Texas Children's®

Consolidated Interim Financial Statements (*Unaudited*)

June 30, 2018

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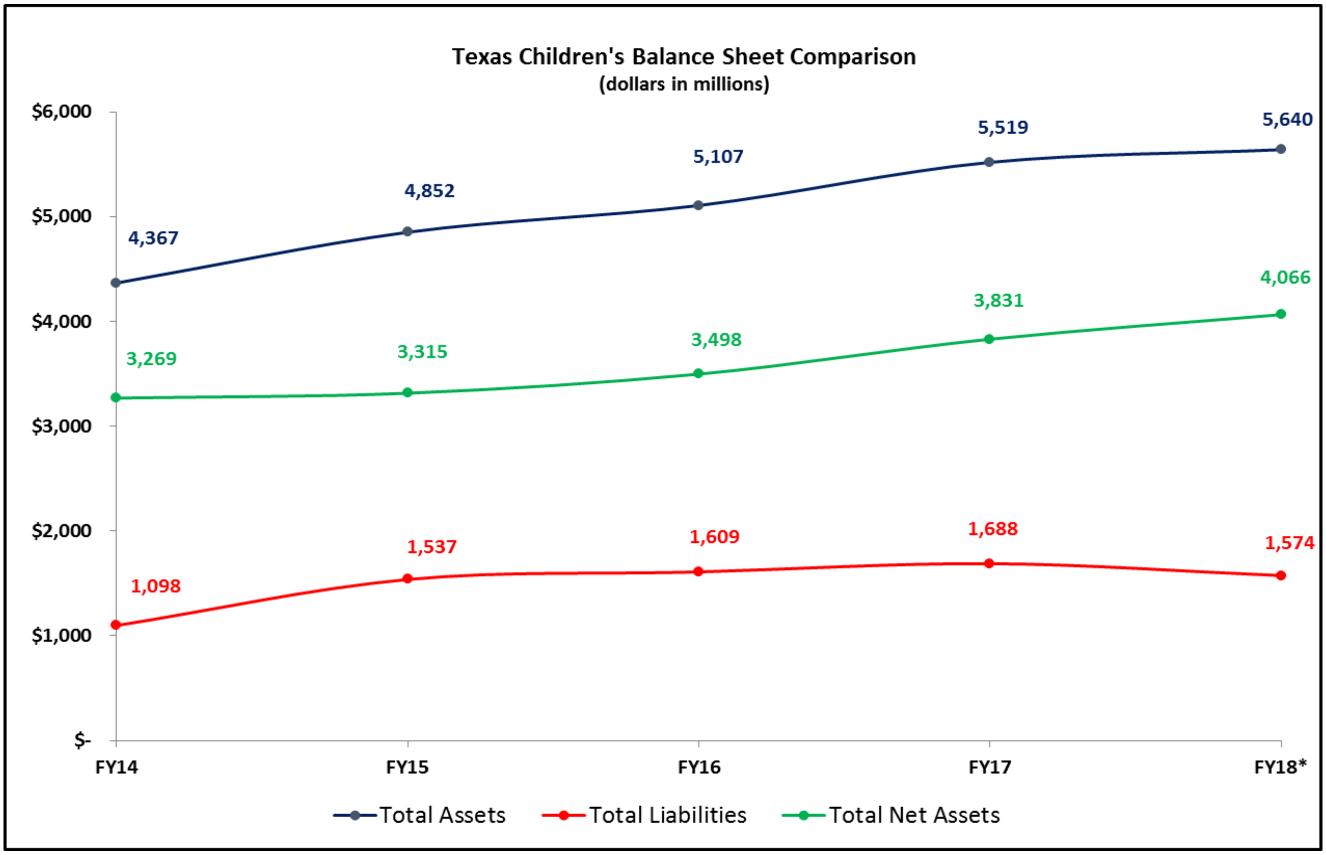
Financial Results – Texas Children's

Texas Children's balance sheet remains strong. As of June 30, 2018, total assets were $5.64 billion and debt to capitalization was 18.8%. Days cash on hand was 230 as of June 30, 2018, a sixteen day decrease from prior year end. This decrease was the result of planned capital expenditures for expansion projects.



**as of June 30, 2018*

For the nine months ended June 30, 2018, Texas Children's operating income was $105.8 million, which was an increase of $86.5 million compared to the same period in the prior year. Texas Children's operating cash flow margin, which is calculated by adding back interest, depreciation, and amortization costs to operating income, was $245.9 million for the nine months ended June 30, 2018, which was an increase of $93.5 million from the same period in the prior year.

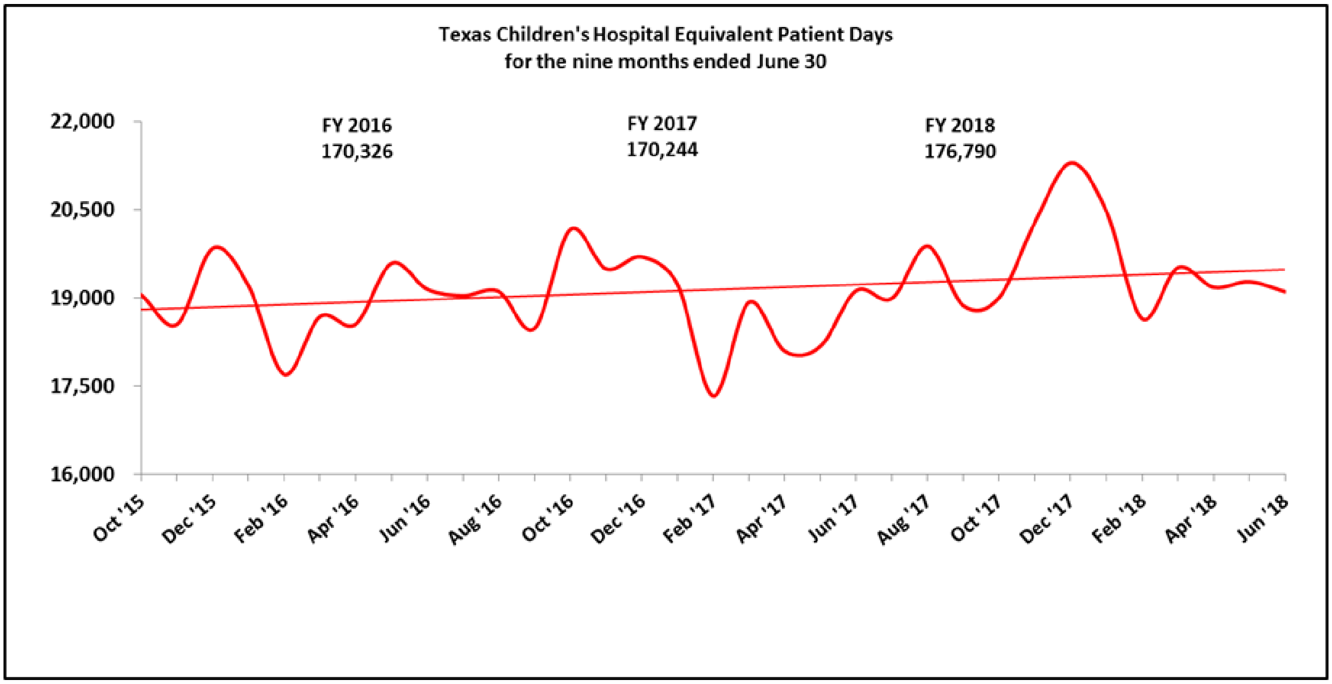
As described in Footnote 11 to the consolidated financial statements, on March 2, 2018, the United States District Court for the District of Columbia issued a final judgment vacating a recent Centers for Medicare and Medicaid Services (CMS) rule that allowed the agency to include private insurance payments, even when Medicaid doesn't 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 nine months ended June 30, 2018, Texas Children's recognized $45.0 million in revenue for DSH and UC funds that had been received in cash and reserved for in prior years. Additionally, Texas Children's recognized $33.6 million of DSH revenue related to the current fiscal year.

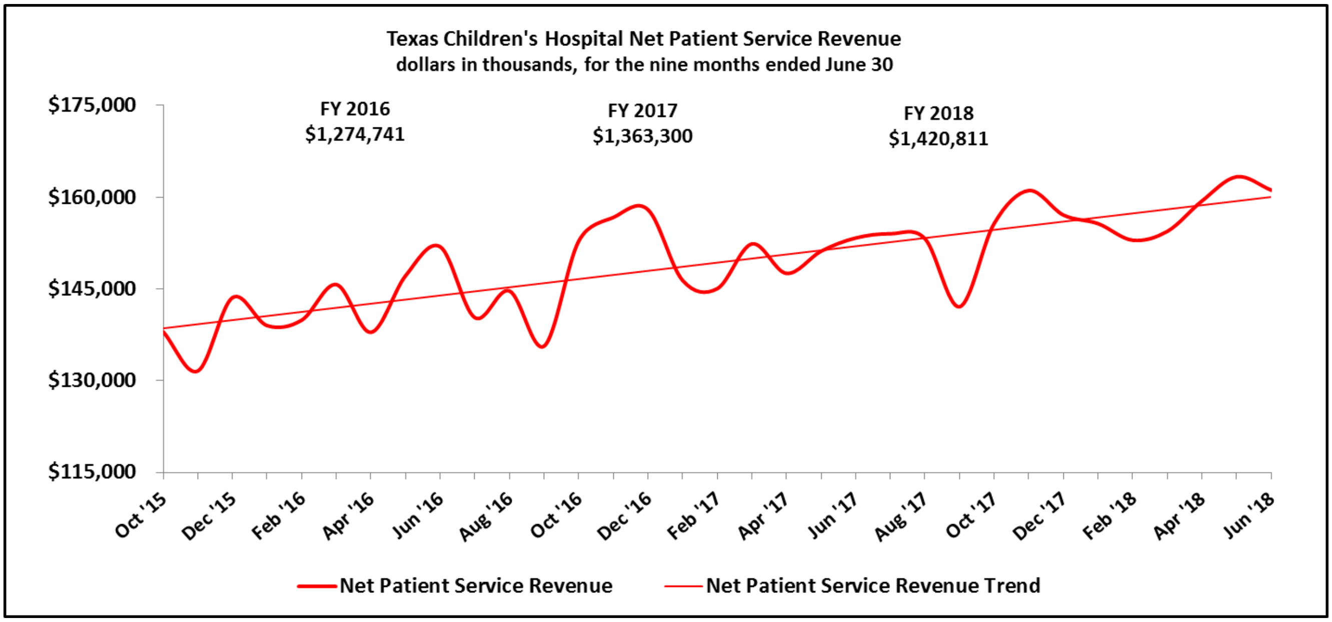
Texas Children's Statistical Summary for the nine months ended June 30				
	FY 2018 Actual	FY 2017 Actual	Increase (Decrease)	%Increase (Decrease)
Admissions	**25,803**	**25,415**	**388**	**1.5%**
Average Daily Census	**648**	**624**	**24**	**3.8%**
Surgery Cases	**27,640**	**25,090**	**2,550**	**10.2%**
Surgery Hours	**42,577**	**40,086**	**2,491**	**6.2%**
Emergency Room Visits	**120,621**	**96,343**	**24,278**	**25.2%**
Urgent Care Encounters	**95,696**	**68,225**	**27,471**	**40.3%**
Births	**4,666**	**4,219**	**447**	**10.6%**

Financial Results – Texas Children's Hospital

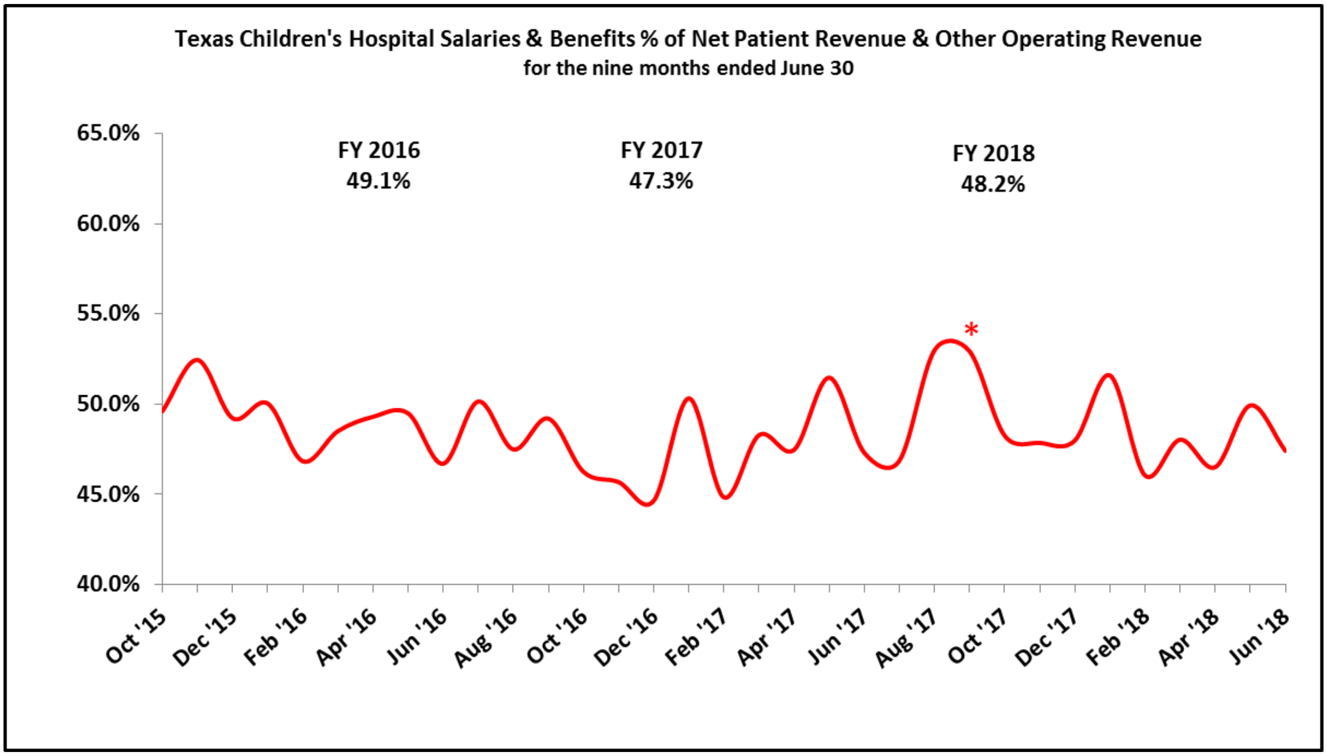
Texas Children's Hospital's (TCH) operating income was $116.4 million for the nine months ended June 30, 2018, an increase of $43.1 million from the same period in the prior year.

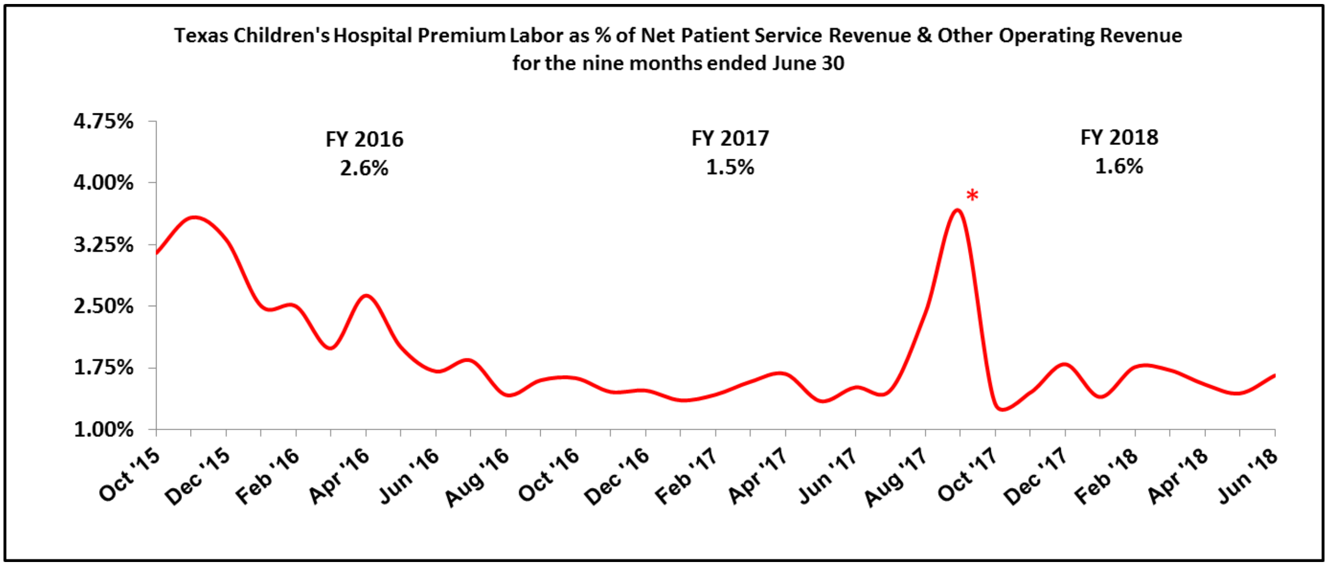
For the nine months ended June 30, 2018, net patient service revenue increased $57.5 million, or 4.2%, compared to the same period in the prior year. The Woodlands hospital, which opened inpatient operations in April 2017, accounted for the majority of the increase. During the first nine months of fiscal year 2018, total equivalent patient days increased 6,546 or 3.8%, driven mainly by The Woodlands hospital. Surgery cases and surgery hours also increased 10.2% and 6.2% respectively, compared to same period in the prior year.



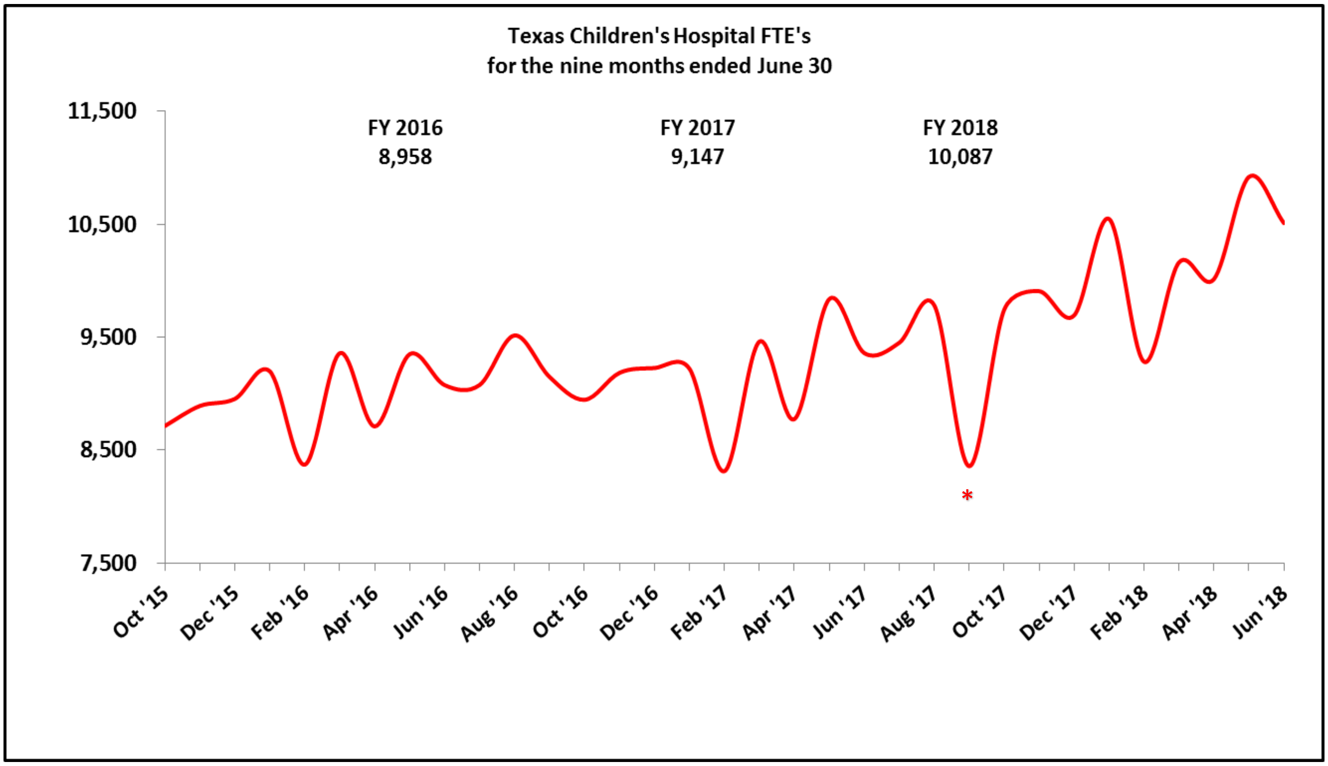


For the nine months ended June 30, 2018, salaries and benefits as a percentage of net patient service revenue and other revenue was 48.2% compared to 47.3% in the same period of the prior year. Advance hiring and training in preparation for the opening of the Legacy Tower in the Texas Medical Center contributed to the increase.





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

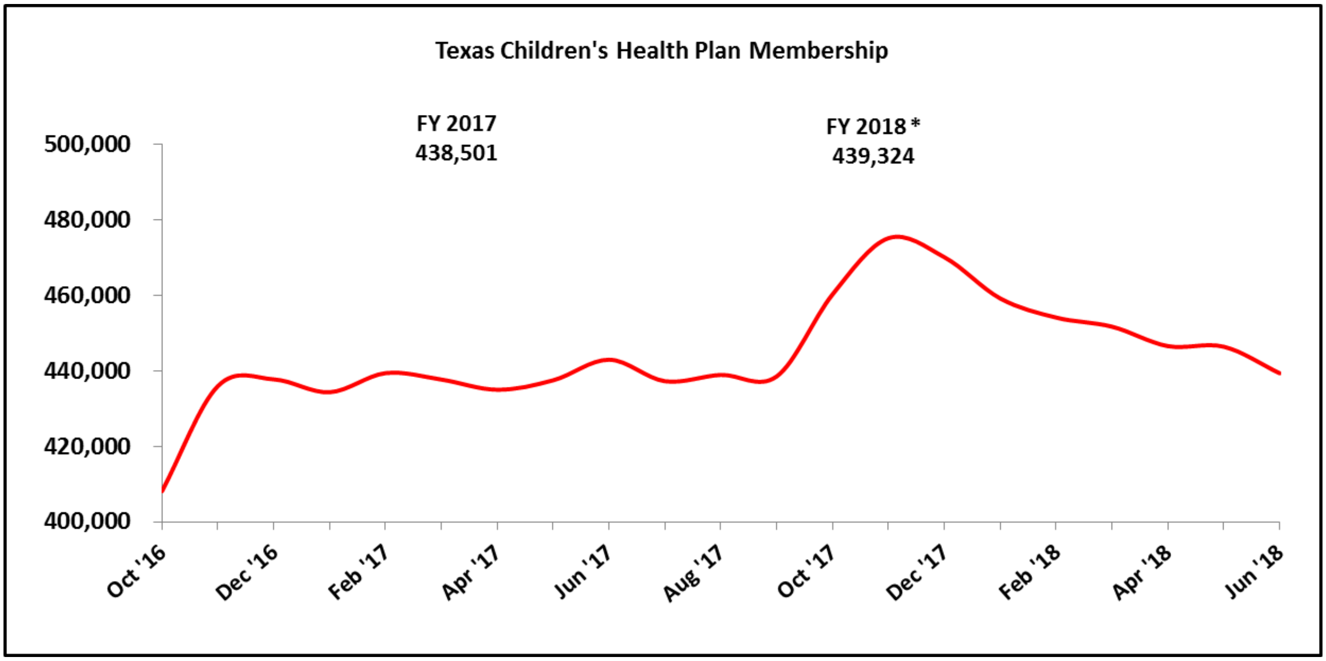


* The decrease during the fourth quarter of fiscal year 2017 in full time equivalents (FTE) was due to Hurricane Harvey.

Financial Results and Membership – Texas Children's Health Plan

Texas Children's Health Plan (TCHP) had an operating loss of $6.1 million for the nine months ended June 30, 2018, which was a $40.3 million increase from the same period in the prior year. Several initiatives to optimize performance impacted the financial results, including premium rate increases from the state that were effective September 1, 2017. The medical loss ratio improved to 91.9% in fiscal year 2018, compared to 93.5% in the same period last year.

Membership increased by 823 for the first nine months ended June 30, 2018. Due to Hurricane Harvey, the state of Texas automatically re-enrolled all Medicaid members in the first quarter of 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.



** as of June 30, 2018*

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Review Report of Independent Auditors

The Audit and Compliance Committee of the Board of Trustees
Texas Children's

We have reviewed the consolidated financial information of Texas Children's, which comprise the consolidated balance sheet as of June 30, 2018, and the related consolidated statements of operations and changes in net assets, and cash flows for the three and nine-month periods ended June 30, 2018 and 2017.

Management's Responsibility for the Financial Information

Management is responsible for the preparation and fair presentation of the interim financial information in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in conformity with U.S. generally accepted accounting principles.

Auditor's Responsibility

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information. Accordingly, we do not express such an opinion.

Conclusion

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial information referred to above for it to be in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

August 23, 2018

Texas Children's

Consolidated Balance Sheets

(Dollars in thousands)

	June 30, 2018	September 30, 2017
	(unaudited)	*(audited)*
Assets:		
Current assets		
Cash and cash equivalents	$ 174,991	$ 216,235
Patient receivables, net of allowances of $381,227 and $272,657, as of June 30, 2018 and September 30, 2017, respectively	298,559	303,784
Receivable for Medicaid and other supplemental reimbursements	8,511	30,021
Assets limited as to use, current portion	37,651	36,824
Other current assets	172,612	140,836
Investment-related receivable	73,446	78,579
Total current assets	765,770	806,279
Assets limited as to use	119,640	125,080
Investments	2,362,051	2,321,378
Property and equipment, net	2,308,469	2,171,787
Other assets	83,880	94,584
Total assets	$ 5,639,810	$ 5,519,108
Liabilities and net assets:		
Current liabilities		
Accounts payable and accrued expenses	$ 435,289	$ 451,260
Investment-related accrued expenses	75,295	104,572
Current portion of long-term debt	18,600	17,415
Current portion of capital lease obligations	6,102	9,203
Line of credit	3,700	21,200
Long-term debt subject to remarketing agreements	141,500	150,000
Total current liabilities	680,486	753,650
Long-term debt	760,619	773,068
Long-term capital lease obligations	895	3,905
Loss reserves for self-insurance program	36,213	36,988
Retirement plan liability	49,836	55,030
Other long-term liabilities	46,152	65,445
Total liabilities	1,574,201	1,688,086
Net assets:		
Unrestricted	3,694,910	3,462,459
Temporarily restricted	193,766	207,757
Permanently restricted	176,933	160,806
Total net assets	4,065,609	3,831,022
Total liabilities and net assets	$ 5,639,810	$ 5,519,108

See accompanying notes to consolidated interim financial statements.

Consolidated Statements of Operations and Changes in Net Assets *(Unaudited)*

(Dollars in thousands)

Three Months Ended June 30, 2018	Three Months Ended June 30, 2017		Nine Months Ended June 30, 2018	Nine Months Ended June 30, 2017
		Changes in unrestricted net assets:		
		Operating revenues:		
$ 498,134	$ 480,295	Patient service revenue, net of contractuals and discounts	$ 1,485,126	$ 1,468,942
(16,759)	(19,756)	Less provision for doubtful accounts	(55,185)	(59,729)
481,375	460,539	Net patient service revenue	1,429,941	1,409,213
420,829	383,081	Premium revenue	1,254,867	1,105,744
40,658	5,979	Medicaid and other supplemental reimbursements	97,662	7,179
7,061	6,692	Grants	21,123	18,762
24,210	20,361	Other	71,058	64,968
13,265	10,615	Net assets released from restrictions for operations	31,825	27,674
987,398	887,267	Total operating revenues	2,906,476	2,633,540
		Operating expenses:		
324,731	306,533	Salaries and benefits	957,897	896,077
259,376	250,298	Medical and hospital	779,292	743,843
129,627	119,910	Professional fees	381,807	350,924
81,477	71,753	Supplies and pharmaceuticals	232,354	201,651
46,829	40,846	Outside purchased services	123,401	117,799
42,335	40,690	Depreciation and amortization	123,279	116,929
35,317	27,527	Operation of plant	86,470	79,304
32,284	29,510	General and administrative	84,397	83,046
5,002	3,980	Enhanced mission support	14,935	8,511
5,965	5,393	Interest	16,879	16,164
962,943	896,440	Total operating expenses	2,800,711	2,614,248
24,455	(9,173)	Operating income (losses)	105,765	19,292
		Nonoperating gains (losses):		
42,764	42,931	Investment return	104,687	112,464
2,575	(1,961)	Change in interest rate swap valuation	11,243	20,937
(274)	(437)	Other	(1,025)	(1,286)
45,065	40,533	Net nonoperating gains	114,905	132,115
$ 69,520	$ 31,360	Revenues and gains in excess of expenses and losses	$ 220,670	$ 151,407

See accompanying notes to consolidated interim financial statements.

Texas Children's

Consolidated Statements of Operations and Changes in Net Assets *(Unaudited), continued*

(Dollars in thousands)

Three Months Ended June 30, 2018	Three Months Ended June 30, 2017		Nine Months Ended June 30, 2018	Nine Months Ended June 30, 2017
		Changes in unrestricted net assets:		
		Revenues and gains in excess of expenses		
$ 69,520	$ 31,360	and losses brought forward	$ 220,670	$ 151,407
		Net assets released from restrictions for		
4,697	6,223	purchases of property, equipment and other	11,781	48,248
74,217	37,583	Change in unrestricted net assets	232,451	199,655
		Changes in temporarily restricted net assets:		
10,598	17,634	Donor-restricted contributions	24,420	93,992
1,526	3,043	Investment return and other income	8,223	5,959
(17,228)	(16,322)	Net assets released from restrictions	(42,666)	(75,404)
		Change in beneficial interest in net assets of		
856	1,103	donor-restricted foundations	(3,968)	1,735
(4,248)	5,458	Change in temporarily restricted net assets	(13,991)	26,282
		Changes in permanently restricted net assets:		
185	18	Donor-restricted contributions	14,939	3,289
4,769	3,223	Investment return and other	1,188	56
4,954	3,241	Change in permanently restricted net assets	16,127	3,345
74,923	46,282	Change in net assets	234,587	229,282
3,990,686	3,680,751	Net assets at beginning of period	3,831,022	3,497,751
$ 4,065,609	$ 3,727,033	Net assets at end of period	$ 4,065,609	$ 3,727,033

See accompanying notes to consolidated interim financial statements.

Consolidated Statements of Cash Flows *(Unaudited)*

(Dollars in thousands)

Three Months Ended June 30, 2018	Three Months Ended June 30, 2017		Nine Months Ended June 30, 2018	Nine Months Ended June 30, 2017
		Operating activities:		
$ 74,923	$ 46,282	Change in net assets	$ 234,587	$ 229,282
		Adjustments to reconcile change in net assets to net cash provided by operating activities:		
(856)	(1,103)	Change in beneficial interest in net assets of donor-restricted foundations	3,968	(1,735)
(41,147)	(46,396)	Net realized and unrealized gains on investments	(96,304)	(106,403)
42,335	40,690	Depreciation and amortization	123,279	116,929
(2,575)	1,961	(Decrease) increase in interest rate swap valuation	(11,243)	(20,937)
16,759	19,756	Provision for doubtful accounts	55,185	59,729
(12,478)	(17,652)	Temporarily and permanently restricted contributions received	(59,944)	(93,992)
		Changes in assets and liabilities		
(27,309)	(30,035)	Increase in patient accounts receivable	(49,960)	(92,848)
(6,481)	(3,412)	(Increase) decrease in receivable for supplemental Medicaid reimbursement	21,510	24,081
4,320	(12,631)	Decrease (increase) in other assets	(20,140)	(68,095)
41,441	27,270	Increase (decrease) in accounts payable and accrued expenses	(7,676)	93,425
(10,634)	(3,875)	Decrease in other liabilities	(17,356)	(765)
3,375	(25,427)	Total adjustments	(58,681)	(90,611)
78,298	20,855	Net cash provided by operating activities	175,906	138,671
		Investing activities:		
39,648	(23,317)	Sale (purchases) of investments, net	30,945	15,827
(83,931)	(102,126)	Purchases of property and equipment	(268,201)	(261,797)
(44,283)	(125,443)	Net cash used in investing activities	(237,256)	(245,970)
		Financing activities:		
(43,800)	-	Repayments on line-of-credit	(17,500)	-
-	-	Principal payment on long-term debt	(17,415)	(15,755)
(885)	(1,308)	Principal payment on capital lease obligation	(6,111)	(3,915)
9,544	17,652	Temporarily and permanently restricted contributions received	53,125	93,992
2,934	2,787	Proceeds from sale of donated securities with restrictions	6,819	7,477
4,769	3,223	Permanently restricted investment return	1,188	56
(27,438)	22,354	Net cash (used in) provided by financing activities	20,106	81,855
6,577	(82,234)	Net increase (decrease) in cash and cash equivalents	(41,244)	(25,444)
168,414	310,141	Cash and cash equivalents at beginning of period	216,235	253,351
$ 174,991	$ 227,907	Cash and cash equivalents at end of period	$ 174,991	$ 227,907
		Supplemental Disclosures:		
$ 13,117	$ 12,392	Cash paid for interest	$ 29,001	$ 27,949
$ 33,373	$ 24,775	Capital in accounts payable and accrued expenses	$ 33,373	$ 24,775

See accompanying notes to consolidated interim financial statements.

1. ORGANIZATION AND BASIS OF PRESENTATION

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 comprised of a 590 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), a 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, 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.

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

BASIS OF PRESENTATION

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature. Operating results for the nine months ended June 30, 2018 are not necessarily indicative of the results expected for the year ending September 30, 2018. For further information, refer to the audited consolidated financial statements and notes thereto for the year ended September 30, 2017.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

USE OF ESTIMATES

The preparation of financial statements in conformity with GAAP 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.

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 81% and 82% of self-pay accounts receivable as of June 30, 2018 and September 30, 2017, respectively, and self-pay write-offs totaled approximately $61,956 and $50,741 for the nine months ended June 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 fiscal years ended September 30, 2015 and September 30, 2016, respectively.

INVESTMENTS AND INVESTMENT RETURN

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

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

Investments in marketable securities, fixed income securities, certain mutual funds, and exchange-traded funds with readily determinable fair values are reported at fair value. Investments in common trust funds and limited liability partnerships and corporations that do not have readily determinable fair values are recorded based on Texas Children's share of the underlying value of portfolio securities held by these funds, as reported to Texas Children's. Alternative investment positions are recorded at amounts as reported by the related investment managers. Alternative investments are accounted for under the equity method of accounting. Under this method, the equity in earnings includes changes in reported values in the underlying investments. Generally, the underlying investments are not readily marketable and the alternative investments may not be redeemable except in certain circumstances, and there can be no assurance that reported amounts will be ultimately realized. As of June 30, 2018, management has utilized the best available data for reported investment values, which in some instances are valuations as of March 31, 2018.

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 revenue. 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.

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

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 for the nine months ended June 30, 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 or 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 June 30, 2018 and September 30, 2017, Texas Children's had inventory of $24,593 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:

	Nine Months Ended June 30,	
	2018	**2017**
Medicaid STAR	55%	59%
Medicaid STAR Kids	36%	32%
CHIP	9%	9%
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 is 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 June 30, 2018 and September 30, 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 AND HOSPITAL EXPENSES

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

The cost to TCHP for health care services provided by contracted providers is accrued in the period in which it is provided to a member, based in part on estimates, including accruals for medical services provided but not billed, and estimates of claims incurred but not yet reported to TCHP, based on actuarial valuations. The methods utilized in determining estimates are continually reviewed, and any changes in estimates are reflected prospectively. As of June 30, 2018 and September 30, 2017, recorded accruals were $44,550 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. The Tax Cuts and Jobs Act (the Act) was enacted on December 22, 2017. Among other provisions, the Act reduces the US federal corporate tax rate from a maximum of 35% to 21%. As of June 30, 2018, we are assessing the accounting and financial impact for the tax effects of enactment of the Act.

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

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

Among other provisions and in addition to expanded disclosure about the nature, amount, timing and uncertainty of revenue, as well as certain additional quantitative and qualitative disclosures, ASU 2014-09 changes the health care industry specific presentation guidance previously under ASU 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*.

ASU 2014-09 is effective for Texas Children's beginning October 1, 2018, including interim periods within that reporting period, by applying the full retrospective method or the cumulative catch-up transition method. The full retrospective method requires application of the provisions of ASU 2014-09 for all periods presented while the modified retrospective transition method requires the application of the provisions of ASU 2014-09 as of the date of adoption with the cumulative effect of the retrospective application of the provisions as an adjustment through net assets. Texas Children's is currently evaluating the appropriate method for application.

In preparation for the adoption of ASU 2014-09, Texas Children's has established an implementation group for this ASU with an implementation plan to transition to the new standard and determine its impact during 2018. Texas Children's has begun its evaluation of its population of revenue sources in order to determine an appropriate level of disaggregation. Texas Children's continues to evaluate and refine its estimates of the anticipated impact ASU 2014-09 will have on its revenue recognition policies, procedures, internal controls, balance sheets, statements of operations, cash flows and financial disclosures.

3. INVESTMENTS AND INVESTMENT RETURN

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 in a wide range of categories including equity, fixed income, real estate, long and short equity positions, natural resources, private equity, managed futures, distressed enterprises, and arbitrage positions. This investment class is subject to numerous risks that could lead to a greater likelihood of invested capital loss. Such risks include the following:

- NON-REGULATION RISK – These funds are not required to register with the U.S. Securities and Exchange Commission (SEC) and are not subject to regulatory controls. However, many of the alternative investment fund managers through which Texas Children's invest are SEC registered investment advisers.

- LIMITED TRANSPARENCY – As unregistered investment vehicles, funds are not required to disclose the holdings in their portfolios to investors.

- INVESTMENT STRATEGY RISK – The funds often employ sophisticated, complex investment strategies and may include speculative strategies or strategies that use leverage, which could result in volatile returns.

- MINIMAL LIQUIDITY – Many funds impose lock-up periods that prevent investors from redeeming their shares or impose penalties to redeem. The lock-up provisions of each investment vary but, when applicable, generally range from twelve months to three years. Notice requirements typically vary from fifteen to ninety days prior to the redemption date. In addition, private equity investments (a category of alternative investments) are self-funding and self-liquidating entities that typically endure for ten years or more.

FAIR VALUE OF FINANCIAL INSTRUMENTS

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

The three levels are defined as follows:

- LEVEL 1 – Inputs to the valuation methodology are quoted prices (unadjusted) in active markets for identical assets or liabilities at the measurement date.

- LEVEL 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

- LEVEL 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The inputs or methodology used for valuing securities are not necessarily an indication of the credit risk associated with investing in those securities. The following tables present the financial instruments carried at fair value as of June 30, 2018 and September 30, 2017, by the valuation hierarchy (as described above). The following tables do not include alternative investments and other investments as they are accounted for using the equity method of accounting.

Money market mutual funds that are included in cash and cash equivalents in the consolidated balance sheets are included in cash and cash equivalents in the tables. As of June 30, 2018 and September 30, 2017, Texas Children's had \$109,680 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 included in the tables.

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

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

	Level 1	Level 2	Level 3	Total
ASSETS				
Investments:				
Cash and cash equivalents	$ 147,331	$ -	$ -	$ 147,331
Derivative financial instruments	-	65,569	-	65,569
U.S. government fixed income securities	-	80,648	-	80,648
U.S. government agency securities	-	89,603	-	89,603
Municipal government securities	-	2,259	-	2,259
Foreign government fixed income securities	-	10,299	-	10,299
Corporate fixed income securities	-	269,627	-	269,627
Domestic equity securities	430,072	-	-	430,072
International equity securities	97,583	-	-	97,583
Interest rate swap agreement	-	965	-	965
Total assets at fair value	$ 674,986	$ 518,970	$ -	$1,193,956
LIABILITIES				
Derivative financial instruments	$ -	$ 65,899	$ -	$ 65,899
Interest rate swap agreement	-	23,025	-	23,025
Total liabilities at fair value	$ -	$ 88,924	$ -	$ 88,924

FINANCIAL ASSETS AND LIABILITIES AT FAIR VALUE as of September 30, 2017

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

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

FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

As of June 30, 2018 and September 30, 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 $939,090 and $969,161 as of June 30, 2018 and September 30, 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 June 30, 2018 and September 30, 2017, Texas Children's had $1,501,600 and $1,451,140, respectively, in alternative investments and other investments, and had committed approximately $271,900 of future funding to various alternative investments as of June 30, 2018.

4. PROPERTY AND EQUIPMENT

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

	June 30, 2018	September 30, 2017
Land and land improvements	$ 139,746	$ 138,730
Improvements to leased facilities	120,552	114,029
Buildings	1,609,853	1,404,076
Building and movable equipment under capital lease obligation	43,351	51,822
Fixed equipment	809,877	743,348
Movable equipment	675,569	605,439
Software	188,565	179,733
	3,587,513	3,237,177
Less accumulated depreciation	(1,476,969)	(1,357,628)
	2,110,544	1,879,549
Construction in progress	197,925	292,238
Net property and equipment	$ 2,308,469	$ 2,171,787

Interest cost is capitalized until the property under construction is placed in service. As of June 30, 2018 and September 30, 2017, the amount recorded as capitalized interest within construction in progress was $3,190 and $4,580, respectively.

TCH had remaining commitments of approximately $90,074 and $231,570 on open construction and equipment contracts as of June 30, 2018 and September 30, 2017, respectively.

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

5. PLEDGES AND CONTRIBUTIONS

Pledges receivable are expected to be realized as follows:

	June 30, 2018	September 30, 2017
In one year or less	$ 35,420	$ 48,033
Between one year and five years	52,379	61,915
More than five years	958	1,060
Total pledges	88,757	111,008
Less present value discount	(6,410)	(8,453)
Less allowance for doubtful pledges	(1,775)	(2,128)
Net pledges receivable	$ 80,572	$ 100,427

As of June 30, 2018, temporarily restricted net assets included $15,597 restricted for capital expansion, of which $14,374 relates to pledges that had not yet been received.

6. DERIVATIVE FINANCIAL INSTRUMENTS

INTEREST RATE SWAPS

Texas Children's utilizes interest rate swap agreements to manage its interest rate exposure on its 2008-1 and 2008-2 Series bonds. As of June 30, 2018 and September 30, 2017, the fair value of the 2008-1 swap agreements was a liability of $23,025 and $30,100, respectively, and is included in other long-term liabilities in the consolidated balance sheets. As of June 30, 2018 and September 31, 2017, the fair value of the 2008-2 swap agreement was an asset of $965 and a liability of $3,203, and is included in other assets and other long term liabilities in the consolidated balance sheets, respectively. 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 nine months ended June 30, 2018 and 2017, the change in fair value resulted in a gain of $11,243 and $20,937, respectively.

The following table summarizes the agreements:

	Series 2008-1	Series 2008-2
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 June 30, 2018	-	-
Collateral posted as of September 30, 2017	$2,410	-

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 on 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.

7. COMMITMENTS AND CONTINGENCIES

INSURANCE PROGRAM

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

As of June 30, 2018 and September 30, 2017, Texas Children's recorded a liability of $36,213 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.

8. 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 (UPMIFA) 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.

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

9. 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 primarily determined using the APR-DRG classification system. Outpatient services are primarily reimbursed at a percentage of the Medicaid outpatient fee schedule.

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

	Nine Months Ended June 30,			
	2018		2017	
Commercial	$ 1,053,486	70.9%	$ 1,002,630	68.3%
Medicaid	84,654	5.7%	97,399	6.6%
Medicaid Managed Care	259,727	17.5%	276,849	18.8%
Self-pay and other	87,259	5.9%	92,064	6.3%
Total All Payors	$ 1,485,126	100.0%	$ 1,468,942	100.0%

10. CHARITY CARE AND COMMUNITY BENEFIT

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

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

- **CHARITY CARE** – represents the unreimbursed cost of providing, funding, or otherwise financially supporting health care services to a patient classified as financially indigent or medically indigent and who has not been insured or partially insured by one of the available government-sponsored means-tested indigent care programs. Because the vast majority of financially or medically indigent pediatric and obstetrical patients qualify for government-sponsored indigent care programs, the amounts of charity care are much less than the unreimbursed cost of government-sponsored indigent care programs. In accordance with Texas Children's established policy and procedure, a patient classified as financially indigent or medically indigent will not be required to pay for the designated portion of the care received. Services designated as charity and provided to these patients are not reported as net patient service revenue in the consolidated statements of operations and changes in net assets. Texas Children's financial assistance policy and procedures are in compliance with internal revenue code section 501(r).

- **UNREIMBURSED COST OF GOVERNMENT SPONSORED INDIGENT HEALTH CARE** – represents the cost of providing services to beneficiaries of public programs, including State Medicaid and indigent care programs, in excess of any payments received from all sources.

- **COMMUNITY BENEFITS** – represents the unreimbursed cost of providing services for the benefit of the entire community. These benefits include philanthropy, education, research and various other community-based healthcare programs. The majority of these benefits are for graduate medical education and academic research. Other benefits for the community target the poor and underserved and include Project Medical Home, immunizations for children, and various community-based health educational resources. These programs are not intended to be financially self-supporting.

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

11. 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 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 nine months ended June 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 since 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. Additionally, Texas Children's recognized $33,680 of DSH revenue related to the current fiscal year. For the nine months ended June 30, 2017, TCH did not recognize any DSH revenue. As of June 30, 2018 and September 30, 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 nine months ended June 30, 2018, TCH recognized $23,816 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. For the nine months ended June 30, 2017, TCH did not recognize any revenue related to the UC pool. For the nine months ended June 30, 2018 and 2017, TCH recognized $6,497 and $2,807 in revenue related to the DSRIP pool. As of June 30, 2018, TCH recorded a receivable of $6,497 related to the 1115 Waiver and $0 liability for UC payments. As of September 30, 2017, TCH recorded a receivable related to the 1115 Waiver of $30,021 and a liability of $14,278 for 2015 UC payments as the 2015 UC application submitted by TCH indicated that the payment received could have been subject to recoupment pending final reconciliation at a later date as the application was based on the HSL calculation that applied FAQ No. 33.

For DSH and UC funding earned in prior years but not yet received pending the result of the litigation, 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 due to the application of FAQ No. 33.

12. 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 nine months ended June 30, 2018 and 2017, Texas Children's recorded expense of $381,807 and $350,924 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 approximately $47,521 and $46,380 are included in accounts payable and accrued expenses in the consolidated balance sheets as of June 30, 2018 and September 30, 2017, respectively.

Texas Children's entered into an agreement with Baylor to provide enhanced mission support for graduate and undergraduate medical education. For the nine months ended June 30, 2018 and 2017, Texas Children's made payments to Baylor of $12,091 and $13,032, respectively. Additionally, as of June 30, 2018 and September 30, 2017, amounts due to Baylor of $695 and $2,880, respectively, were recorded in accounts payable and accrued expenses. For the nine months ended June 30, 2018 and 2017, Texas Children's recognized $7,935 and $2,484, respectively, in expenses which are included in enhanced mission support in the consolidated statement of operations and changes in net assets. As of June 30, 2018 and September 30, 2017, the amount recorded as prepaid expense was $16,555 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 fiscal year 2016, Texas Children's purchased the Baylor Clinic building and the O'Quinn Medical Tower within the Texas Medical Center from CHI St. Luke's Health Baylor College of Medicine Medical Center and St. Luke's Medical Tower Corporation (collectively, the sellers). As part of the sale and purchase agreement, certain space is leased back to the sellers, which is a joint venture between CHI St. Luke's Health and Baylor. For the nine months ended June 30, 2018 and 2017, Texas Children's recognized $7,473 and $7,654, respectively, of rent revenue from the sellers.

TCH has a beneficial interest in the net assets of The Gordon and Mary Cain Pediatric Neurology Research Foundation (Cain Foundation), which is restricted for pediatric neurology programs and is included in temporarily restricted net assets. The Cain Foundation supports research, teaching, treatment, and related activities with respect to pediatric neurological disorders. The assets held by the Cain Foundation include primarily investments in debt and equity securities. TCH and the Cain Foundation are financially interrelated organizations in that the Cain Foundation manages assets for the sole benefit of TCH. The beneficial interest in the net assets of the Cain Foundation was $20,587 and $24,913 as of June 30, 2018 and September 30, 2017, respectively, and is included in assets limited as to use in the consolidated balance sheets and within alternative investments and other investments as referenced in Footnote 3.

13. SUBSEQUENT EVENTS

Texas Children's evaluated events and transactions occurring subsequent to June 30, 2018 through August 23, 2018, the date of issuance of the financial statements. 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

Supplemental Schedules
(*Unaudited*)

Texas Children's
Consolidating Balance Sheet
As of June 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	Eliminations	Total
Assets:											
Current assets											
Cash and cash equivalents	$ 8,816	$ 15,367	$ -	$ 24,183	$ 22,032	$ 119,472	$ 2,769	$ -	$ 6,535	$ -	$ 174,991
Patient receivables, net of allowances	345,894	-	-	345,894	7,284	-	-	-	19,891	(74,510)	298,559
Receivable for Medicaid and other supplemental reimbursements	8,511	-	-	8,511	-	-	-	-	-	-	8,511
Assets limited as to use, current portion	37,651	-	-	37,651	-	-	-	-	-	-	37,651
Other current assets	145,168	-	-	145,168	5,723	30,148	7,166	53,133	93,438	(162,164)	172,612
Investment-related receivable	-	72,870	-	72,870	-	576	-	-	-	-	73,446
Total current assets	546,040	88,237	-	634,277	35,039	150,196	9,935	53,133	119,864	(236,674)	765,770
Assets limited as to use	1,967,932	-	(1,943,658)	24,274	-	4,525	90,901	-	-	(60)	119,640
Investments	293,261	2,223,665	(293,013)	2,223,913	-	138,138	-	-	-	-	2,362,051
Property and equipment, net	2,243,284	-	-	2,243,284	30,860	27,791	-	6,081	453	-	2,308,469
Other assets	78,104	-	-	78,104	5,130	646	-	-	-	-	83,880
Amounts due from affiliate	59,149	-	-	59,149	-	-	-	-	-	(59,149)	-
Investment in subsidiary	111,055	-	-	111,055	-	-	-	-	-	(111,055)	-
Total assets	$ 5,298,825	$ 2,311,902	$ (2,236,671)	$ 5,374,056	$ 71,029	$ 321,296	$ 100,836	$ 59,214	$ 120,317	$ (406,938)	$ 5,639,810
Liabilities and net assets (deficit):											
Current liabilities											
Accounts payable and accrued expenses	$ 293,157	$ 293,013	$ (293,013)	$ 293,157	$ 36,551	$ 169,990	$ 259	$ 71,912	$ 98,085	$ (234,665)	$ 435,289
Investment-related accrued expenses	-	75,231	-	75,231	-	64	-	-	-	-	75,295
Current portion of long-term debt	18,600	-	-	18,600	-	-	-	-	-	-	18,600
Current portion of capital lease obligations	6,102	-	-	6,102	-	-	-	-	-	-	6,102
Line of credit	3,700	-	-	3,700	-	-	-	-	-	-	3,700
Long-term debt subject to remarketing agreements	141,500	-	-	141,500	-	-	-	-	-	-	141,500
Total current liabilities	463,059	368,244	(293,013)	538,290	36,551	170,054	259	71,912	98,085	(234,665)	680,486
Long-term debt	760,619	-	-	760,619	-	-	-	-	-	-	760,619
Long-term capital lease obligations	895	-	-	895	-	-	-	-	-	-	895
Loss reserves for self-insurance program	-	-	-	-	-	-	38,463	-	-	(2,250)	36,213
Retirement plan liability	49,836	-	-	49,836	-	-	-	-	-	-	49,836
Other long-term liabilities	36,135	-	-	36,135	29	9,993	58,899	-	6	(58,910)	46,152
Total liabilities	1,310,544	368,244	(293,013)	1,385,775	36,580	180,047	97,621	71,912	98,091	(295,825)	1,574,201
Net assets (deficit):											
Unrestricted	3,617,582	1,943,658	(1,943,658)	3,617,582	34,449	141,249	3,215	(12,698)	22,226	(111,113)	3,694,910
Temporarily restricted	193,766	-	-	193,766	-	-	-	-	-	-	193,766
Permanently restricted	176,933	-	-	176,933	-	-	-	-	-	-	176,933
Total net assets (deficit)	3,988,281	1,943,658	(1,943,658)	3,988,281	34,449	141,249	3,215	(12,698)	22,226	(111,113)	4,065,609
Total liabilities and net assets (deficit)	$ 5,298,825	$ 2,311,902	$ (2,236,671)	$ 5,374,056	$ 71,029	$ 321,296	$ 100,836	$ 59,214	$ 120,317	$ (406,938)	$ 5,639,810

Texas Children’s
Consolidating Statement of Operations and Changes in Net Assets
For the nine months ended June 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	Eliminations	Total
Changes in unrestricted net assets:											
Operating revenues:											
Patient service revenue,											
net of contractuals and discounts	$ 1,463,370	$ -	$ -	$ 1,463,370	$ 160,363	$ -	$ -	$ -	$ 213,931	$ (352,538)	$ 1,485,126
Less provision for doubtful accounts	(42,559)	-	-	(42,559)	(810)	-	-	-	(11,816)	-	(55,185)
Net patient service revenue	1,420,811	-	-	1,420,811	159,553	-	-	-	202,115	(352,538)	1,429,941
Premium revenue	-	-	-	-	-	1,254,892	8,342	-	-	(8,367)	1,254,867
Medicaid and other supplemental reimbursements	97,469	-	-	97,469	5,065	-	-	-	-	(4,872)	97,662
Grants	20,599	-	-	20,599	58	536	-	-	-	(70)	21,123
Other	131,982	-	-	131,982	2,032	3	1,632	6,474	154,289	(225,354)	71,058
Net assets released from restrictions for operations	31,744	-	-	31,744	81	-	-	-	-	-	31,825
Total operating revenues	1,702,605	-	-	1,702,605	166,789	1,255,431	9,974	6,474	356,404	(591,201)	2,906,476
Operating expenses:											
Salaries and benefits	773,402	-	-	773,402	110,266	45,301	-	3,651	25,277	-	957,897
Medical and hospital	-	-	-	-	-	1,153,230	9,668	-	-	(383,606)	779,292
Professional fees	217,536	-	-	217,536	-	-	-	3	321,353	(157,085)	381,807
Supplies and pharmaceuticals	199,567	-	-	199,567	30,604	8	-	867	1,308	-	232,354
Outside purchased services	114,303	-	-	114,303	13,433	30,393	69	1,749	7,033	(43,579)	123,401
Depreciation and amortization	112,303	-	-	112,303	4,796	5,554	-	425	201	-	123,279
Operation of plant	81,218	-	-	81,218	2,691	41	6	2	12	2,500	86,470
General and administrative	56,053	-	-	56,053	4,123	27,030	231	691	828	(4,559)	84,397
Enhanced mission support	14,935	-	-	14,935	-	-	-	-	-	-	14,935
Interest	16,879	-	-	16,879	-	-	-	-	-	-	16,879
Total operating expenses	1,586,196	-	-	1,586,196	165,913	1,261,557	9,974	7,388	356,012	(586,329)	2,800,711
Operating income (loss)	116,409	-	-	116,409	876	(6,126)	-	(914)	392	(4,872)	105,765
Nonoperating gains (losses):											
Investment return	980	102,990	-	103,970	-	717	-	-	-	-	104,687
Change in interest rate swap valuation	11,243	-	-	11,243	-	-	-	-	-	-	11,243
Other	(5,892)	-	-	(5,892)	-	(5)	-	-	-	4,872	(1,025)
Net nonoperating gains	6,331	102,990	-	109,321	-	712	-	-	-	4,872	114,905
Revenues and gains in excess (deficiency) of expenses and losses	$ 122,740	$ 102,990	$ -	$ 225,730	$ 876	$ (5,414)	$ -	$ (914)	$ 392	$ -	$ 220,670

Texas Children's
Consolidating Statement of Operations and Changes in Net Assets, *continued*
For the nine months ended June 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	Eliminations	Total
Changes in unrestricted net assets:											
Revenues and gains in excess (deficiency) of expenses and losses brought forward	$ 122,740	$ 102,990	$ -	$ 225,730	$ 876	$ (5,414)	$ -	$ (914)	$ 392	$ -	$ 220,670
Net assets released from restrictions for purchases of property, equipment and other	11,218	-	-	11,218	563	-	-	-	-	-	11,781
Change in pension liabilities	-	-	-	-	-	-	-	-	-	-	-
Equity transfer	177,273	(177,273)	-	-	-	-	-	-	-	-	-
Contributed capital	-	-	-	-	1,642	50,000	-	-	-	(51,642)	-
Beneficial interest in Texas Children's Hospital Foundation	(74,283)	-	74,283	-	-	-	-	-	-	-	-
Change in unrestricted net assets	236,948	(74,283)	74,283	236,948	3,081	44,586	-	(914)	392	(51,642)	232,451
Changes in temporarily restricted net assets:											
Donor-restricted contributions	24,420	-	-	24,420	-	-	-	-	-	-	24,420
Investment return and other income	8,223	-	-	8,223	-	-	-	-	-	-	8,223
Net assets released from restricions	(42,666)	-	-	(42,666)	-	-	-	-	-	-	(42,666)
Change in beneficial interest in net assets of donor-restricted foundations	(3,968)	-	-	(3,968)	-	-	-	-	-	-	(3,968)
Change in temporarily restricted net assets	(13,991)	-	-	(13,991)	-	-	-	-	-	-	(13,991)
Changes in permanently restricted net assets:											
Donor-restricted contributions	14,939	-	-	14,939	-	-	-	-	-	-	14,939
Investment return and other income	1,188	-	-	1,188	-	-	-	-	-	-	1,188
Change in permantly restricted net assets	16,127	-	-	16,127	-	-	-	-	-	-	16,127
Change in net assets	239,084	(74,283)	74,283	239,084	3,081	44,586	-	(914)	392	(51,642)	234,587
Net assets (deficit) at beginning of period	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
Net assets (deficit) at end of period	$ 3,988,281	$ 1,943,658	$ (1,943,658)	$ 3,988,281	$ 34,449	$ 141,249	$ 3,215	$ (12,698)	$ 22,226	$ (111,113)	$ 4,065,609

Texas Children's
Consolidating Statement of Cash Flows
For the nine months ended June 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	Eliminations	Total
Operating activities:											
Net cash provided by (used in) operating activities	$ 271,396	$ (125,405)	$ (36,478)	$ 109,513	$ 7,689	$ 55,194	$ 803	$ 38	$ 2,669	$ -	$ 175,906
Investing activities:											
(Purchases) sales of investments, net	(21,317)	50,516	36,478	65,677	-	(36,544)	1,812	-	-	-	30,945
(Purchases) sales of property and equipment	(261,455)	-	-	(261,455)	(8,241)	1,587	-	(38)	(54)	-	(268,201)
Net cash (used in) provided by investing activities	(282,772)	50,516	36,478	(195,778)	(8,241)	(34,957)	1,812	(38)	(54)	-	(237,256)
Financing activities:											
Borrowings under line-of-credit	(17,500)	-	-	(17,500)	-	-	-	-	-	-	(17,500)
Principal payment on long-term debt	(17,415)	-	-	(17,415)	-	-	-	-	-	-	(17,415)
Principal payment on capital lease obligations	(6,111)	-	-	(6,111)	-	-	-	-	-	-	(6,111)
Temporarily and permanently restricted contributions received	53,125	-	-	53,125	-	-	-	-	-	-	53,125
Proceeds from sale of donated securities with restrictions	-	6,819	-	6,819	-	-	-	-	-	-	6,819
Permanently restricted investment return	1,188	-	-	1,188	-	-	-	-	-	-	1,188
Net cash provided by financing activities	13,287	6,819	-	20,106	-	-	-	-	-	-	20,106
Net increase (decrease) in cash and cash equivalents	1,911	(68,070)	-	(66,159)	(552)	20,237	2,615	-	2,615	-	(41,244)
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 period	$ 8,816	$ 15,367	$ -	$ 24,183	$ 22,032	$ 119,472	$ 2,769	$ -	$ 6,535	$ -	$ 174,991
Supplemental Disclosures											
Cash paid for interest	$ 29,001	$ -	$ -	$ 29,001	$ -	$ -	$ -	$ -	$ -	$ -	$ 29,001
Capital in accounts payable and accrued expenses	$ 33,025	$ -	$ -	$ 33,025	$ 348	$ -	$ -	$ -	$ -	$ -	$ 33,373