,893	\$ 168,254	\$ 8,292	\$ 74,299	\$ 104,033	\$ 229	\$ (227,760)	\$ 456,329
Investment-related accrued expenses	-	89,808	-	89,808	-	64	-	-	-	-	-	89,872
Current portion of long-term debt	18,600	-	-	18,600	-	-	-	-	-	-	-	18,600
Current portion of capital lease obligations	2,996	-	-	2,996	-	-	-	-	-	-	-	2,996
Line of credit	5,000	-	-	5,000	-	-	-	-	-	-	-	5,000
Long-term debt subject to remarketing agreements	141,500	-	-	141,500	-	-	-	-	-	-	-	141,500
<b>Total current liabilities</b>	<b>458,185</b>	<b>386,212</b>	<b>(296,404)</b>	<b>547,993</b>	<b>38,893</b>	<b>168,318</b>	<b>8,292</b>	<b>74,299</b>	<b>104,033</b>	<b>229</b>	<b>(227,760)</b>	<b>714,297</b>
Long-term debt	759,825	-	-	759,825	-	-	-	-	-	-	-	759,825
Long-term capital lease obligations	870	-	-	870	-	-	-	-	-	-	-	870
Loss reserves for self-insurance program	-	-	-	-	-	-	42,333	-	-	-	(2,036)	40,297
Retirement plan liability	22,255	-	-	22,255	-	-	-	-	-	-	-	22,255
Other long-term liabilities	36,079	-	-	36,079	-	9,879	52,397	-	6	-	(52,409)	45,952
<b>Total liabilities</b>	<b>1,277,214</b>	<b>386,212</b>	<b>(296,404)</b>	<b>1,367,022</b>	<b>38,893</b>	<b>178,197</b>	<b>103,022</b>	<b>74,299</b>	<b>104,039</b>	<b>229</b>	<b>(282,205)</b>	<b>1,583,496</b>
Net assets (deficit):												
Unrestricted	3,730,137	1,978,019	(1,978,019)	3,730,137	31,626	139,674	3,215	(11,997)	22,307	23,041	(111,882)	3,826,121
Temporarily restricted	226,817	-	-	226,817	-	-	-	-	-	-	-	226,817
Permanently restricted	185,001	-	-	185,001	-	-	-	-	-	-	-	185,001
<b>Total net assets (deficit)</b>	<b>4,141,955</b>	<b>1,978,019</b>	<b>(1,978,019)</b>	<b>4,141,955</b>	<b>31,626</b>	<b>139,674</b>	<b>3,215</b>	<b>(11,997)</b>	<b>22,307</b>	<b>23,041</b>	<b>(111,882)</b>	<b>4,237,939</b>
<b>Total liabilities and net assets (deficit)</b>	<b>\$ 5,419,169</b>	<b>\$ 2,364,231</b>	<b>\$ (2,274,423)</b>	<b>\$ 5,508,977</b>	<b>\$ 70,519</b>	<b>\$ 317,871</b>	<b>\$ 106,237</b>	<b>\$ 62,302</b>	<b>\$ 126,346</b>	<b>\$ 23,270</b>	<b>\$ (394,087)</b>	<b>\$ 5,821,435</b>

**Texas Children's**  
**Consolidating Statement of Operations and Changes in Net Assets**  
**Year ended September 30, 2018**  
*(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	Cain Foundation	Eliminations	Total
Changes in unrestricted net assets:												
Operating revenues:												
Patient service revenue, net of contractals and discounts	\$ 1,978,485	\$ -	\$ -	\$ 1,978,485	\$ 215,398	\$ -	\$ -	\$ -	\$ 294,674	\$ -	\$ (469,195)	\$ 2,019,362
Less provision for doubtful accounts	(57,379)	-	-	(57,379)	(995)	-	-	-	(15,959)	-	-	(74,333)
Net patient service revenue	1,921,106	-	-	1,921,106	214,403	-	-	-	278,715	-	(469,195)	1,945,029
Premium revenue	-	-	-	-	-	1,666,816	11,105	-	-	-	(11,125)	1,666,796
Medicaid and other supplemental reimbursements	116,099	-	-	116,099	6,684	-	-	-	-	-	(6,500)	116,283
Grants	28,592	-	-	28,592	77	748	-	-	-	-	(72)	29,345
Other	179,945	-	-	179,945	2,832	99	3,480	9,819	203,347	-	(303,437)	96,085
Net assets released from restrictions for operations	43,907	-	-	43,907	111	-	-	-	-	-	-	44,018
<b>Total operating revenues</b>	<b>2,289,649</b>	<b>-</b>	<b>-</b>	<b>2,289,649</b>	<b>224,107</b>	<b>1,667,663</b>	<b>14,585</b>	<b>9,819</b>	<b>482,062</b>	<b>-</b>	<b>(790,329)</b>	<b>3,897,556</b>
Operating expenses:												
Salaries and benefits	1,043,378	-	-	1,043,378	148,241	59,823	-	4,932	32,298	-	-	1,288,672
Medical claims	-	-	-	-	-	1,528,972	14,204	-	-	-	(511,526)	1,031,650
Professional fees	289,056	-	-	289,056	-	-	-	3	435,764	-	(209,330)	515,493
Supplies and pharmaceuticals	265,761	-	-	265,761	46,014	55	-	1,228	1,505	-	-	314,563
Outside purchased services	166,100	-	-	166,100	18,018	41,130	92	2,361	10,639	-	(58,244)	180,096
Depreciation and amortization	156,730	-	-	156,730	6,677	7,347	-	563	293	-	-	171,610
Operation of plant	113,005	-	-	113,005	3,651	62	8	2	20	-	2,036	118,784
General and administrative	78,705	-	-	78,705	5,614	39,177	281	943	1,070	-	(6,765)	119,025
Enhanced mission support	22,601	-	-	22,601	-	-	-	-	-	-	-	22,601
Interest	21,843	-	-	21,843	-	-	-	-	-	-	-	21,843
<b>Total operating expenses</b>	<b>2,157,179</b>	<b>-</b>	<b>-</b>	<b>2,157,179</b>	<b>228,215</b>	<b>1,676,566</b>	<b>14,585</b>	<b>10,032</b>	<b>481,589</b>	<b>-</b>	<b>(783,829)</b>	<b>3,784,337</b>
Operating income (loss)	132,470	-	-	132,470	(4,108)	(8,903)	-	(213)	473	-	(6,500)	113,219
Nonoperating gains (losses):												
Investment return	1,971	159,371	-	161,342	-	1,919	-	-	-	-	-	163,261
Change in interest rate swap valuation	14,709	-	-	14,709	-	-	-	-	-	-	-	14,709
Other	(6,610)	-	-	(6,610)	-	(5)	-	-	-	-	6,500	(115)
Net nonoperating gains	10,070	159,371	-	169,441	-	1,914	-	-	-	-	6,500	177,855
Revenues and gains in excess (deficiency) of expenses and losses	\$ 142,540	\$ 159,371	\$ -	\$ 301,911	\$ (4,108)	\$ (6,989)	\$ -	\$ (213)	\$ 473	\$ -	\$ -	\$ 291,074

**Texas Children's**  
**Consolidating Statement of Operations and Changes in Net Assets, *continued***  
**Year ended September 30, 2018**  
*(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	Cain Foundation	Eliminations	Total
<b>Changes in unrestricted net assets:</b>												
Revenues and gains in excess (deficiency) of expenses and losses brought forward	\$ 142,540	\$ 159,371	\$ -	\$ 301,911	\$ (4,108)	\$ (6,989)	\$ -	\$ (213)	\$ 473	\$ -	\$ -	\$ 291,074
Net assets released from restrictions for purchases of property, equipment and other	13,343	-	-	13,343	1,955	-	-	-	-	-	-	15,298
Change in pension liabilities	34,020	-	-	34,020	-	-	-	-	-	-	-	34,020
Other changes in net assets	229	-	-	229	-	-	-	-	-	23,041	-	23,270
Equity transfer	199,293	(199,293)	-	-	-	-	-	-	-	-	-	-
Contributed capital	-	-	-	-	2,411	50,000	-	-	-	-	(52,411)	-
Beneficial interest in Texas Children's Hospital Foundation	(39,922)	-	39,922	-	-	-	-	-	-	-	-	-
<b>Change in unrestricted net assets</b>	<b>349,503</b>	<b>(39,922)</b>	<b>39,922</b>	<b>349,503</b>	<b>258</b>	<b>43,011</b>	<b>-</b>	<b>(213)</b>	<b>473</b>	<b>23,041</b>	<b>(52,411)</b>	<b>363,662</b>
<b>Changes in temporarily restricted net assets:</b>												
Donor-restricted contributions	92,723	-	-	92,723	-	-	-	-	-	-	-	92,723
Investment return and other	8,771	-	-	8,771	-	-	-	-	-	-	-	8,771
Net assets released from restrictions	(57,844)	-	-	(57,844)	-	-	-	-	-	-	-	(57,844)
Change in beneficial interest in net assets of donor-restricted foundations	(24,590)	-	-	(24,590)	-	-	-	-	-	-	-	(24,590)
<b>Change in temporarily restricted net assets</b>	<b>19,060</b>	<b>-</b>	<b>-</b>	<b>19,060</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>19,060</b>
<b>Changes in permanently restricted net assets:</b>												
Donor-restricted contributions	13,641	-	-	13,641	-	-	-	-	-	-	-	13,641
Investment return and other	10,554	-	-	10,554	-	-	-	-	-	-	-	10,554
<b>Change in permanently restricted net assets</b>	<b>24,195</b>	<b>-</b>	<b>-</b>	<b>24,195</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>24,195</b>
<b>Change in net assets</b>	<b>392,758</b>	<b>(39,922)</b>	<b>39,922</b>	<b>392,758</b>	<b>258</b>	<b>43,011</b>	<b>-</b>	<b>(213)</b>	<b>473</b>	<b>23,041</b>	<b>(52,411)</b>	<b>406,917</b>
Net assets (deficit) at beginning of year	3,749,197	2,017,941	(2,017,941)	3,749,197	31,368	96,663	3,215	(11,784)	21,834	-	(59,471)	3,831,022
<b>Net assets (deficit) at end of year</b>	<b>\$ 4,141,955</b>	<b>\$ 1,978,019</b>	<b>\$ (1,978,019)</b>	<b>\$ 4,141,955</b>	<b>\$ 31,626</b>	<b>\$ 139,674</b>	<b>\$ 3,215</b>	<b>\$ (11,997)</b>	<b>\$ 22,307</b>	<b>\$ 23,041</b>	<b>\$ (111,882)</b>	<b>\$ 4,237,939</b>

**Texas Children's**  
**Condensed Consolidating Statement of Cash Flows**  
**Year ended September 30, 2018**  
*(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	Cain Foundation	Eliminations	Total
<b>Operating activities:</b>												
Net cash provided by (used in) operating activities	\$ 350,981	\$ (146,740)	\$ (39,869)	\$ 164,372	\$ 7,923	\$ 46,253	\$ (3,092)	\$ 44	\$ 5,885	\$ 226	\$ -	\$ 221,611
<b>Investing activities:</b>												
(Purchases) sales of investments, net	(19,103)	85,092	39,869	105,858	-	(28,504)	3,117	-	-	(17)	-	80,454
(Purchases) sales of property and equipment	(319,437)	-	-	(319,437)	(10,108)	3,922	-	(44)	(54)	-	-	(325,721)
Net cash (used in) provided by investing activities	(338,540)	85,092	39,869	(213,579)	(10,108)	(24,582)	3,117	(44)	(54)	(17)	-	(245,267)
<b>Financing activities:</b>												
Repayments on line-of-credit	(16,200)	-	-	(16,200)	-	-	-	-	-	-	-	(16,200)
Principal payment on long-term debt	(17,415)	-	-	(17,415)	-	-	-	-	-	-	-	(17,415)
Principal payment on capital lease obligations	(9,242)	-	-	(9,242)	-	-	-	-	-	-	-	(9,242)
Temporarily and permanently restricted contributions received	34,959	-	-	34,959	-	-	-	-	-	-	-	34,959
Proceeds from sale of donated securities with restrictions	-	6,968	-	6,968	-	-	-	-	-	-	-	6,968
Temporarily and permanently restricted investment return	6,710	-	-	6,710	-	-	-	-	-	-	-	6,710
Net cash provided by financing activities	(1,188)	6,968	-	5,780	-	-	-	-	-	-	-	5,780
Net increase (decrease) in cash and cash equivalents	11,253	(54,680)	-	(43,427)	(2,185)	21,671	25	-	5,831	209	-	(17,876)
Cash and cash equivalents at beginning of year	6,905	83,437	-	90,342	22,584	99,235	154	-	3,920	-	-	216,235
Cash and cash equivalents at end of year	\$ 18,158	\$ 28,757	\$ -	\$ 46,915	\$ 20,399	\$ 120,906	\$ 179	\$ -	\$ 9,751	\$ 209	\$ -	\$ 198,359
<b>Supplemental disclosures</b>												
Cash paid for interest	\$ 33,139	\$ -	\$ -	\$ 33,139	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 33,139
Capital in accounts payable and accrued expenses	\$ 30,510	\$ -	\$ -	\$ 30,510	\$ 207	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 30,717